A Tale Of Three Markets: The Law And Economics Of Predatory Lending*

by

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I. INTRODUCTION

Predatory lending – exploitative high-cost loans to naïve borrowers, resulting in soaring rates of foreclosures – has dominated the headlines in recent years.¹ There is fierce debate over how best to respond to this surge in predatory loans.² Too often, the debate over predatory lending has been couched in moral terms. Opponents of predatory lending air exposés of unscrupulous lenders and diabolical tactics. Industry supporters, on the other hand, question the seriousness of predatory lending, blame borrowers for their profligacy, and assert that existing remedies suffice.

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Predatory lending is highly visible; however, gaps in reported data have hampered efforts to accurately assess the extent of the problem. In December 2000, the Federal Reserve Board proposed remedying that gap by expanding the types of data that must be reported on home mortgage loans under the Home Mortgage Disclosure Act (HMDA), and by expanding the nonbank entities required to file HMDA reports. Under the proposed regulation, HMDA reporting entities would have to report on all home mortgage refinancings, home improvement loans and home equity lines of credit. In addition, lenders would have to report the annual percentage rates of these loans, regardless whether the loans fell within the Home Ownership and Equity Protection Act or whether the loans involved mobile homes. *See* Federal Reserve System, Proposed Rule, *Home Mortgage Disclosure*, 65 Fed. Reg. 78656 (Dec. 15, 2000).

The Coalition for Responsible Lending recently estimated that predatory lending costs U.S. borrowers \$9.1 billion annually. Eric Stein, Quantifying the Economic Cost of Predatory Lending (July 25, 2001) (available at <www.responsiblelending.org/CostofPredLend.PDF>); cf. Robert E. Litan, A Prudent Approach To Preventing "Predatory" Lending 3-6 (Working Paper Feb. 2001) (tracing the corresponding growth in the subprime market) (hereinafter "Litan, Prudent Approach"). One of the most noteworthy indicia of the rise in predatory lending has been an unprecedented rise in foreclosures across the country. Between 1990 and 1998, when interest rates were dropping, the home foreclosure rate increased by 384 percent. See United States Census Bureau, STATISTICAL ABSTRACT OF THE UNITED STATES, BANKING, FINANCE AND INSURANCE, Table No. 823, "Mortgage Delinquency and Foreclosure Rates: 1980 to 1998" (1999). The bulk of these foreclosures actions involved borrowers who had subprime -- including predatory -- loans. See Cathy L. Mansfield, The Road to Subprime 'HEL' was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market, 51 S.C. L. REV. 473 (2000); see also National Training and Information Center, Preying on Neighborhoods: SUBPRIME MORTGAGE LENDING AND CHICAGOLAND FORECLOSURES 11-21 (Sept. 21, 1999) (available at http://www.ntic-us.org/preying/preying.html) (hereinafter cited as "PREYING ON NEIGHBORHOODS") (noting that in metropolitan Chicago alone, foreclosures nearly doubled from 1993 to 1998. Subprime lenders and services accounted for 1.4 percent of the foreclosures in 1993, but 35.7 percent of the 1998 foreclosures).

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

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

To advance the debate beyond the realm of moral accusations, we need to determine how incentive structures in the home mortgage market have fueled predatory lending and how these incentives can best be countered. In this article, we embark on these tasks. We argue that the market incentives that historically led lenders to engage in credit rationing have given way to a market where lenders can profit from exploiting new information asymmetries to the detriment of unsophisticated borrowers. We further argue that government intervention is needed to curb these lending abuses and propose a remedy – suitability – that is narrowly tailored to address these harms.

The Article proceeds in four parts. Following this introduction, in Section II, we identify five problems associated with the various lending practices that have been characterized as predatory. We define predatory lending as a syndrome of abusive loan terms or practices that involve one or more of these five problems.

In Section III, we begin by describing the information asymmetries that until recently led to credit rationing. We then describe how changes in the financial services market have altered the conventional home mortgage market. In particular, we argue that an increase in the amount of capital available for mortgages due to securitization, increased incentives for lenders to specialize in lending to low and moderate income borrowers and new information asymmetries

have made it possible for predatory lenders to thrive. We argue that the convergence of these forces has produced three markets for home mortgages: a prime market, a legitimate subprime market, and a predatory market.

The prime market provides mortgages to low-risk borrowers with strong credit histories. Legitimate subprime lenders, who are usually nonbank³ lenders, cater to borrowers who have experience shopping for credit but who, for one reason or another, lack the sterling credentials needed to qualify for prime loans. Predatory lenders, on the other hand, target naïve people who, because of historical credit rationing, discrimination, the exodus of banks from inner-city neighborhoods and other social and economic forces, are disconnected from the credit market and hence are vulnerable to predatory lenders' hard-sell tactics.

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

Based on this understanding of the home mortgage market, in Section IV, we ask which remedy or remedies would force predatory lenders to internalize the harm that they cause. To that end, we evaluate extant remedies for redressing predatory lending, including market vehicles, remedies sounding in contract or the Uniform Commercial Code, antifraud statutes, disclosure laws, consumer education and counseling, price regulation, and antidiscrimination

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

laws. We conclude that neither market forces nor any of the remedies just described would succeed in curbing predatory lending. Furthermore, price regulation would curtail the availability of credit. Instead, a direct approach that addresses abusive loan terms and practices, without re-imposing usury limits, would offer the best protection against predatory lending.

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

II. "PREDATORY LENDING" DEFINED

In 2000, Senator Phil Gramm, then the chairman of the Senate Banking Committee, famously asserted that predatory lending could not be addressed until it could be defined.⁴ With that remark, Senator Gramm shrewdly seized on the difficulties in defining predatory lending to date, while stoking the flames that have surrounded any attempt at definition. Opponents of reforms to redress predatory lending have maintained that in the absence of a definable problem,

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See Michele Heller & Rob Graver, Gramm Takes Stand Against Predator Bills, Am. BANKER, Aug. 24, 2000, at 1 ("As the regulators themselves admit, there is no definition of predatory lending. I don't know how we can hope to address the problem before we have decided what it is"); see also News Conference with Senator Phil Gramm, Federal News Service (Jan. 22, 2001).

remedies are not needed.⁵ Conversely, some community activists have brushed definitional issues aside, reasoning that "you know predatory lending when you see it."

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

These catalogues provide a useful starting point for detecting and describing the pathologies that underlie predatory lending. When these lists are examined, five basic problems

- racial targeting in advertising and loan solicitations
- loans in connection with home improvement scams
- kickbacks in the form of yield spread premiums
- steering to high-cost lenders
- loan payments in excess of the borrowers' ability to repay, resulting in foreclosure (equity skimming)
- fraud on borrowers and on secondary market buyers via falsified loan applications, forged signatures, inflated appraisals and the like
- high annual interest rates
- high points
- balloon payments
- negative amortization
- padded or duplicative closing costs and fees
- insurance packing and single premium credit life insurance
- excessive prepayment penalties
- mandatory arbitration clauses
- loan flipping (repeated refinancings by the same lender)
- refinancings of low- or no-interest mortgages at higher rates
- shifting unsecured debt into mortgages
- making loans in excess of 100 percent of the loan-to-value ratio of the underlying collateral
- abusive collection practices
- foreclosure abuses

See Patricia Sturdevant & William J. Brennan, Jr., A Catalogue of Predatory Lending Practices, 5 THE CONSUMER ADVOCATE 4 (1999). See also Mansfield, supra note ____, at 532-61.

⁵ See, e.g., In Reality, "Predatory Lending" Isn't Easy to Define, News & Observer (Raleigh, N.C.), Oct. 24, 2000, at A10.

In one of the most exhaustive catalogues of predatory lending practices, Patricia Sturdevant and William J. Brennan, Jr., listed a broad array of exploitative terms and practices, including:

emerge. We can thus define predatory lending as a syndrome of abusive loan terms or practices that involve one or more of the following five problems:⁷

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

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

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

As we argue later in this Article, predatory lenders target vulnerable consumers for financial exploitation, often because of their race, gender, income or class. However, predatory loans can occur in the absence of such targeting and therefore we do not include it as a defining feature.

See Testimony of Donna Tanoue, former Chairman of the FDIC, before the House Committee on Banking and Financial Services, 2000 WL 19304112 (May 24, 2000). The Interagency Guidance on Subprime Lending defines subprime lending as credit extensions "to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers." Board of Governors of the Federal Reserve System et al., Interagency Guidance on Subprime Lending 1 (Mar. 3, 1999); see also Board of Governors of the Federal Reserve System, Expanded Interagency Guidance for Subprime Lending Programs (Jan. 31, 2001). Subprime loans have higher interest rates to compensate lenders for the higher risk of default. See, e.g., Departments of the Treasury and Housing and Urban Development, Curbing Predatory Home Mortgage Lending 28 (June 20, 2000) (hereinafter cited as "HUD-Treasury Report").

predatory loans are not necessarily subprime. It is possible for prime interest loans to display one or more of the problems that are common to predatory loans.

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

A. Loans Structured To Result In Seriously Disproportionate Net Harm To Borrowers

In the subprime market, numerous conventional underwriting standards have been relaxed in order to facilitate loans to less creditworthy customers. Many of the standards that have been relaxed redound to the mutual benefit of subprime lenders and borrowers. In some instances, however, lenders have overridden conventional underwriting norms in order to structure loans that inflict seriously disproportionate harm on borrowers, often in catastrophic proportions. Because the harm seriously outweighs the benefit of those loans to borrowers and society at large, such practices are predatory in nature.

The foremost example today involves violations of the norm that no mortgage shall be made to anyone who, on the face of the loan application, cannot afford the monthly payments (a

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

Examples include loans to borrowers with histories of late payments or bankruptcies or higher debt-to-income ratios, and loans with higher loan-to-value ratios. *See*, *e.g.*, JOHN WEICHER, THE HOME EQUITY LENDING INDUSTRY: REFINANCING MORTGAGES FOR BORROWERS WITH IMPAIRED CREDIT 30, 34, 60-61 & table 4.4 (1997).

practice known as "asset-based lending"). These are the quintessential predatory loans and the borrowers often suffer bankruptcy or lose their homes to foreclosure as a consequence. 12

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

Asset-based lending often spawns another abusive practice known as "loan flipping," in which lenders persuade homeowners to refinance their mortgages repeatedly at extremely short

Arguably, due to the high costs of foreclosure, lenders are not acting in their best interests when they make loans without regard to borrowers' ability to repay the loans. Evidence, however, suggests the contrary. If borrowers have sufficient equity in their homes when they default, lenders can repeatedly refinance the borrowers' loans upon default, each time tacking huge fees onto the principal. Alternatively, where lenders can convince secondary market purchasers to purchase predatory loans, the lenders can foist future losses off on these unsuspecting purchasers. *See* text accompanying notes *infra*.

See, e.g., HUD-Treasury Report, supra note ____, at 21, 22, 24-25, 27 n.12; Sturdevant & Brennan, supra note ____, at 37; Hargraves v. Capital City Mortgage Corp., Plaintiffs' Statement of Points and Authorities in Opposition to Defendant's Motion for Judgment on the Pleadings, or in the Alternative, for Summary Judgment, at 1, 19, Civ. No. 98-1021 (JHG)/(AK) (D.D.C.); Mortgage Bankers Association of America, Best Practices/Legislative Guidelines: Subprime Lending, Legislative Guidelines ¶ 6 (available at http://www.mbaa.org/resident/lib2000/0525b.html);

cf. Fannie Mae, Lender Letter No. 03-00 (Apr. 11, 2000) ("the borrower [must have] a reasonable ability to make the mortgage payments and [must be] likely to do so"). PREYING ON NEIGHBORHOODS, *supra* note _____, at 23-27 (suggesting that foreclosure rates in Chicago are rising because "loans are being pushed upon borrowers who are not able to repay them."

This latter problem is endemic of the agency problems among brokers, lenders and secondary market purchasers that we discuss later in this Article.

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

Likewise, from borrowers' perspectives, there is usually little economic rationale for mortgages with negative amortization. Under negative amortization, scheduled payments are not enough to cover the interest due, causing the outstanding principal to increase with time. As a result, borrowers who make regular payments actually lose equity in their homes as time goes

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In December 2000, the Federal Reserve Board proposed prohibiting creditors or assignees of high-cost loans under HOEPA from refinancing these loans within the first twelve months unless the refinancings are in the borrower's interest. The Board also elicited comment on whether prepayment penalties and points assessed in refinancings by those creditors or assignees should be included in computing HOEPA's trigger on points and fees. *See* Federal Reserve System, Proposed Rule, *Truth in Lending*, 65 Fed. Reg. 81438 (Dec. 26, 2000) (hereinafter "Federal Reserve, *Truth in Lending*).

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

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

on.¹⁷ Other examples of loans that result in seriously disproportionate net harm to borrowers include loans where lenders persuade borrowers to shift unsecured debt into mortgages in order to strip the equity out of their homes or where lenders insist on financing higher principal amounts than customers request.¹⁸ Still another refinancing abuse involves lenders who induce homeowners to refinance no-interest or low-interest mortgages at higher interest rates without economic justification.¹⁹

Similarly, the harm seriously outweighs the benefit where lenders steer naïve borrowers who qualify for prime-rate loans (or other loans on better terms) to costlier loans that are better

See, e.g., HUD-Treasury Report, *supra* note ____, at 91-92. Reverse mortgages under the Home Equity Conversion Mortgage program administered by HUD are an exception. These reverse mortgages permit elderly homeowners to cash out their home equity in exchange for an income stream. Reverse mortgages are heavily regulated, however, and are subject to mandatory counseling requirements. *See id.* at 92.

Concerns about the injurious effects of negative amortization led the Federal Reserve Board, pursuant to its authority under HOEPA, to ban negative amortization in high-cost, closed-end home mortgage refinance loans. 12 C.F.R. § 226.32(d). Today, mortgages with negative amortization provisions are limited to loans that are not covered by HOEPA.

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

See, e.g., Nina Simon, Predatory Lending From Around the Country: A Broad Range of Tools 3; Sturdevant & Brennan, supra note ____, at 40; Hargraves v. Capital City Mortgage Corp., Brief of the United States as Amicus Curiae in Support of Plaintiffs' Opposition to Defendant's Motion for Judgment on the Pleadings or, in the Alternative for Summary Judgment, at 1, 6, Civ. No. 98-1021 (JHG)/(AK) (D.D.C.); Teresa Dixon Murray, Borrower Beware Predatory Mortgage Brokers Don't Give Terms Promised, Causing Some to Lose Their Homes, Plain Dealer, Aug. 28, 2000, at 1C.

See Sturdevant & Brennan, supra note ____, at 39-40. In the most egregious cases, lenders convince borrowers to refinance their original zero-percent Habitat for Humanity loans in the early years of those mortgages. See, e.g., Sandra Fleishman, Fed Favors Tougher Loan Rules; Abuses in Subprime Lending Are Targeted, WASHINGTON POST, Dec. 14, 2000, at E1; Joe McDermott, Predatory Lending Termed "A Major Problem," THE MORNING CALL (ALLENTOWN), Dec. 10, 2000, at B1; Richard A. Oppel Jr. & Patrick McGeehan, Along With a Lender, Is Citigroup Buying Trouble?, N.Y. TIMES, Oct. 22, 2000, at § 3, p. 1. The Federal Reserve Board's December 2000 proposed rule under HOEPA would prohibit creditors in the first five years of zero-interest rate or other low-cost loans from refinancing these loans with higher-rate loans, unless the refinancings were in the interest of the borrowers. Federal Reserve, Truth in Lending, supra note at 81438.

suited for customers with weaker credit ratings.²⁰ Such steering is frequently fueled by "yield spread premiums," which are side payments by lenders to mortgage brokers for persuading borrowers to agree to higher interest rates when the lenders in fact are willing to extend credit to the borrowers at lower rates.²¹ In computing finance charges under the Truth in Lending Act (TILA), lenders do not have to include yield spread premiums.²² Even when yield spread premiums are disclosed, few, if any borrowers understand the purpose of those payments or the fact that their interest rates are higher as a result.

For instance, a Freddie Mac study reported that anywhere from between ten and thirty-five percent of subprime borrowers qualified for prime-rate loans. *See* Freddie Mac, AUTOMATED UNDERWRITING: MAKING MORTGAGE LENDING SIMPLER AND FAIRER FOR AMERICA'S FAMILIES ch. 5 & nn.5-6 (Sept. 1996) (hereinafter "Freddie Mac, AUTOMATED UNDERWRITING") (available at http://www.freddiemac.com/corporate/reports/moseley/mosehome.html). *See also* Sturdevant & Brennan, *supra* note ____, at 37; Stein, *supra* note 1, at 9-10; *cf.* Fannie Mae, Lender Letter No. 03-00 (Apr. 11, 2000) ("Lenders that offer higher cost products that are designed for less creditworthy borrowers should not steer applicants to these products if they can qualify for a lower-cost standard mortgage product").

See, e.g., HUD-Treasury Report, supra note ____, at 40; Simon, supra note ____, at 22-23. For a description of the finance charge for purposes of TILA, see text accompanying note ____ infra.

See, e.g., Kenneth M. Lapine, Referral Fees and Other Compensation Issues Under the Real Estate Settlement Procedures Act of 1974, in BANKING LAW (1998); Ralph J. Rohner & Fred H. Miller, TRUTH IN LENDING 121, 187-88 (2000). Courts are divided over whether yield spread premiums are prohibited kickbacks or legitimate payments for goods and services under RESPA, 12 U.S.C. §§ 2601(b)(2), 2607(a), (c). Compare Culpepper v. Inland Mortgage Corp., 132 F.3d 692 (11th Cir. 1998) (yield spread premiums are prohibited kickbacks; reversing grant of summary judgment for lender); DuBose v. First Security Sav. Bank, 974 F. Supp. 1426 (N.D. Ala. 1997) (denying lenders' motion for summary judgment on grounds that yield spread premiums may be illegal referral fees); Martinez v. Weyerhaeuser Mortgage Corp., 959 F. Supp. 1511 (S.D. Fla. 1996) (same); Mentecki v. Saxon Mortgage, Inc., 1997 U.S. Dist. LEXIS 1197, No. 96-1629-A, slip op. (E.D. Va. Jan. 10, 1997) (denying lender's motion to dismiss; borrowers stated a claim that a yield spread premium violated the anti-kickback provisions of RESPA); Moses v. Citicorp Mortgage, Inc., 982 F. Supp. 897 (E.D.N.Y. 1997) (same) with Barbosa v. Target Mortgage Corp., 968 F. Supp. 1548 (S.D. Fla. 1997) (a yield spread premium was a lawful payment for services). See also Robert M. Jaworski, Overages: To Pay or Not to Pay, That is the Question, 13 BANKING L.J. 909 (1996) (questioning legality of yield spread premiums under RESPA); Leonard A. Bernstein, RESPA Invades Home Equity, Home Improvement and Mobile Home Financing, 48 CONSUMER FIN. L.Q. 194, 197 (1994) (same).

In 1999, the Department of Housing and Urban Development (HUD) issued a policy statement on the legality of yield spread premiums paid by lenders. 64 Fed. Reg. 10079 (Mar. 1, 1999). HUD does not consider yield spread premiums illegal *per se*. Rather, the legality of those payments is to be judged according to two questions: (1) were goods, services or facilities actually provided for the compensation paid?; and (2) were the payments reasonably related to the value of those goods, services or facilities? *Id.* at 10085-86.

B. Harmful Rent-seeking

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

From the viewpoint of distributive justice, interest *per se* and high interest in particular have been condemned as usurious since ancient times because they impose heavy costs on those who are least able to pay them. With experience, however, it has become apparent that subprime loans to riskier borrowers entail increased costs that lenders must be able to recoup. Subprime loans historically have had higher rates of delinquency, default and foreclosure than loans in the prime market.²⁴ As a result, they carry higher interest rates to compensate for the increased risk.²⁵ In addition, higher interest rates, either alone or with prepayment penalties, compensate lenders for the fact that subprime loans "tend to be prepaid at a much faster rate than prime mortgages."²⁶

Origination costs and servicing costs of subprime loans are higher as well. Subprime loans are more expensive than prime loans to originate because they require closer scrutiny of

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

See WEICHER, supra note ____, at 56-57 & table 4.1, 69, 74-88; HUD-Treasury Report, supra note ____, at 28; see also Sturdevant & Brennan, supra note ____, at 38 ("Predatory lenders may charge rates of 19 to 25 percent, or 2 times rates being charged for conventional mortgages, which are usually obtainable at rates of 7 to 7.5 percent").

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

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

income and credit history and result in a lower percentage of approved applications.²⁷

Concomitantly, subprime mortgage loans on average are substantially smaller than prime mortgages. Their smaller average loan size makes the origination costs for subprime loans higher than prime loans, not only in absolute dollars but also as a percentage of loan amounts.²⁸

Likewise, servicing costs are higher because subprime borrowers are more likely to default than their prime counterparts and loan administration requires more constant vigilance.²⁹

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

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See WEICHER, supra note ____, at 67; HUD-Treasury Report, supra note ____, at 28. This assumes, of course, that underwriting is actually performed, which is not always true in asset-based loans by predatory lenders.

²⁸ See WEICHER, supra note ____, at 61-62, 67, 69-70; HUD-Treasury Report, supra note ____, at 28.

See WEICHER, supra note ____, at 56-57 & table 4.1, 69, 74-88; HUD-Treasury Report, supra note ____, at 28.

See Sturdevant & Brennan, supra note ____, at 38-39. In a recent study of settlement fees, Mark Shroder found "huge deviations in total lending and title fees paid for transactions" of similar value to sellers. He further found that higher fees for particular line items correlated positively with higher fees for other line items, suggesting that "some people are candidates for high fees in both title insurance and lending." Mark Shroder, The Value of the Sunshine Cure: Efficacy of the RESPA Disclosure Strategy 14-15, Figure 2, Table 4 (Working Paper Apr. 14, 2000).

the life of the loan, policies issued to borrowers who do not qualify for insurance³² and insurance policies written on total indebtedness, not on repayment of the principal.³³

C. Fraud Or Deceptive Practices

The most blatant forms of predatory lending involve the age-old problem of fraud. All of the deceptive practices in this category are in violation of existing laws, such as state fraud statutes, state consumer protection laws, state fiduciary duties or federal disclosure statutes such as TILA³⁴ or the Real Estate Settlement Procedures Act (RESPA).³⁵

Lending fraud comes in endless varieties and is only limited by the ingenuity of the perpetrator. Nevertheless, recent incidents in the home lending market can be divided into two basic types of fraud. The first type of fraud consists of deception aimed at borrowers.³⁶ Among the many types of deception that have been reported in this regard, the more notorious include fraudulent disclosures, failures to disclose information as required by law, bait and switch tactics, and loans made in collusion with home repair scams. Fees may be financed without the

See Sturdevant & Brennan, supra note, at 38-39.

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

See HUD-Treasury Report, supra note ____, at 81, 88 & n.85, 89, 91; Sturdevant & Brennan, supra note ____, at 39; Unscrupulous Lenders Exploit Poor, Elderly, ATLANTA JOURNAL-CONSTITUTION, Dec. 13, 1998, at R4; cf. Freddie Mac, Seller Guide Bulletin, Single-Premium Credit Insurance Products (Apr. 21, 2000) (available at http://www.freddiemac.com/sell/selbultn/421indltr.html) (prohibiting prepaid single-premium credit life insurance in mortgages sold to Freddie Mac); Fannie Mae, Lender Letter No. 03-00 (Apr. 11, 2000) (same for mortgages sold to Fannie Mae). See generally National Association of Insurance Commissioners, A BACKGROUND STUDY OF THE REGULATION OF CREDIT LIFE AND DISABILITY INSURANCE (1970); National Consumer Law Center, COMPUTING RATES FOR CREDIT LIFE INSURANCE AND CREDIT ACCIDENT AND HEALTH INSURANCE (Feb. 6, 1976).

³⁴ 15 U.S.C. §§ 1601 et seq.

³⁵ 12 U.S.C. §§ 2601 et seq.

See generally HUD-Treasury Report, supra note ____, at 24, 79-90; Expanded Interagency Guidance for Subprime Lending Programs, supra note ____; Hargraves v. Capital City Mortgage Corp., Brief of the United States as Amicus Curiae in Support of Plaintiffs' Opposition to Defendant's Motion for Judgment on the Pleadings or, in the Alternative for Summary Judgment, at 1, 6-13, Civ. No. 98-1021 (JHG)/(AK) (D.D.C.); Lara Becker et al., Some Subprime Lenders are Causing Pain for Residents, DEMOCRAT AND CHRONICLE, Feb. 27, 2000, at A1.

borrowers' knowledge, title in their property may be secretly conveyed or liens on their homes may be deliberately concealed. Borrowers may be defrauded into thinking that they must buy credit life insurance in order to proceed to closing or that a lender is officially affiliated with a federal agency such as the Veterans Administration or FHA. Brokers may dupe borrowers into believing that they are acting in the best interests of the borrowers when their real financial loyalties are to the lenders. Brokers and lenders may lure borrowers to closing by promising to finance needed home repairs to fix housing code violations or to refinance loans later on at lower rates.

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

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

See, e.g., HUD-Treasury Report, supra note ____, at 21-22, 80; Sturdevant & Brennan, supra note ____, at 37; Patrick Barta, Is Appraisal Process Skewing Home Values?, WALL St. J., Aug. 13, 2001, at A-1 (hereinafter "Barta, Is Appraisal process Skewing").

characterize lenders, borrowers, mortgage brokers, federal loan guarantors and the secondary market, as we will describe.

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

In other mortgages that are devoid of fraud, lack of transparency may still be a problem. In contrast to loans involving fraud, this group of loans involves misleading omissions that are currently countenanced by law.

In most mortgages, federal law requires the disclosure of certain loan terms or costs, either under TILA³⁹ or RESPA.⁴⁰ Both statutes seek to supply consumers with standardized cost information about mortgage loans in order to facilitate comparison shopping. TILA does so by requiring lenders to disclose two key figures, the finance charge and the annual percentage rate (APR). The finance charge purports to measure the total cost of credit in dollars, including interest payments, points, origination fees and private mortgage insurance. The APR provides a different measure of total credit costs by translating the lump sum finance charge into an effective interest rate per year.⁴¹

RESPA seeks to provide consumers with adequate disclosures about closing costs for mortgages. Under RESPA, lenders must provide borrowers with two different disclosure statements. In the good faith estimate of settlement costs (GFE), lenders must provide borrowers

³⁹ 15 U.S.C. §§ 1601 et seq.

⁴⁰ 12 U.S.C §§ 2601 et seq.

See generally HUD & Federal Reserve Board, *Truth in Lending Act and the Real Estate Settlement Procedures Act*, Joint Report to Congress, Executive Summary I (July 1998) (available at http://www.federalreserve.gov/boarddocs/rptcongress/tila.pdf) (hereinafter cited as "HUD-Fed Joint Report"); Rohner & Miller, *supra* note _____, at 179.

with an itemized estimate of the closing costs. Later, at the closing, lenders must provide a HUD-1 settlement statement that reflects the actual closing costs that borrowers must pay.⁴²

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

Other pricing practices that are not regulated by TILA and RESPA hamper transparency as well. In the prime mortgage industry, points generally are accompanied by a reduction in the

See generally HUD-Fed Joint Report, supra note ____, Executive Summary II.

See id. at VII-XI.

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

See HUD-Fed Joint Report, *supra* note ____, Executive Summary XIX. HOEPA provides somewhat stronger protections for the scant one percent of subprime laws that fall within its coverage. Under HOEPA, the lender must make certain written disclosures three days before closing. See 12 C.F.R. § 226.32; notes___- *infra* and accompanying text.

interest rate.⁴⁶ The purpose of this tradeoff is to afford borrowers the option of defraying part of the cost of borrowing by paying a liquidated sum up-front in points in exchange for lower interest payments in the future. For similar reasons, conventional lending norms state that prepayment penalty provisions go hand-in-hand with reductions in interest rates.⁴⁷

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

See, e.g., Kathleen E. Keest & Elizabeth Renuart, THE COST OF CREDIT REGULATION AND LEGAL CHALLENGES 163 (2d ed. 2000) ("points are usually treated as a discount withheld from the loan, thus reducing the amount that the borrower receives") (footnote omitted) (hereinafter cited as "THE COST OF CREDIT"); Sturdevant & Brennan, supra note ____, at 38; WEICHER, supra note ____, at 67 (in the legitimate subprime market, "[t]he higher the interest rate a borrower is willing to pay, the fewer points may be charged, and conversely").

See In Reality, "Predatory Lending" Isn't Easy to Define, supra note ____ ("[p]lease keep in mind that having no prepayment penalty is a double-edged sword: it helps with eliminating prepayment penalties at the price of a much higher interest rate"); WEICHER, supra note ____, at 71-74.

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

E. Loans That Require Borrowers To Waive Meaningful Legal Redress

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

III. MARKET SEGMENTATION AND PREDATORY LENDING

As we have suggested, the pathologies that epitomize predatory lending are the product of market failures in the subprime mortgage market. In this section of the paper, we describe how changes in the financial services market have altered the conventional home mortgage market and given rise to predatory lending. In particular, we argue that today's home mortgage market is replete with information asymmetries that predatory lenders have exploited to the detriment of borrowers who are disconnected from the credit market.

We begin with a discussion of the conventional theory of the market for home mortgages and the impact of historical lending practices on low and moderate income (LMI) borrowers.

Later, we examine the ways in which securitization, new mortgage products, and incentives for lenders to focus on LMI borrowers have altered the home mortgage market. We then explain

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

See HUD-Treasury Report, supra note ____, at 99.

In the recent case of Green Tree Financial Corp.-Alabama v. Randolph, ____ U.S. ____, 121 S. Ct. 513 (2000), which involved a TILA claim by a borrower against a mobile home finance lender, the loan contained a mandatory arbitration clause that was silent as to arbitration procedures, costs and fees. The borrower sought to invalidate the arbitration clause, arguing that she did not have sufficient resources to pay if the arbitration eventually resulted in fees. In a 5-to-4 decision, the Supreme Court rejected her claim for lack of evidence of prohibitive fees: "[W]here, as here, a party seeks to invalidate an arbitration agreement on the ground that arbitration would be prohibitively expensive, that party bears the burden of showing the likelihood of incurring such costs." ____ U.S. at ____, 121 S. Ct. at 522. While the Court suggested that prohibitive filing fees or charges by the arbitrator would

predatory lenders' emergence and how they have been able to exploit information asymmetries to the detriment of many LMI borrowers. In the concluding section, we explain why the market will not correct these inefficiencies.

A. The Conventional Theory Of The Market For Home Mortgages

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

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

provide grounds for striking down an arbitration clause, it created a Catch-22 by requiring litigants to proceed to arbitration in order to adduce proof that they face excessive fees at all.

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

Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AMER. ECON. REV. 393 (1981) (hereinafter Stiglitz & Weiss, *Credit Rationing*); Joseph E. Stiglitz & Andrew Weiss, *Macro-Economic Equilibrium and Credit Rationing* (NBER Working Paper Series No. 2164, 1987). For an expanded discussion of the Stiglitz and Weiss model, *see* William C. Gruben, *et al.*, *Imperfect Information and the Community Reinvestment Act*, ECON. REV. 27, 30-31 (Summer 1990).

default.⁵² Thus, according to Stiglitz and Weiss, if lenders raise interest rates, they will attract loan applicants who present elevated risks of default and they will deter borrowers who present lower default risks.⁵³

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

Less risk-averse borrowers will be more likely to assume loan obligations that they cannot meet. This may be because they have an inflated sense of their ability to meet their loan obligations, they are by nature risk-taking, they do not understand the loan terms and/or the personal costs of default may be low for them. For an analysis of the private costs of default, *see* Jan K. Brueckner, *Mortgage Default with Asymmetric Information*, 20 J. R.E. FINANCE & ECON. 251, 252 (2000).

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

Stiglitz & Weiss, *Credit Rationing*, *supra* note ____, at 394.

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

See Brueckner, supra note ____, at 252, 264.

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

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

lenders will reject their applications for loans; and (3) among the remaining applicants in the queue, who are observationally indistinct, some will receive loans and other will not.⁵⁹

Until the late 1980s, the home mortgage market behaved as Stiglitz and Weiss predicted. Federally insured banks and thrifts dominated the market for home mortgage loans. ⁶⁰ There was minimal risk-adjusted pricing, ⁶¹ each bank was limited in the amount of funds it could lend ⁶² and demand exceeded supply. ⁶³ Most importantly, for the purposes of this paper, credit rationing significantly constrained the amount of mortgage capital available to low and moderate income borrowers. This is because LMI borrowers tend to present greater risks of default than their more affluent counterparts. ⁶⁴

The reason that lenders will not lend to all observationally indistinct borrowers is that when lenders set the price of loans at a rate below the market clearing level, the amount of funds that they can raise to lend is limited. The marginal cost of procuring additional funds that would meet the demand of the excluded, observationally indistinct borrowers would exceed the marginal benefit that would accrue from lending to them. For a model of this phenomenon, *See* Stiglitz & Weiss, *Credit Rationing*, *supra* note _____, at 397.

The theory of credit rationing persists even if borrowers are able to provide collateral. For a discussion of the role of collateral in credit rationing, *see* Dwight M. Jaffee & Franco Modigliani, *A Theory and Test of Credit Rationing: Reply*, 66 AM. ECON. REV. 918 (1976).

As one author described the market: "the banking system had a monopoly on the liquid assets of the nation." Lowell Bryan, *The Risks, Potential and Promise of Securitization, in* A PRIMER ON SECURITIZATION 171-72 (Leon T. Kendall & Michael J. Fishman, eds. 1996). Finance companies and other nonbank lenders wrote home loans, but they only represented a fraction of the home mortgager market.

John V. Duca & Stuart S. Rosenthal, *Do Mortgage Rates Vary Based on Household Default Characteristics? Evidence on Rate Sorting and Credit Rationing*, 8 J. REAL ESTATE FINANCE & ECON. 99, 107 (1994).

Leland C. Brendsel, Securitization's Role in Housing Finance: The Special Contributions of the Government Sponsored Enterprises, in Kendall & Fishman, supra note _____, at 19.

Lewis S. Ranieri, *The Origins of Securitization, Sources of its Growth, and its Future Potential, in* Kendall & Fishman, *supra* note _____, at 32.

Keith N. Hylton & Vincent D. Rougeau, *Lending Discrimination: Economic Theory, Econometric Evidence, and the Community Reinvestment Act*, 85 GEO. L.J. 237, 259 (1996); Klausner, *supra* note _____, at 1568.

While there was some rate sorting in the past, *i.e.*, offering borrowers different loan prices based on their observable levels of risk, the overwhelming evidence reveals that credit rationing had the effect of rationing most LMI borrowers out of the home mortgage market. Stiglitz & Weiss, *Credit Rationing*, *supra* note ____, at 406; Duca & Rosenthal, *supra* note ____, at 101-02.

B. Changes In The Home Mortgage Market

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

1. Securitization

Freddie Mac spearheaded the securitization movement in the 1970s in an effort to increase the amount of available mortgage capital. Widespread securitization by government-sponsored entities (GSEs)⁶⁵ and the private sector began in the 1980s and by 1993, sixty percent of home mortgage loans were securitized.⁶⁶ In the process, securitization single-handedly transformed the financial services market. It is now routine for lenders to originate loans and sell them to secondary market institutions, which provide a steady stream of capital to lend.⁶⁷

Securitization is the process of converting packages of home loans into securities that are backed by collateral in the form of loans.⁶⁸ The first step in the securitization process is for a

The most well-known GSEs today are Fannie Mae and Freddie Mac.

Brendsel, *supra* note ____, at 17-19. During the same time period, investment fund managers were looking for new investment vehicles and mortgage-backed securities fit the bill. Leon T. Kendall, *Securitization: A New Era in American Finance, in* Kendall & Fishman, *supra* note ____, at 2-3.

Securitization not only generates more mortgage capital, it also adds value by reducing risks and costs through diversification. For example, by pooling individual loans, the collective risk of a package of loans defaulting is less than the average risk of any one loan going into default.

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

Tamar Frankel, Securitization (Asset-Backed Securities and Structured Financing), in Financial Product Fundamentals: A Guide for Lawyers 4-2 (1999).

lender to make loans to borrowers. The loans then are bundled and transferred to an entity, often known as a "special purpose vehicle" (SPV) that passively holds the loans.⁶⁹ The SPV adds credit-enhancements that have the effect of reducing the risks associated with defaults.⁷⁰ The SPV then creates and issues the mortgage-backed securities and sells the securities to investors.⁷¹ The proceeds from the sale of the securities are passed on to the entity that sold the loans less the expenses that the SPV incurred. In some cases, the SPV services the loans, *i.e.*, collects the loan payments, and distributes the proceeds to the investors.⁷² Other times, the seller of the loans retains the servicing rights.

Securitization, by making possible a constant flow of money to the home mortgage market, has dramatically altered the business of mortgage lending. Banks and other lenders do not suffer from liquidity restraints and more funds are available to lend borrowers.

Securitization also has created opportunities for nonbank lenders to enter the home mortgage market. Lenders no longer need to be large financial institutions with significant deposits and capitalization. Rather, thinly-capitalized mortgage bankers and finance companies can originate loans for sale on the secondary market. A

These entities may take a number of different organizational forms, *e.g.*, trusts, corporations, or partnerships. Frankel, *supra* note ____, at 4-4.

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

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

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

Brendsel, *supra* note ____, at 24.

⁷⁴ *Id*.

2. Expanded Mortgage Products

Historically, lenders primarily offered cookie-cutter, fixed-rate loans. Coincident with the expansion of the home mortgage market in the early 1980s, Congress enacted the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA)⁷⁵ and the Alternative Mortgage Transactions Parity Act of 1982 (AMTPA),⁷⁶ both of which paved the way for the proliferation of new mortgage products.⁷⁷

In DIDMCA, Congress extended the favorable variable rate ceiling for national banks to all federally insured banks and thrift institutions⁷⁸ and preempted all state usury ceilings on "interest, discount points, finance charges, or other charges" for loans secured by first mortgages on debtors' homes, including conventional homes and mobile homes.⁷⁹ As a result, lenders who wanted to charge higher rates had new incentives to refinance first mortgages, rather than to offer junior mortgages, whether home equity lines or otherwise, that were subject to state usury laws.⁸⁰

Along a similar vein, in AMTPA, Congress extended the liberal mortgage lending regulations for federally chartered depository institutions to most lenders making senior and

⁷⁵ Pub. L. No. 96-221, 94 Stat. 164 (1980).

⁷⁶ Pub. L. No. 97-320, 96 Stat. 1469 (1982).

See generally Office of Thrift Supervision, Advance notice of proposed rulemaking, *Responsible Alternative Mortgage Lending*, 65 Fed. Reg. 17811, 17813-14 (Apr. 5, 2000).

⁷⁸ 12 U.S.C. §§ 1463(g), 1785(g), 1831d(a); *see also* 12 U.S.C. § 85. That change permits insured depository institutions of all types to set interest rates as high as one per cent over the discount rate on ninety day commercial paper in effect at the Federal Reserve District in which the institution "is located." *Id*.

⁷⁹ 12 U.S.C. § 1735f-7a.

Although Congress permitted the states to enact laws opting out of federal preemption, only sixteen did so, either in part or in whole. See THE COST OF CREDIT, supra note ____, at 64, 72-74; Julia Patterson Forrester, Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing, 69 TULANE L. REV. 373, 398-400 (1994) (hereinafter "Forrester, American Dream"); Mansfield, supra note ____, at 492-520.

junior residential mortgages.⁸¹ These regulations preempted old restrictions that limited lenders to making fixed-rate, amortizing mortgages.⁸² As a result, lenders received the green light to make adjustable rate mortgages, mortgages with balloon payments and non-amortizing mortgages where borrowers pay off the interest but not the principal.

3. Incentives To Lend To LMI Borrowers

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

In terms of federal initiatives, one piece of legislation that has encouraged lenders to focus on LMI borrowers is the 1992 Federal Housing Enterprise Financial Safety and Soundness

⁸¹ 12 U.S.C. §§ 3801 et seq.

Congress gave states an opt-out provision, but only six states chose to exercise that option. *See* THE COST OF CREDIT, *supra* note ____, at 64, 72-74, 109-111; Office of Thrift Supervision, Advance notice of proposed rulemaking, *Responsible Alternative Mortgage Lending*, 65 Fed. Reg. 17811, 17813-14 (Apr. 5, 2000); Forrester, *American Dream, supra* note ____, at 400-01. The act authorizes lenders to make alternative mortgage loans as long as the transactions are "in accordance with" appropriate and applicable OTS regulations. OTS is giving consideration to whether to amend those regulations in some way to deter predatory loans. *See Responsible Alternative Mortgage Lending, supra*, at 17815-16.

Arthur Kennickell *et al.*, *Family Finance in the U.S.: Recent Evidence from the Survey of Consumer Finances*, 83 FED. RES. BULL. 1, 5 (January 1997); Glenn B. Canner *et al.*, *Recent Developments in Home Equity Lending*, FED. RES. BULL. 241, 249 (April 1998) (hereinafter "Canner et al., *Recent Developments*").

Low and moderate income borrowers are the fastest growing group of borrowers in the mortgage market. Keith N. Hylton, *Banks and Inner Cities: Market and Regulatory Obstacles to Development Lending*, 17 YALE J. ON REG. 197, 205 (2000) (citing John R. Wilke, *Giving Credit: Mortgage Lending to Minorities Shows a Sharp 1994 Increase*, WALL St. J., Feb. 13, 1996, at A1).

Act, ⁸⁴ pursuant to which the Department of Housing and Urban Development (HUD) sets affordable housing lending goals for Freddie Mac and Fannie Mae. The 1996-2000 goals issued pursuant to the Act required that forty-two percent of Freddie Mac's and Fannie Mae's loan purchases come from low and moderate income households. The goal for 2001 was fifty percent. ⁸⁵ Additional HUD mandates required that Fannie Mae and Freddie Mac significantly increase their purchases of loans from high minority and/or low-income census tracts. ⁸⁶ The HUD goals expanded the market for lenders who originate loans in LMI neighborhoods with the intention of selling their loans to Fannie Mae and/or Freddie Mac. Similarly, the Community Reinvestment Act (CRA) created incentives for bank and thrift holding companies to originate or purchase loans in LMI neighborhoods in order to improve their CRA examination ratings and prospects for merger approval. ⁸⁷

Federal Housing Administration (FHA) insurance through HUD creates an additional incentive⁸⁸ for lending in LMI neighborhoods by reducing the cost to lenders of default. The

⁸⁴ 12 U.S.C.A. § 4501, et seq. (1992).

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

⁸⁶ *Id.*

See, e.g., HUD-Treasury Report, supra note ____, at 106.

There is some dispute whether the CRA actually is responsible for increased home mortgage lending to LMI borrowers. For a discussion of attempts to study the impact of the CRA on low and moderate income lending, see Sally R. Merrill et al., III HOUSING FINANCE FOR LOW AND MODERATE INCOME HOUSEHOLDS: INNOVATIONS IN THE UNITED STATES AND AROUND THE WORLD 14-17 (2000). See also ROBERT E. LITAN et al., THE COMMUNITY REINVESTMENT ACT AFTER FINANCIAL MODERNIZATION: A BASELINE REPORT 69 (2000) (assessing the impact of the CRA on LMI lending) (hereinafter "LITAN et al., BASELINE REPORT"); Eric S. Belsky et al., The Impact of the Community Reinvestment Act on Bank and Thrift Home Purchase Mortgage Lending (unpublished paper) (March 2001) (finding that the CRA has been effective in increasing home purchase mortgages in LMI neighborhoods); but see Drew Dahl et al., Does the Community Reinvestment Act Influence Lending? An Analysis of Changes in Bank Low-Income Mortgage Activity (unpublished paper) (May 2000) (calling into question the impact of regulatory pressure on low and moderate income lending); Keith N. Hylton & Vincent D. Rougeau, The Community Reinvestment Act: Questionable Premises and Per Verse Incentives, 18 Ann. Rev. Banking L. 163 (March 1999) (challenging the efficiency of the CRA).

majority of borrowers who are covered by FHA insurance are low to moderate income households.⁸⁹ If and when these FHA-insured borrowers default, the FHA reimburses the lenders for their foreclosure costs and expenses related to the sale of covered property.⁹⁰ In addition, FHA insurance reimburses lenders for the outstanding interest that accrues between default and foreclosure, property taxes and maintenance costs.⁹¹ Given that many LMI borrowers have elevated risks of default, the increased availability of FHA insurance decreases the downside risk to lenders.⁹²

4. The New Market Structure

The changes in home mortgage market have made it possible for borrowers of all risk levels to work with an array of different loan originators and select from a menu of loan products offered by both prime and subprime lenders. An irony of these market changes is that they have contributed to the emergence and success of predatory lenders. Conceivably, predatory lenders now can originate predatory loans in LMI neighborhoods and sell them to private secondary participants and, conceivably, the GSEs: Fannie Mae and Freddie Mac.⁹³ Likewise, they can find

In January 2001, HUD announced an increase of nine percent in the size of the mortgages that it insures. *HUD Raises Ceiling on FHA Mortgages*, PORTLAND OREGONIAN (Jan. 14, 2001).

Low and moderate income borrowers accounted for seventy percent of FHA insured loans in 1998. *See* Merrill *et al.*, *supra* note ____.

Terrence M. Clauretie & Thomas Herzog, *The Effect of State Foreclosure Laws on Loan Losses: Evidence from the Mortgage Insurance Industry*, 22 J. MONEY, CREDIT & BANKING 225 (1990).

This reduction in transaction costs also has the perverse effect of reducing the costs to predatory lenders of foreclosure. HUD-Treasury Report, *supra* note , at 21.

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

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

In response to this risk, Fannie Mae and Freddie Mac instituted controls to help them to identify predatory lenders and loans containing predatory terms. *See* David Andrukonis, Address to the Neighborhood Reinvestment

potential loan purchasers among banks that seek to fulfill their CRA obligations by purchasing loans made to LMI borrowers. Similarly, predatory lenders can make predatory, FHA-insured loans and insulate themselves somewhat from the cost of defaults. Lastly, as we discuss *infra*, AMTPA has enabled predatory lenders to peddle complex and predatory loan products that are difficult for inexperienced and unsophisticated borrowers to understand.

We contend that as a result of the changes in the home mortgage market, the market has segmented into three mortgage markets: a prime market, a legitimate subprime market and a predatory market.⁹⁶ The prime market looks much like its historical predecessor. It continues to cater to low-risk borrowers, who obtain loans from traditional banks and thrifts as well as from the new breeds of lenders. Although prime lenders still set interest rates below the market clearing rate to attract borrowers who present low risks of default,⁹⁷ more of the observationally

Corporation Training Conference (February 23, 2000) (transcript available at <www.freddiemac.com/speeches/pred_spch.html>); Fannie Mae, *Comment Letter, supra* note _____, at 30, 167-69.

Nothing in the CRA restricts banking entities from fulfilling their CRA obligations by purchasing or originating loans that contain predatory terms. Remarks by Donna Tanoue, former Chairman, FDIC, before the Bank Administrative Institute Conference, Arlington, Va., June 19, 2000 (available at http://www.fdic.gov/news/speeches/chairman/sp19June00.html); ("[t]he problem is that our examination procedures today concentrate on where a loan was made without regard for the characteristics of the loan"); Adam Wasch, *CRA Assessment Methods Need Update, Seidman Says, Calling It Top Regulatory Issue*, BNA BANKING REP., Oct. 16, 2000, at 497; Adam Wasch, *Democrats Propose CRA Update Bill Supporters Say Gore Would Sign*, BNA BANKING REP., July 24, 2000, at 131. *See generally* Patricia A. McCoy, BANKING LAW MANUAL: FEDERAL REGULATION OF FINANCIAL HOLDING COMPANIES, BANKS AND THRIFTS § 8.03[1][b] (2d ed. 2000).

The FHA has become aware of this risk and is now taking steps to identify predatory lenders who work with FHA-eligible borrowers. HUD-Treasury Report, *supra* note ____, at 11; John B. O'Donnell, *FHA Begins Acting on Complaints of "Flipping;" U.S. Will Demand Redress for Exploited Homeowners*, THE BALTIMORE SUN, May 20, 2000, at 4-B; *see also* 66 FED. REG. 38302-10 (July 23, 2001) (listing dozens of administrative actions HUD took against mortgagees who engaged in predatory lending in violation of FHA requirements).

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

For reasons discussed *infra* at text accompanying notes _____, banks and thrifts tend to continue to focus their direct lending activities on prime borrowers and, to the extent that they do engage in risk-adjusted pricing, it is often limited to prime borrowers.

reasons for this change. The first is that lenders now have longitudinal data and sophisticated credit scoring and underwriting models that make it possible for them to engage in more accurate risk assessment of people who, in the past, were observationally indistinct. The second factor is securitization itself. Securitization has reduced the marginal cost of procuring additional capital to lend and consequently lenders are less constrained in terms of the amount of money that they can lend. 99

Borrowers who present elevated risk levels, including people with impaired credit, can now look to the subprime market for credit, where they can take advantage of the influx of mortgage capital and flexible, subprime loan products. Subprime lenders charge these borrowers interest and fees that exceed the rate that traditional prime borrowers pay, commensurate with the higher risk that they present. Most subprime lenders are nonbank

For example, Fannie Mae's Desktop Underwriter provides for more accurate risk assessment. Fannie Mae, *Comment Letter, supra* note _____, at 166-68.

Arguably, lenders' enhanced ability to assess risk and the increased availability of mortgage capital should lead to risk-based pricing, in which the terms of any loan would reflect the unique risk that a borrower presents based on the lender's risk-assessment model. For reasons discussed *infra*, banks and thrifts may be reluctant to charge higher interest rates for riskier borrowers and thus limit their direct lending to prime borrowers. Just the same, some commentators contend that as automated underwriting becomes more commonplace in the subprime market, the prime and subprime markets will integrate and risk-based pricing will become the norm. *See* MAKING FAIR LENDING A REALITY IN THE NEW MILLENNIUM 23-27 (A. Bogdon & C. Bell, eds. 2000).

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

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

See Canner et al., Recent Developments, supra note ____, at 244.

entities¹⁰² that emerged as the result of securitization. We refer to the subprime lenders who do not engage in predatory practices as legitimate subprime lenders.

The third market is the predatory loan market. The borrowers in this market are people who, because of historical credit rationing, discrimination, and other social and economic forces, are disconnected from the credit market.¹⁰³ They have a range of credit ratings and some actually would qualify for prime loans.¹⁰⁴ Others may have blemished credit histories and rightly are classified as subprime borrowers. Still others may be able to afford modest loan payments, but cannot afford large loans with high interest rates. The final group of borrowers in the predatory loan market cannot afford any credit regardless of the terms. In the predatory loan market, brokers and originators exploit borrowers' disconnection to the credit market and make loans with predatory terms.

C. Market Failures And Predatory Lending

The fact that there are subprime and prime-eligible borrowers who are entering into predatory loans suggests that the home mortgage market is inefficient. In this section of the paper, we identify the inefficiencies that have impeded the evolution of a price-competitive home mortgage market and enabled predatory lenders to thrive. We begin by discussing how

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

Cf. Associates Home Equity Services, Inc. v. Troup, No. A-3410-00T1F, 2001 N.J. Super. LEXIS 318, at *8 n.2 (N.J. App. July 25, 2001) (citing expert testimony that a "dual housing finance market exists in New Jersey for the refinance and home repair loans" market).

See Freddie Mac, AUTOMATED UNDERWRITING, supra note ____, ch. 5 & nn.5-6 (estimating that between ten and thirty-five percent of subprime borrowers qualified for prime-rate loans); see also Howard Lax et al., Subprime Lending: An Investigation of Economic Efficiency 16 (Working Paper December 21, 2000) (empirically finding that there are borrowers with subprime loans who do not present elevated levels of risk).

predatory lenders can exploit information asymmetries to the detriment of borrowers who are disconnected from the market. We then discuss why lenders and secondary market participants, both of whom ostensibly have an interest in countering the information asymmetries in the market, will not take steps to correct them. In the concluding portion, we explain why competition among banks, thrifts, legitimate subprime lenders, and predatory lenders has not eliminated the market for predatory loans.

1. Information Asymmetries: Opportunities For Predatory Lenders And Brokers

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

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

See Brendsel, supra note ____, at 26 (noting that when lenders originated and held loans, the lenders were more committed to maintaining quality).

Information asymmetries also exist between brokers and lenders, and lenders and secondary market participants, as we discuss *infra*.

options.¹⁰⁷ Many of them historically were excluded from the home mortgage market because of credit rationing. They may need credit, but may not be aware that they are eligible for loans. Many do not know that there are alternative sources of less expensive credit. And when lenders and brokers give these borrowers estimates and loan documents, the borrowers may not be able to comprehend the information. Predatory brokers and lenders take advantage of these information asymmetries and induce borrowers to commit to loans that are predatory. When the borrowers cannot repay these loans, the predatory lenders reappear on their doorsteps, offering the borrowers an opportunity to escape foreclosure by refinancing ("flipping") their loans.¹⁰⁸ Each time the borrowers refinance,¹⁰⁹ the lenders tack huge "refinancing" fees and prepayment penalties on to the original principal. The fees and penalties mount with each refinancing and eventually many borrowers leverage all their equity. Upon default, the lenders collect their profits at foreclosure.¹¹⁰

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

HUD-Treasury Report, *supra* note , at 74.

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

Any strategy based on realizing the price through foreclosure is risky because the profits from the predatory loans may be offset by the costs of foreclosure, and because there is a risk of deflating housing values. *See generally* Schill, *supra* note ____, at 489 (reviewing the costs associated with foreclosure).

- 2. Taking Advantage Of Information Asymmetries: Locating And Marketing Predatory Loans To Disconnected Borrowers'
 - a. Identifying Communities And People To Target

In order to exploit these information asymmetries, predatory lenders need to identify people who are disconnected from the credit economy and therefore, are unlikely or unable to engage in comparison shopping. The people most likely to meet these criteria are LMI people¹¹¹ of color¹¹² who, because of credit rationing, discrimination, and other social forces, have not had experience with legitimate lenders.¹¹³ It is relatively easy for predatory lenders to identify these potential borrowers. They can use HMDA data to identify areas of cities in which there is minimal or no lending activity by prime lenders. They can also use census data to find neighborhoods with high percentages of people of color and LMI residents.

Not all LMI borrowers are disconnected from the credit market and thus vulnerable to the wiles of predatory lenders. Just the same, there may be practical reasons why even LMI borrowers with past experience with lenders fall prey to predatory lenders. This may be because they have become infirm or feel that it is not safe to venture far from their homes. They may not have phones needed for comparison shopping and applications or, if they have them, they

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

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

Approximately thirteen percent of American households do not have any relationship with a bank; the bulk of these people have low to moderate incomes. Kennickell *et al.*, *supra* note _____, at 7. Less than half of African-American households maintain checking accounts. Peter P. Swire, *Equality of Opportunity and Investment in Creditworthiness*, 143 U. PENN. L. REV. 1533, 1536 (1995).

HUD-Treasury Report, *supra* note _____, at 39, 72.

may find it difficult to understand people over the phone.¹¹⁵ Likewise, they may not have access to transportation that could bring them to the offices of legitimate lenders. These concerns are heightened for disabled people and senior citizens.¹¹⁶ More affluent borrowers facing these obstacles can enlist friends or family members who have the resources to help them understand and shop for loans.

Armed with these various incentives to lend in LMI neighborhoods, predatory lenders procure information that enables them to identify specific individuals¹¹⁷ with equity in their homes and pressing needs for money.¹¹⁸ They can search registries of deeds to identify homeowners who do not have mortgages or who are close to paying off their mortgages.¹¹⁹ From the local tax office, they can learn of homeowners who have outstanding taxes¹²⁰ and, therefore,

LITAN et al., BASELINE REPORT, supra note _____, at 18.

An AARP study found that over half of all people over fifty do not comparison shop before taking out loans. American Association of Retired Persons, *AARP Consumer Home Equity/Home Improvement Lending Survey* 4 (November 2000).

Anecdotal evidence suggests that predatory lenders and brokers focus on refinancing and second mortgages. This is because they target homeowners who are not necessarily shopping for mortgages and obtain loan commitments before the borrowers become aware of other avenues for obtaining loans. Predatory lenders identify homeowners through title records and then approach them to refinance or take out second mortgages. This marketing strategy is less effective in capturing home purchasers who are already in the market for mortgages and are more likely to comparison shop.

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

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

For an example, see Steve Jordon, Lending Agency Convicted of Predatory Lending Practices, OMAHA WORLD-HERALD, January 23, 2001. In Cleveland, a lender sent out notices the week that real estate property taxes were due, saying that property owners' taxes might be overdue and offering loans to cover their overdue taxes and other expenses. Teresa D. Murray, Notices Alarming Property Owners, The Plain Dealer, July 21, 2001, at C1.

may need money. From municipal offices, they can identify homeowners who have been cited for housing code violations and thus may be in need of home repair loans. They can drive through neighborhoods and identify homes with sagging porches, aged roofs and peeling paint.¹²¹

b. Predatory Lenders' Marketing Tools

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

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

Predatory lenders pressure naïve borrowers to commit to loans under the pretext that their opportunity to borrow will soon vanish. The coup de grâce lies in persuading customers to sign their loan applications; once they have signed the applications, customers have a strong

Cf. Lambert, *supra* note _____, at 2186-89 (1999) (discussing different sources lenders can tap to identify potential borrowers).

Forrester, American Dream, supra note ____, at 389.

See, e.g., Associates Home Equity Services, Inc. v. Troup, No. A-3410-00T1F, 2001 N.J. Super. LEXIS 318, at *5 (N.J. App. July 25, 2001) (noting evidence that a home improvement contractor "arranged a limousine to transport" homeowners to lender's "office to close the loan").

psychological urge to justify their decisions, rather than second-guess them.¹²³ In the end, the borrowers commit to the loans, grateful for the lenders' personal service and willingness to loan them money.

c. Predatory Lenders' Products

As we have already discussed, the information asymmetries between lenders and brokers, and borrowers are greatest when the borrowers are disconnected from the credit market. These borrowers are least able to understand the terms of their loans¹²⁴ and associated risks. In addition, they often do not know how to seek help understanding loan documents and identifying important questions to ask lenders. Predatory lenders take advantage of borrowers' lack of sophistication and lack of access to financial advice and insert loan terms that are not transparent¹²⁵ and that would not be acceptable to more experienced borrowers.

In the prime market, borrowers with the best credit can obtain conventional rate mortgages with payment terms that are relatively easy to analyze. The prime market features conventional fixed-rate mortgages with interest rates that do not fluctuate, thereby assuring borrowers that they will have the same payments for principal and interest every month for the life of the loan. Although the prime market does offer balloon payments and adjustable rate mortgages, these mortgages are alternatives to the fixed-rate variety and are left to the discretion of borrowers. Prepayment penalties are likewise rare in the prime market. Thus, prime borrowers who are contemplating a fixed-rate loan can calculate with assurance the due date and

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

Lax *et al.*, *supra* note _____, at 10.

HUD-Treasury Report, *supra* note , at 60.

amount of each payment due under their loans. Their ability to repay hinges solely on their future income and not on changes in the wider economy such as interest rate movements.

In contrast to prime mortgage products, predatory lenders rarely sell plain vanilla, fixedrate mortgages with easily understood payment terms. Most predatory loans contain terms that
require borrowers to make difficult probabilistic computations about the likelihood and
magnitude of future market events¹²⁶ that are entirely outside their control. For example,
predatory loans often feature adjustable rate mortgages (ARMs) whose interest rates and,
therefore, monthly payments fluctuate. In order for borrowers to predict their monthly mortgage
payments in any rigorous way, they would have to calculate the probability of changes in interest
rates for each period in the life of the loan, and determine how the projected changes in the
interest rates would affect their monthly payments. Introductory teaser rates, which also are
common in predatory loans, exacerbate matters by masking true interest rates and lulling loan
applicants into a false sense of security about their ability to repay. Predicting interest rate
movements confounds even the brightest financial analysts. Thus, the prevalence of adjustable
rate mortgages in predatory loans makes it difficult for borrowers to predict their ability to meet
their monthly payments with any confidence.

To compound the market uncertainty associated with adjustable rate mortgages, the ARMs that predatory lenders market often contain onerous provisions that increase the risk to borrowers' equity. For example, ninety-eight percent or more of subprime home loans contain

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

substantial prepayment penalties that exceed the liquid resources of most LMI borrowers.¹²⁷ On their face, prepayment penalties only become problematic if borrowers seek to refinance their loans on their own initiative. The reality, however, is that in the subprime market, prepayment penalties spring to life when borrowers default or are forced to refinance on less favorable terms in order to avoid default. Because borrowers with ARMs and prepayment penalties cannot predict with confidence their ability to meet their loan obligations, they cannot predict the likelihood that they will trigger the prepayment penalties.

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

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HUD-Treasury Report, *supra* note _____, at 93.

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

See, e.g., Associates Home Equity Services, Inc. v. Troup, No. A-3410-00T1F, 2001 N.J. Super. LEXIS 318, at *32 (N.J. App. July 25, 2001) (Homeowner "was confused because of the number and complexity of the documents. When she asked [the lenders' attorney] if the principal balance [would] be due in fifteen years, the attorney told her not to worry about it").

Most borrowers, whether they are LMI borrowers or more affluent, are risk-averse and measure the benefits of entering into loans against the downsides, *i.e.*, the increased debt burden and the risk of default and foreclosure. Almost everyone who engages in this calculation, however, "discount[s] risks whose likely occurrence is some time away." Such discounting may be rational because most mortgage borrowers, including LMI borrowers, have never lost their homes to foreclosure before. Just the same, LMI borrowers may be more likely to make unintentional errors in discounting because of their tight finances and the complex, probabilistic terms of their subprime loans. The consequences of such errors are more devastating for LMI borrowers, who have fewer personal and familial resources to draw upon if they misjudge the risks that they can afford.

In short, the borrowers whom predatory lenders target end up committing to complex mortgages with probabilistic terms, while prime borrowers, who are generally more sophisticated, can take advantage of straightforward, fixed-rate mortgages without any penalty provisions or contingent price terms.¹³¹ In the end, the victims of predatory lenders sign documents without having a clear sense of the terms of the contracts, how much they borrowed, what they have purchased, the terms of repayment, or the risks they have assumed.

3. Efforts By Lenders And Secondary Market Participants To Protect Themselves Against The Risks Of Predatory Lending Will Not Correct Market Inefficiencies

Borrowers are not the only market actors who can be harmed when predatory lenders and predatory brokers exploit information asymmetries. Predatory brokers deceive lenders about

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Langevoort, *supra* note ____, at 640.

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

borrowers' true credit risks, and predatory lenders similarly deceive secondary market purchasers. As a result, both lenders and secondary market participants can assume more risk than they intend and may be faced with unexpectedly high numbers of loans in default.

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

Lenders who sell loans on the secondary market often use brokers¹³² to market their products.¹³³ These brokers have little incentive to insure that borrowers are creditworthy because they do not bear the risk of loss in the event of default.¹³⁴ Brokers do, however, have an incentive to deceive lenders regarding borrowers' ability to pay. This is because lenders typically compensate brokers only for loans that the lenders approve, based on the interest rate and the size of the loans.¹³⁵ For example, predatory brokers may write loans with very high interest rates that borrowers cannot afford and then falsify borrowers' credit histories to indicate

Mansfield, *supra* note _____, at 534; HUD-Treasury Report, *supra* note _____, at 40.

The mortgage broker industry estimates that brokers originate over half of all home mortgages. Patrick Barta, *Land Grab? Why Big Lenders are so Frightened by Fannie and Freddie*, WALL ST. J., April 15, 2001.

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

¹³⁴ *Id.* at 40.

to the lenders that the borrowers have the financial wherewithal to meet their loan obligations. ¹³⁶ Brokers stand to benefit from such fraud in three ways: (1) loans are made that otherwise would have been denied, thereby generating commissions for the brokers; (2) these commissions are larger than normal because the face amount of the loans often is more than borrowers can afford; and (3) the brokers may earn yield spread premiums. ¹³⁷ Meanwhile, lenders have assumed the risk of loans that are almost certain to default.

Lenders who sell loans on the secondary market may not care whether brokers deceive them about borrowers' default risks because the lenders do not bear the ultimate risk of loss. ¹³⁸ In this situation, there are reduced incentives for lenders to police the brokers they use. Even when lenders retain predatory loans generated through brokers, if the lenders themselves are predatory, they can still make tidy profits by repeatedly refinancing the properties to strip borrowers' of their equity, and then foreclosing. ¹³⁹

Lenders who are not predatory may find it difficult to identify and exert control over predatory brokers. They can inadvertently finance predatory loans¹⁴⁰ through brokers and not

HUD-Treasury Report, *supra* note _____, at 22; *see also* Barta, *Is Appraisal Process Skewing*, *supra* note _____ at A-1 (writing that "[s]ince brokers at times collect fees based on loan size and have little or no stake in whether the mortgage defaults, they could be tempted to pressure appraisers to come up with bigger values").

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

Cf. Barta, Is Appraisal Process Skewing, supra note _____, at A-1 (noting that since lenders can now sell loans on the secondary market, they should be less concerned about the accuracy of property appraisals).

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

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

learn of the predatory nature of the loans for some time because borrowers generally do not default immediately. In addition, if a broker originates predatory and non-predatory loans, it may be difficult for a lender to determine whether any particular default was bad luck or the result of a predatory loan. Even in the best case scenario, where a lender identifies and terminates its relationship with a predatory broker, the broker can always find another predatory lender with which to work and predatory lending will continue.

Principal-agent problems also arise because lenders have greater access than secondary market purchasers to information about borrowers' creditworthiness and loan purchasers rely on lenders' assurances about credit quality. Lenders who sell the loans that they originate to the secondary market make their profits from high origination fees and not interest. Thus, their incentives to maintain credit quality are low relative to those of the loan purchasers. This information asymmetry and reduced commitment to creditworthiness creates incentives for lenders to obscure from secondary market purchasers the true risk of borrowers defaulting ¹⁴¹ and enables the lenders to make substantial profits from up-front points and fees.

Secondary market institutions can protect themselves¹⁴² to some extent from deception by lenders. For example, secondary market actors can insert recourse provisions, requiring that

Wayne Passmore & Roger W. Sparks, *Automated Underwriting and the Profitability of Mortgage Securitization*, 28 REAL ESTATE ECON. 285 (2000).

For a discussion of how the secondary market can insulate itself against the risks created by inadequate incentives to assure credit quality, see Neil D. Baron, The Role of Rating Agencies in the Securitization Process, in Kendall & Fishman, supra note _____, at 85; see also Karen B. Gelernt, Comment: Avoiding Predator Risk in the

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

lenders take back loans in the event of borrower default. Recourse provisions will not necessarily deter predatory lending. If defaulting borrowers have sufficient equity in their property, the lenders can take back the loans pursuant to the recourse provisions, flip the loans a few times, each time tacking on huge fees, and eventually foreclose. Alternatively, if the lenders are undercapitalized and secondary market institutions try to invoke recourse provisions following widespread defaults, the lenders can declare bankruptcy or dissolve. Of course, if lenders continuously misinform loan purchasers about risk, the lenders' ability to sell loans on the secondary market will decline. However, lenders, like brokers, can tuck predatory loans in with bundles of good loans, *i.e.*, with low default risks, making it difficult for secondary market participants to detect the lenders' predatory lending activities. For these reasons, of the various measures that legitimate lenders and secondary market participants can implement to protect themselves from predatory brokers and lenders, none has the intended or consequential effect of adequately protecting the borrowers who are victims of predatory lending.

4. Deterrents To Banks And Thrifts Making Loans To Borrowers Who Are Disconnected From The Credit Market

If, in fact, there is unmet demand in LMI neighborhoods and borrowers are entering into loans with inflated fees that do not reflect their risk levels, banks, thrifts and legitimate subprime

Secondary Market, Am. Banker, July 7, 2000, at 9 (outlining measures secondary market participants should take when evaluating loan packages and originators).

An unanswered question is the extent to which secondary market actors could be liable for the predatory lending activities of the lenders from whom they buy loans. *See* Robert Julavits, *Legal Risks Move Up Financial World's Food Chain*, Am. Banker, April 12, 2000, at 1 (discussing predatory lending claims brought against trustees and underwriters).

Market for B & C Servicing on the Rise, NATIONAL MORTGAGE NEWS, Sept. 22, 1997; Brendsel, supra note _____, at 26.

lenders should be entering the market¹⁴⁴ and stimulating competition. This has not occurred. We posit that this disequilibrium has arisen because there are disincentives for banks and thrifts to enter the subprime market and because the business models that legitimate subprime lenders employ prevent them from identifying many of the potential borrowers who ultimately become victims of predatory lenders.

a. Reputational Concerns

Banks and thrifts are community institutions with valuable reputations. They may perceive that even legitimate subprime lending could damage their reputations. Subprime loans entail a greater risk of default either because of risks associated with the particular borrowers or the risk that the assets securing the loans will depreciate because of unstable prices¹⁴⁵ in LMI neighborhoods. When applicants present higher risks, lenders will either charge higher, risk-adjusted prices or reject the applicants. Either response could evoke community protests that the lenders are being unfair. Furthermore, in some cases, the only way to realize the price of a

Only two percent of FDIC insured banks have significant subprime loan portfolios. Mark Maremont & William M. Bulkeley, *FDIC Seizes Chicago-Area Thrift Institution*, WALL St. J., July 30, 2001, at C1.

If neighborhood housing prices are dropping or there is a probability that they will drop in the future, the value of borrowers' collateral will decrease. *See* Robert B. Avery *et al.*, *Information Dynamics and CRA Strategy*, ECON. COMMENTARY (February 1997) (available at http://www.clev.Federal Reserve Board.org/research/com97/0201.htm>) (hereinafter "Avery, *et al.*, *Information Dynamics*").

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

loan is through foreclosure.¹⁴⁷ Banks often find foreclosure socially repugnant as well as unprofitable, and worry that multiple foreclosures could hurt their reputations.¹⁴⁸

Banks and thrifts also are concerned that if their rejection rates¹⁴⁹ and/or risk-adjusted prices bear any correlation with race, they will be perceived as engaging in mortgage-lending discrimination.¹⁵⁰ This perception could hurt their reputations and give rise to enforcement actions and costly lawsuits.¹⁵¹

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

Cf. John Hechinger & Patrick Barta, Banker Beware: As Economy Slows, "Subprime" Lending Looks Even Riskier, WALL St. J., August 16. 2001, at A1 (noting that banks' reputations may be damaged if they have to "crack[] down on financially shaky borrowers who [are] late on their mortgage payments").

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

McGarthy & Quercia, *supra* note _____, at 28.

LITAN *et al.*, BASELINE REPORT, *supra* note _____, at 76.

Duca & Rosenthal, *supra* note _____, at 99 (discussing how the fear of liability under fair lending laws may make lenders wary of using risk-adjusted prices if they are correlated with race).

Predatory lenders sweep through communities until their tactics are disclosed and community pressure forces them to relocate or resurface under a new name.

b. Regulatory Concerns

Banking regulations that mandate loan loss reserves and require adequate capitalization may create further obstacles to banks that want to expand into subprime and/or predatory lending. ¹⁵³ If banks and thrifts engage in subprime lending, bank examiners may view the loans as a risk to the safety and soundness of the banks and require that the banks increase their loan loss reserves. In addition, federal banking regulators have tightened capital requirements for subprime loans and they are expected to tighten those requirements even further. ¹⁵⁴ In contrast nonbank lenders are not subject to federal loan loss reserve or capitalization requirements. ¹⁵⁵

Banks and thrifts also have heavier reporting requirements for subprime loans than nonbank subprime lenders. In May 2000, federal banking regulators proposed amending call reports by banks to include information on subprime loans, securitizations and asset sale activities. *See* Federal Reserve System *et al.*, Notice and request for comment, *Proposed Agency Information Collection Activities; Comment Request*, 65 Fed. Reg. 34801 (May 31, 2000); *see also* Office of Thrift Supervision, Notice and request for comment, *Proposed Agency Information Collection Activities*, 65 Fed. Reg. 48049 (Aug. 4, 2000); Kenneth Talley, *Proposal for More Data on Subprime Loans Could Burden Banks, Limit Credit, CBA Says*, BNA BANKING REP., Aug. 28, 2000, at 272. Later that year, the Federal Reserve Board sought to address reporting disparities in part by proposing expanded reporting responsibilities under the Home Mortgage Disclosure Act (HMDA) for nonbank subprime lenders. *See* Federal Reserve System, Proposed Rule, *Home Mortgage Disclosure*, 65 Fed. Reg. 78656 (Dec. 15, 2000); *supra* note _____.

Regulators are also concerned about the risks that arise when banks purchase securities backed by subprime mortgages that could be predatory. In response to this concern, in December 1999, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System

WEICHER, *supra* note ____, at 30. Of course, banks may be able to avoid some of these regulatory concerns by selling the higher risk loans on the secondary market. *See* Baron, *supra* note ____, at 83.

At worst, the regulatory concerns include closure. In July 2001, FDIC regulators closed down Superior Bank, FSB when the bank "ran aground lending money to people with bad credit." David Barboza, *Regulators Close Savings and Loan after Partnership Disintegrates*, N. Y. TIMES, July 31, 2001.

In January 2001, federal banking regulators increased the capital requirements for all institutions with subprime lending programs that equaled or exceeded twenty-five percent of their tier one regulatory capital. Board of Governors of the Federal Reserve System *et al.*, Expanded Interagency Guidance on Subprime Lending (Jan. 31, 2001); Seth Lubove, *Bust and Boom in the Subprime Market: Wall Street Overhyped it a Few Years Ago and Underrates it Now: the Business of Lending to Iffy Consumers*, FORBES, Dec. 27, 1999, at 71 (citing statement by then FDIC Chairman Donna Tanoue that the banks she oversaw that were involved with subprime lending would be "getting extra attention from her examiners"); Susan M. Phillips, *The Place of Securitization in the Financial System: Implications for Banking and Monetary Policy in* Kendall & Fishman, *supra* note ______, at 137 (stating that the Federal Reserve is concerned "whether there is an appropriate level of protection for unsophisticated parties," and has questions about "banks' responsibilities in assessing whether a transaction is appropriate for a particular customer"); *cf.* Jeffrey W. Gunther, *Between a Rock and a Hard Place: The CRA-Safety and Soundness Pitch*, ECON. AND FINANCIAL REV. 32 (2nd Quar. 1999) (discussing safety and soundness concerns in the context of CRA lending).

c. Difficulties Assessing Creditworthiness

Borrower creditworthiness and collateral are core concerns of regulated lenders¹⁵⁶ regardless whether they are engaged in prime, subprime or predatory lending. This is because bank examiners require banks to document the ability of borrowers to repay their loans and the adequacy of the equity in the property securing the loans. These concerns, which unregulated lenders do not have, are made more burdensome by the fact that banks and thrifts are ill-equipped to evaluate the creditworthiness of many LMI borrowers or to assess property values in LMI neighborhoods.

and the Office of Thrift Supervision announced that, in light of securitization, they would review institutions that purchased mortgage-backed securities on the secondary market and might "require, in appropriate circumstances, that [these] institutions hold additional capital commensurate with their risk exposure." Office of the Comptroller of the Currency *et al.*, Interagency Guidance on Asset Securitization Activities 11 (Dec. 13, 1999). Federal banking regulators also have proposed joint interagency regulations that would require insured banks and thrifts to hold higher capital against residual interests retained from asset securitizations. Federal Reserve System *et al.*, Notice of Proposed Rulemaking, *Capital; Leverage and Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance; Residual Interest in Asset Securitization or Other Transfers of Financial Assets*, 65 Fed. Reg. 57993 (Sept. 27, 2000).

HUD-Treasury Report, *supra* note , at 18.

There are some regulations and laws that predatory lenders may be more sensitive to than legitimate lenders. For example, one subprime lender stated that it would "shy away from states like Illinois with . . . stringent licensing requirements." Scott Kersnar, *JBI Funding Stresses Service as it Starts High LTV Lending*, NATIONAL MORTGAGE NEWS (Sept. 22, 1997). Similarly, predatory lenders may avoid states where the costs of foreclosure are high and instead opt to focus their lending activity in states where they more economically can strip equity and foreclose. *See* Clauretie & Herzog, *supra* note ____, at 221 (outlining the various foreclosure provisions across states and observing that foreclosure rates are higher in states where the laws facilitate the foreclosure process); Terrence M. Clauretie, *State Foreclosure Laws*, *Risk Shifting*, *and the Private Mortgage Insurance Industry*, 56 J. OF RISK AND INSURANCE 544, 547 (1989) (citing a 1975 Federal Home Loan Bank Board study that found that "the magnitude of the financial impact of foreclosure is a function of state foreclosure law"); Austin J. Jaffe & Jeffrey M. Sharp, *Contract Theory and Mortgage Foreclosure Moratoria*, 12 J. REAL ESTATE FINANCE & ECON. 77, 80-82, and 88 (1996) (discussing the impact of foreclosure moratoria legislation on loan prices).

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

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

LITAN *et al.*, BASELINE REPORT, *supra* note ____, at 87-88. For example, LMI borrowers are more likely to have weak or non-existent credit histories. Similarly, some LMI borrowers do not have documentation of their finances in a form that is easy for lenders to assess, *e.g.*, people who are self-employed or who function solely in the cash economy. *See* Passmore & Sparks, *supra* note ____, at 3.

See Avery et al., Information Dynamics supra note ____ (noting that it is expensive to gather information on loan applicants and neighborhoods).

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

The increased availability of historical data on subprime loans and more sophisticated underwriting models should lead to more cost-effective and accurate risk assessment throughout the home mortgage market. Robert B. Avery et al., Credit Risk, Credit Scoring, and the Performance of Home Mortgages, FED. RES. BULL. 621, 627 (July 1996); see also Raphael W. Bostic & Brian J. Surette, Have the Doors Opened Wider? Trends in Home Ownership Rates by Race and Income 9 (Working Paper April 2000) (discussing the efficiency gains from credit scoring and automated underwriting in the subprime market).

Klausner, *supra* note ____, at 1567-68; *see also* Robert B. Avery *et al.*, *Neighborhood Information and Home Mortgage Lending*, 45 J. URBAN ECON. 287 (1999) (empirically finding that there are economies of scale to collecting information on neighborhood characteristics, but that insufficient market demand may prevent banks from exploiting these economies).

In addition to the costs associated with assessing risk, banks would incur additional costs servicing loans. This is because the servicing of higher risk loans entails special expertise and more personnel than prime loans require. Lax *et al.*, *supra* note _____, at 18.

Similarly, the lack of available data on home values in LMI neighborhoods can impede banks' ability to accurately assess the value of property securing loans. In low and moderate income communities, where there are fewer home sales, there is little comparative data on home values. Without reliable comparative data, ¹⁶¹ banks may not be able to provide the documentation on home values that examiners require. Given that traditional methods for validating home appraisals in the prime market are not available, lenders need to develop alternative tools for determining the value of homes. Again, this would require a level of specialization and an expenditure of funds that banks and thrifts may be unwilling to assume.

Relative to banks and thrifts, predatory lenders are much less concerned about borrower risk because they can engage in an array of possible deceptions and then unload their loans on the secondary market. Even if secondary market institutions attempt to shift the loss back to lenders when borrowers default, lenders can avoid liability by dissolving or declaring bankruptcy. In addition, predatory lenders do not have regulators and examiners looking over their shoulders to ensure that borrowers are creditworthy and that their loans are adequately collateralized. Lastly, predatory lenders are willing to pursue foreclosure aggressively, which makes it more likely that they will recover their investments before property values decline.

When predatory lenders do engage in some evaluation of borrowers' risk, they can do so more cost effectively than banks. This is because predatory lending is a niche market. Lenders serving this market focus on one class of borrowers and provide only one service -- home loans. This enables them to concentrate on particular geographic areas, and, either directly or through

Avery et al., Information Dynamics, supra note _____ (noting that it is expensive to gather information on loan applicants and neighborhoods); see also William W. Lang & Leonard I. Nakamura, A Model of Redlining, 33 J. OF URBAN ECON. 223 (1993) (modeling the effect of limited sales transactions on banks' willingness to lend in poor and minority areas); David C. Ling & Susan M. Wachter, Information Externalities and Home Mortgage Underwriting, 44 J. OF URBAN ECON. 317 (1998) (empirically establishing the Lang and Nakamura hypothesis).

brokers, gather information about the relevant economic conditions and residents. They then use this information to determine home values and borrowers' creditworthiness.

d. Discrimination

The racial composition of the neighborhoods that predatory lenders target is disproportionately people of color. To the extent that banks have an aversion to lending to people of color that outweighs any market incentives to expand into subprime and/or predatory lending, they will refuse to lend in these areas. Similarly, lenders may use race as a proxy if they find that it is correlated with creditworthiness. If race is easy to determine and creditworthiness is not, then making loans based on race can be more efficient for lenders than investing significant resources into determining applicants' ability to pay. Of course, either type of discrimination, whether based on animus or efficiency, is illegal. In contrast to banks, some of which may discriminate against people of color, predatory lenders target people of color

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

For a discussion of the few banks that successfully have specialized in non-predatory, LMI, neighborhood-based lending, *see* Klausner, *supra* note ____, at 1578-79.

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

Charles W. Calomiris et al., Housing Finance Intervention and Private Incentives: Helping Minorities and the Poor, 26 J. of Money, Credit & Banking 634, 650 (1994).

precisely because discrimination, as well as credit rationing, has prevented these borrowers from having access to capital.

e. Geographic Constraints

Banks and thrifts, for the most part, do not have a significant presence in LMI neighborhoods.¹⁶⁵ As a result, they have limited opportunities to develop relationships with LMI borrowers at retail sites¹⁶⁶ or to obtain valuable information on social capital in LMI communities.¹⁶⁷ To compound this problem, LMI borrowers may be reluctant to approach banks and thrifts outside their own neighborhoods.¹⁶⁸ Thus, banks' most effective means of soliciting customers whom they could target for predatory loans would be to establish or, in some cases, re-establish branch banks in LMI neighborhoods, operate out of storefronts¹⁶⁹ or solicit borrowers

A number of major cities have small, minority-owned banks that one might expect to fill some of the gap in lending that was created when larger banks left LMI neighborhoods. However, anecdotal and statistical evidence suggests that these banks have not filled the gap and that their lending practices parallel those of their large, commercial counterparts. This may be because the banks do not have sufficient capitalization. *See* Hylton & Rougeau, *supra* note ____, at 254-255.

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

Cf. Michael S. Padhi et al., Credit Scoring and Small Business Lending in Low and Moderate Income Communities, in Business Access to Capital and Credit 587, 604-605 (1999) (empirically finding that the presence of branch banks in LMI communities is "a significant factor" in the number of small business loans that lenders originate).

Hylton, *supra* note _____, at 218.

LITAN et al., BASELINE REPORT, supra note ____, at 18.

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

door-to-door. Banks may perceive that the cost of establishing new offices would outweigh any profits¹⁷⁰ they could realize from predatory lending. Less expensive options like, storefront operations and door-to-door solicitations, often run counter to bank culture.

f. The Role Of Holding Company Subsidiaries And Affiliates Of Banks And Thrifts

Although there are compelling reasons why banks and thrifts may be reluctant to enter LMI communities and compete with predatory lenders, banks and thrifts can be involved in and benefit from predatory lending in a veiled capacity. Some banks and thrifts, whose direct lending is legitimate, have subsidiaries and affiliates that employ predatory lending practices. For example, in July 2001, employees of CitiFinancial Mortgage, a subprime mortgage lending unit of Citigroup, Inc., signed affidavits alleging that Citifinancial "had a policy of not giving borrowers legally required disclosures in a timely manner, that employees there regularly forged borrowers' signatures on legal documents, and that loan officers were instructed to avoid telling

Some banks have established branches in supermarkets or partnered with check-cashing outlets. *See*, *e.g.*, Laura Mandaro, *Union Bank*, *Check Casher Team Up*, Am. BANKER, Sept. 25, 2000 at 1. These lenders have the vantage point and customer base that could make it profitable for them to engage in LMI lending.

Even if banks opened new branches in LMI neighborhoods, borrowers, who have experienced mortgage lending discrimination by banks in the past or who for other reasons are wary of banks might not consider applying for bank loans. This could further reduce the potential profitability to banks of setting up branches in LMI neighborhoods. *See* Hylton & Rougeau, *supra* note ____, at 250 (discussing the demoralizing effect of discrimination); *see also* Anthony Pennington-Cross *et al.*, *Credit Risk and Mortgage Lending: Who Uses Subprime and Why*? 14, 16 (Research Institute for Housing America Working Paper No. 00-03, Oct. 2000) (discussing the role that fear of discrimination may play in the decision of whom people of color approach for loans); Barbara A. Good, *The "Unbanked" Population: Who are They and Why Do They Shun Banks?*, COMMUNITY REINVESTMENT FORUM 2 (1998) (citing John P. Caskey, FRINGE BANKING: CHECK-CASHING OUTLETS, PAWNSHOPS, AND THE POOR (1994) (citing findings that unbanked consumers "harbor a deep-seeded distrust of financial institutions and prefer to handle their financial affairs through alternative financial service providers")).

During a period of declining profits on prime loans, banks may have a strong incentive to increase their bottom-line profitability by having subsidiaries enter the subprime/predatory lending market. For a general discussion of banks purchasing subprime lenders, some of which could engage in predatory lending, *see* Lubove, *supra* note ____, at 71; Gilreath, *supra* note ____ at 149.

potential borrowers about points and fees on loans."¹⁷² These alleged practices fall within our definition of predatory lending.

Bank subsidiaries and affiliates can shield their relationships with their parent or sister banks by functioning under different names.¹⁷³ The lack of a transparent association allows the subsidiaries and affiliates to offer predatory loans without many of the regulatory and reputational concerns that the banks would have to take into account if they adopted predatory lending tactics.¹⁷⁴ Banks and thrifts can also play a role in predatory lending by purchasing securities that are backed by mortgages obtained through predatory lending.

5. Impediments To Legitimate Subprime Lenders Making Loans To Borrowers Who Are Disconnected From The Credit Market

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

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

LITAN *et al.*, BASELINE REPORT, *supra* note ____, at 76 (discussing how banks can use subsidiaries to engage in subprime lending without having to contend with the same reputational concerns banks face).

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Rob Garver, Citi Corroborates Two Allegations, Am. BANKER, July 30, 2001.

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

Legitimate subprime lenders, like banks and thrifts, rely on widespread, impersonal marketing to attract customers. For example, they advertise their products through mass mailings, in newspapers and on-line. This business model is based on the premise that their potential customers are people who are looking for loans and are comfortable contacting an anonymous lender and/or using a computer to apply for a loan. Given that the people who fall prey to predatory lenders tend not to be actively looking for loans, are disconnected from the credit market, and do not know how to shop for loans, they are unlikely to respond to the marketing efforts that legitimate subprime lenders have adopted. 175 As a result of these differences in marketing strategies, legitimate subprime and predatory lenders serve separate and distinct groups of borrowers. The legitimate subprime lenders attract and cater to borrowers who have blemished credit histories, but are knowledgeable enough about credit markets to shop for loans among legitimate subprime lenders. In contrast, predatory lenders solicit and cater to borrowers who need credit (and may or may not be high risk) and are disconnected from the credit market. For legitimate subprime lenders to attract the borrowers that predatory lenders serve, they would have to transform their business models and engage in unsavory practices that they may find untenable.

6. Lack Of Price Competition Among Predatory Lenders

One also would expect that competition among predatory lenders would drive down the price of loans. Again, information asymmetries prevent this from occurring.¹⁷⁶ The typical borrowers who commit to predatory loans often believe that they are ineligible for any credit.

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

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

Frequently, they are not actively looking for loans even though they have pressing financial needs. These borrowers have little or no experience with lenders and loan terms, ¹⁷⁷ and do not know how to shop for credit. The arrival of a lender on their doorstep just when they are facing a daunting financial obligation is a "dream come true." They leap at the chance to obtain the money and look no further, fearful that the opportunity to borrow is fleeting. ¹⁷⁸ As a result, they do not look beyond the lenders whom approach them first. Although the predatory lenders who reach borrowers first do run the risk that other lenders will be on their heels and will offer less expensive loans, the lenders minimize this risk by creating a false sense of urgency¹⁷⁹ so that borrowers will move quickly to commitment and closing. The combination of market power¹⁸⁰

It is noteworthy that Freddie Mac is trying to reach these same borrowers by putting personal computers that have access to information on homeownership and credit at selected McDonald's restaurants. Amilda Dymi, *Financial Literacy on McDonald's Menu*, The Banking Channel, August 6, 2001 (available at http://www.thebankingchannel.com).

HUD-Treasury Report, *supra* note ____, at ____. This is particularly true for borrowers who are facing a serious personal crisis, *e.g.*, the need to generate cash to cover a family member's medical care or prosecution for housing code violations.

Predatory lenders often accelerate the loan process by telling borrowers that the time period in which they can secure the loan is limited. HUD-Treasury Report, *supra* note _____, at 79.

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

As Richard Hynes and Eric A. Posner have noted, "[e]ven if there are numerous lenders in a market, each lender may have market power because of the inability of consumers to costlessly compare prices and terms. Depending on the source of the information failure, this may result in either an abnormally high price or abnormally harsh [loan] terms. Some creditors will lend only to those customers who are unable to compare the (price or nonprice) terms of the loan offered with the terms available elsewhere in the market." Richard Hynes & Eric A. Posner, *The Law and Economics of Consumer Finance* 6 (Working Paper February 20, 2001).

and savvy thus enables predatory lenders to write loans with onerous terms that borrowers cannot decipher. 181

IV. REMEDIES

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

A. Market Discipline

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

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

See, e.g., E. Allan Farnsworth, Contracts § 4.29 (2d ed. 1990) ("legislatures have favored . . . disclosure of terms, rather than control of terms . . . as more consistent with a market economy") (hereinafter "Farnsworth (1990)").

Despite these predictions, the market will not correct. As we have already discussed, regulatory and reputational concerns impede legitimate lenders from entering the subprime market. In addition, the marketing strategies that they would have to employ to reach the typical victims of predatory lending run counter to their business plans and firm culture. Likewise, secondary market purchasers will not drive out predatory lenders. This is because the protections that secondary market purchasers implement to insulate themselves from the harms arising from predatory lending do not trickle down to benefit the consumer victims of predatory lending.¹⁸³

B. Remedies Under Contract Law And The Uniform Commercial Code

By definition, predatory loans are grounded in the law of contract and the Uniform Commercial Code, which govern promissory notes and security agreements. Most contract defenses go to defects in formation of assent, rather than to disparities in bargaining power or fairness in contracts' substantive provisions.¹⁸⁴

Three doctrines in the law of contracts and the U.C.C. permit challenges to the underlying substance of contract provisions: unconscionability, impracticability and frustration.

Of these, the latter two generally do not apply to predatory lending cases.¹⁸⁵ The doctrine of unconscionability holds out some promise for victims of predatory lending, although its utility in practice has been limited.

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See Section ____ supra.

Traditional contract defenses include fraud, mental incompetency, incapacity, infancy, duress, undue influence and mistake. In general (apart from infancy and fraud), these defenses are construed narrowly so as to preclude relief in the vast majority of cases. *See generally* E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS chs. 4-5, 9 (2d ed. 1998).

Impracticability only applies when a party to a contract cannot perform for reasons outside that party's control, such as a change in the controlling law. Frustration is limited to situations in which the contract relies on

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

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

Although Section 2-302 only applies by its terms to "transactions in goods" and not to credit, numerous courts have extended the unconscionability doctrine to contracts generally.¹⁸⁶

Unconscionability has been defined to include "an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party." For a number of reasons, many courts have been reluctant to condemn excessive prices as unconscionable, "without more." As E. Allan Farnsworth has explained, "the price

the occurrence of an event that later fails to materialize. *See generally* James J. White & Robert S. Summers, UNIFORM COMMERCIAL CODE § 3-10 (2000).

See Farnsworth (1990), supra note ____, § 4.28. The doctrine of unconscionability can be used as a defense to enforcement of a contract. See id. Recent cases have also allowed borrowers to sue affirmatively for unconscionability in order to obtain damages, rescission or injunctive relief. See, e.g., Associates Home Equity Services, Inc. v. Troup, No. A-3410-00T1F, 2001 N.J. Super. LEXIS 318, at *29-*33 (N.J. App. July 25, 2001); Williams v. First Gov't Mortgage & Investors Corp., 225 F.3d 738, 747-752 (D.C. Cir. 2000); Dienese v. McKenzie Check Advance of Wisconsin, LLC, Case No. 99-C-50, slip op. at *10-*13 (E.D. Wis. Dec. 11, 2000); Mitchem v. American Loan Co., 2000 U.S. Dist. LEXIS 5785, at 9-11 (N.D. Ill. Mar. 13, 2000); Sharp v. Chartwell Financial Services, 2000 U.S. Dist. LEXIS 3143, at *10-*12 (N.D. Ill. Feb. 28, 2000); Eva v. Midwest Nat'l Banc, Inc. 143 F.Supp.2d 862, 894-96 (N.D. Ohio 2001); Cobb v. Monarch Finance Corp., 913 F. Supp. 1164, 1179 (N.D. Ill. 1995).

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

Farnsworth (1990), *supra* note ____, § 4.28. For the rare cases to the contrary, *see* White & Summers, *supra* note ____, § 4-5 ("the reported litigation based on excessive price has dwindled to a trickle"). *See also* Carpenter v. Suffolk Franklin Sav. Bank, 346 N.E.2d 892, 900 (Mass. 1976) (suit to enforce a mortgage); Steven W. Bender, *Rate Regulation at the Crossroads of Usury and Unconscionability: The Case for Regulating Abusive Commercial and Consumer Interest Rates Under the Unconscionability Standard, 31 Hous. L. Rev. 721, 762 (1994) ("[p]rice litigation has slowed under section 2-302"; noting that unfair pricing claims generally proceed under newer statutes with more detailed standards); Farnsworth (1990), <i>supra*, § 4.28. The fact that the plaintiff signed a non-negotiable boilerplate loan agreement that was drafted by the lender is usually not enough, standing alone, to demonstrate unconscionability. *See id.*

term is somewhat peculiar, for rarely can a party claim surprise as to price."¹⁸⁹ Of equal importance, courts have legitimate reservations about their competence to judge fairness as to price. Accordingly, to the extent that borrowers have prevailed in asserting unconscionability, they have largely prevailed only with respect to non-price terms in loan contracts.¹⁹⁰

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

Farnsworth (1990), *supra* note ____, § 4.28. *See also* White & Summers, *supra* note ____, § 4-5.

See, e.g., Williams v. Walker-Thomas Furniture Co., 350 F. 2d 445 (D.C. Cir.1965) (striking down a security provision that gave the seller the right to repossess all consumer purchases by a borrower if she missed a payment before her debt on all of her retail installment accounts had been paid; retailer sold borrower a \$514 stereo on credit knowing that she had seven children and only received \$218 a month in welfare).

See generally White & Summers, supra note ____, §§ 14-1 through 14-7.

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

The Federal Trade Commission's (FTC) rule abrogating the holder in due course rule only applies to HOEPA loans and the financing of sales of goods or services secured by home mortgages. *See id.* § 4-9(b) (discussing FTC holder in due course regulations, 16 C.F.R. § 433.2); THE COST OF CREDIT, *supra* note ____, at 426; 12 C.F.R. § 226.32(e) (HOEPA); Federal Reserve, *Truth in Lending, supra* note ____, at 81438. *See also* Associates Home Equity Services, Inc. v. Troup, No. A-3410-00T1F, 2001 N.J. Super. LEXIS 318, at *21-*29 (N.J. App. July

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

The sum effect of these limitations is to make it exceedingly difficult for borrowers to challenge their loan agreements as void under traditional contract law or the Uniform Commercial Code. Secondary market purchasers can evade responsibility for most misconduct by loan originators, thereby depriving borrowers of relief and relieving loan purchasers of important incentives to police loan originators.

C. Antifraud Laws

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

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^{25, 2001) (}holding that a fact issue existed whether lenders who granted mortgage to finance home repairs could cut off claims under the holder in due course rule).

See, e.g., Creola Johnson, Welfare Reform and Asset Accumulation: First We Need a Bed and a Car, 2000 Wis. L. Rev. 1221, 1256 (2000); Walter K. Olson, The Litigation Explosion 211 (1991); Arthur A. Leff, Unconscionability and the Crowd--Consumers and the Common Law Tradition, 31 U. Pitt. L. Rev. 349, 354-57 (1969) (criticizing case-by-case litigation of unconscionability claims as inefficient in consumer transactions); Sinal Deutch, Unfair Contracts 243 (1977) (unconscionability challenges are rare due to the cost and risk of litigation).

See, e.g., RESTATEMENT OF THE LAW, SECOND, TORTS §§ 525, 537-45.

The limited scope of common-law fraud, coupled with pragmatic concerns, has constrained the number of criminal fraud prosecutions against predatory lenders and brokers. Effective criminal fraud prosecution depends on the willingness of district attorneys to prosecute predatory lending fraud. With isolated exceptions such as the model program in the County of Los Angeles, 195 state criminal law systems have been slow to mount fraud prosecutions against predatory lenders. In part, this is due to the technical nature of predatory lending cases, combined with the lack of systematic reporting systems to bring predatory abuses to prosecutors' attention. Even absent these impediments, the fact that state criminal enforcement is highly dispersed at the local level means that individual local prosecutors make the decision whether to make predatory lending a priority. All too often, limited local expertise, constrained resources and other pressing prosecutorial demands, such as violent crime and drug trafficking, combine to militate against prosecution.

Criminal fraud actions generally afford little or no relief to the victims of predatory lending. Rather, private causes of action for common-law fraud are the vehicles for such redress. As mentioned earlier, however, "fraud" is narrowly defined at common law. In addition, common-law fraud actions may not afford victims full relief in the form of loan forgiveness. Similarly, the private bar lacks adequate incentives to file suits for loan fraud. Under the "American Rule," in which each party bears its own attorneys' fees and costs, suits for injunctive relief such as rescission or loan forgiveness generally do not generate sufficient funds to compensate plaintiffs' counsel. The need to prove individual reliance, moreover, in fraud cases

See Joan Potter, Fighting Home Equity Fraud and Predatory Lending: One Community's Solution, Community Reinvestment Report (Federal Reserve Bank of Cleveland Summer 2000). See also Mike Tobin & Bob Paynter, Feds raid real estate, mortgage operations, Plain Dealer, Aug. 22, 2001, at A1.

often makes it difficult to bring class actions. Compounding matters, mandatory arbitration clauses in many predatory loan agreements preclude resort to court altogether.

In response to the limitations inherent in common-law fraud, in the twentieth century, Congress, all of the states and the District of Columbia passed unfair and deceptive acts and practices (UDAP) statutes.¹⁹⁶ The federal statute, which the states followed, prohibits unfair or

 196 See generally National Consumer Law Center, Unfair and Deceptive Acts and Practices § 1.1 (4th ed. 1997 & Supp.) (hereinafter cited as "Unfair and Deceptive Acts and Practices").

The Racketeer Influenced and Corrupt Organization Act (RICO), 18 U.S.C. §§ 1961 et seq., may afford another source of civil redress and one that offers treble damages. Cf. Emery v. American General Finance, 71 F.3d 1343, 1395 (7th Cir. 1996) (ruling that complaint stated a claim under state civil Racketeering Influenced and Corrupt Organization statute for predatory lending). Under RICO, "any person injured in his business or property by reason of a violation of section 1962" may sue for civil redress. 18 U.S.C. § 1964. Section 1962 forbids "any person" from (a) using income received from a pattern of racketeering activity or from the collection of an unlawful debt to acquire an interest in an enterprise affecting interstate commerce; (b) acquiring or maintaining through a pattern of racketeering activity or through collection of an unlawful debt an interest in an enterprise affecting interstate commerce; (c) conducting or participating in the conduct of the affairs of an enterprise affecting interstate commerce through a pattern of racketeering activity or through collection of an unlawful debt; and (d) conspiring to participate in any of these activities. Richard L. Bourgeois, Jr. et al., Racketeer Influenced and Corrupt Organizations, 37 Am. CRIM. L. REV. 879 (2000); 18 U.S.C. § 1962. A "pattern of racketeering activity" requires proof of commission of two or more predicate acts, among which are mail fraud and wire fraud. 18 U.S.C. § 1961(1); H.J., Inc. v. Northwestern Bell Telephone Co., 492 U.S. 229 (1989); Sedima, S.P.R.L. v. Imrex Co., 473 U.S. 479 (1985). For a comprehensive description of the elements of RICO, see Bourgeois et al., supra (the elements of a RICO claim include: "(A) two or more predicate acts of racketeering activity; (B) pattern; (C) enterprise; (D) effect on interstate commerce; (E) prohibited acts; and (F) scope of outsider liability.").

RICO claims are not a panacea, however. Because the typical RICO claim in the predatory lending context would rest on predicate acts of fraud, RICO claims for predatory lending have some of the same drawbacks as fraud claims generally. See, e.g., Vandenbroeck v. Commonpoint Mortgage Company, 210 F.3d 696, 701-02 (6th Cir. 2000) (holding that plaintiffs failed to allege mail fraud or wire fraud with specificity). Furthermore, satisfying the complex elements of a RICO claim can be difficult. For RICO violations under Section 1962(c), the defendant must be distinct from the enterprise. See Cedric Kushner Promotions, Ltd. v. King, ___ U.S. ___, 121 S.Ct. 2087, 2090-91 (2001). Proof of that distinction can be difficult in predatory lending cases. See Vandenbroeck v. Commonpoint Mortgage Company, 210 F.3d 696, 699-701 (6th Cir. 2000) (holding that plaintiffs failed to allege that subprime lender and the secondary purchasers to whom it sold formed an enterprise). In addition, the circuits disagree on what level and duration of activity rises to a pattern of racketeering. See Bourgeois, supra, at 885-92, 900. Indeed, under analogous provisions in HOEPA providing a cause of action for a pattern and practice of assetbased lending, 15 U.S.C. § 1639(h), 12 C.F.R. § 226.32(e)(1), plaintiffs have had difficulty proving that lenders engaged in a pattern and practice of making subprime mortgages without regard to repayment ability. See Newton v. United Companies Financial Corp., 24 F. Supp. 2d 444, 456 (E.D. Pa. 1998). See generally Donna S. Harkness, Predatory Lending Prevention Project: Prescribing a Cure for the Home Equity Loss Ailing the Elderly, 10 B.U. PUB. INT. L.J. 1, 14-15, 24-26 (2000). Proving a pattern of racketeering is also costly, involving extensive discovery and expert witnesses. Finally, some predatory lending victims have had difficulty satisfying the statute of limitations under RICO. See Hargraves v. Capital City Mortgage Corp., 140 F. Supp. 2d 7 (D.D.C. 2000) (granting summary judgment for lenders on certain RICO claims due to limitations bar).

deceptive acts or practices in or affecting trade or commerce.¹⁹⁷ The federal act grants enforcement to the Federal Trade Commission (FTC), but does not provide a private right of action (either express or implied).¹⁹⁸ In contrast, state UDAP statutes usually allow for private damages actions as well as enforcement by the state.¹⁹⁹

The FTC has filed a number of recent enforcement actions challenging actions by predatory lenders as unfair and deceptive under Section 5 of the Federal Trade Commission Act. Some of those actions have resulted in monetary relief to borrowers.²⁰⁰ Nevertheless, the absence of a private cause of action and constraints on the FTC's enforcement resources make private relief under the Federal Trade Commission Act highly unlikely for the vast majority of victimized borrowers.

Although state UDAP statutes allow private rights of action, they are sometimes restricted in their scope. Some state statutes exclude credit and insurance transactions, often

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Section 5(a)(1) of the Federal Trade Commission Act, 15 U.S.C. § 45(a)(1).

See Unfair and Deceptive Acts and Practices, supra note _____, § 9.1 & n.2 (citing cases).

¹⁹⁹ See id. ch. 8.

²⁰⁰ See FTC v. Fleet Finance, Inc., No. C3899 (FTC Oct. 5, 1999) (settlement resulting in \$1.3 million in consumer redress and injunctive relief, based on charges that failure to provide accurate, timely disclosure of the costs and terms of home equity loans to consumers and cancellation rights violated Section 5 of the Federal Trade Commission Act); Consent Judgment and Order, FTC v. Barry Cooper Properties, No. 99-07782 WDK (Ex) (C.D. Cal. July 30, 1999) (asset-based lending violated Section 5); Complaint, FTC v. Capital City Mortgage Corp., No. 1:98-CV-00237 (D.D.C. filed Jan. 29, 1998) (alleging that asset-based lending violated the Federal Trade Commission Act); Prepared Statement of the Federal Trade Commission before the California State Assembly Committee on Banking and Finance on Predatory Lending Practices in the Home-Equity Lending Market 5-7 (Feb. 21, 2001) (available at http://www.ftc.gov/os/2001/02/predlendstate.htm); FTC, Sub-prime Lender Agreed to Pav \$350,000 Civil Penalty to Settle Charges of Violating Federal Lending Laws, Press Release (Aug. 24, 2000) (lender violated Section 5 by misrepresenting that consumers were purchasing only credit life insurance when, in fact, they were also purchasing accident and health insurance); FTC, Home Equity Lenders Settle Charges That They Engaged in Abusive Lending Practices; Over Half Million Dollars To Be Returned to Consumers, Press Release (July 18, 2000). See also Paul Beckett, FTC Charges Citigroup Unit In Lending Case, WALL St. J., Mar. 7, 2001, at B15; Richard A. Oppel, Jr., U.S. Suit Cites Citigroup Unit on Loan Deceit, N.Y. TIMES, Mar. 7, 2001, at A1. The FTC has predicated other enforcement actions and counts involving allegations of predatory lending on violations of the HOEPA, TILA, RESPA, ECOA, and the Fair Debt Collection Practices Act. See Prepared Statement of the Federal Trade Commission, supra, at 5-7.

because financial institutions are exempted or because credit and insurance are deemed not to be "goods and services." In states where state UDAP statutes do cover credit, enforcement heavily depends on the priorities of individual state attorneys general and available resources.

Only a few attorneys general, such as in North Carolina and New York, have actively pursued enforcement of any sort under state UDAP statutes. Similarly, weak attorneys' fee provisions in some state UDAP statutes discourage the private bar from bringing state UDAP claims.

D. Disclosure

Disclosure is yet another paradigm for remedying abusive lending practices. In consumer lending, several federal statutes mandate the disclosure of standardized price information on loans. For example, TILA requires lenders to disclose finance charges and annual percentage rates to applicants for home mortgages.²⁰⁴ Similarly, RESPA entitles home mortgage borrowers to good faith estimates of settlement costs (GFEs) and statements of their actual closing costs in HUD-1 settlement statements.²⁰⁵

For high-cost, closed-end home mortgages (other than purchase money mortgages),
HOEPA requires additional disclosures three days before closing.²⁰⁶ Under HOEPA's advance

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See Unfair and Deceptive Acts and Practices, supra note ____, §§ 2.2.1-2.2.1.4, 2.3.1.

See, e.g., National Association of Attorneys General, Need Cash? Carefully Examine Your Options First (available at http://www.naag.org/consumer/needcash.cfm); Richard A. Oppel Jr. & Patrick McGeehan, Along with a Lender, Is Citigroup Buying Trouble?, N.Y. TIMES, Oct. 22, 2000, at § 3, p. 1; Rob Christensen, Easley, NEWS AND OBSERVER (RALEIGH, N.C.), Oct. 6, 2000, at A1; Office of New York State Attorney General Eliot Spitzer, Court Freezes Assets of Mortgage Bank, Press Release (Feb. 22, 2001) (Anvil Mortgage Bank, Ltd.); Office of New York State Attorney General Eliot Spitzer, Spitzer Announces Landmark, \$6 Million Settlement With Long Island Mortgage Company, Press Release (June 23, 1999) (settlement with Delta Funding).

See Unfair and Deceptive Acts and Practices, supra note ____, §§ 8.8.2.1-8.8.6.2.

See notes ____- supra and accompanying text.

See notes _____ supra and accompanying text.

²⁰⁶ 15 U.S.C. §§ 1601 *et seq.* HOEPA is a subsection of TILA.

disclosure provisions, the lender must inform the borrower of the APR and the dollar amount of the periodic payments. HOEPA lenders must also advise borrowers in writing that they could lose their homes and are not obligated to proceed to closing simply because they signed a loan application or received disclosures. Finally, for adjustable rate mortgages that fall within HOEPA, lenders must disclose that the interest rate and monthly payment could increase, plus the amount of the single maximum monthly payment.²⁰⁷

Violations of all three statutes are subject to agency enforcement.²⁰⁸ Violations of TILA and HOEPA are also subject to criminal penalties.²⁰⁹ In addition, TILA, RESPA and HOEPA authorize private rights of action, but differ significantly in the types of relief they afford borrowers. Under TILA, injured borrowers may seek actual damages, statutory damages and attorneys' fees, either individually or in class actions.²¹⁰ In addition, homeowners can stave off foreclosure for up to three years after closing under TILA's provisions granting the right to rescind covered home mortgages, where specified disclosures were not correctly made at

Agency enforcement authority for RESPA is vested in HUD. 12 U.S.C. §§ 2602(6), 2617.

²⁰⁷ 12 C.F.R. § 226.32(c). *See generally* NATIONAL CONSUMER LAW CENTER, TRUTH IN LENDING ch. 10 (4th ed. 1999) (hereinafter cited as "TRUTH IN LENDING").

In December 2000, the Federal Reserve Board proposed amending HOEPA's regulations to provide that HOEPA borrowers must be informed in advance of the loan closing that the total amount borrowed may be substantially higher than the amount requested due to the financing of insurance, points and fees. *See* Federal Reserve, *Truth in Lending*, *supra* note ____, at 81438.

¹⁵ U.S.C. § 1607. The Federal Reserve Board of Governors has exclusive authority for promulgating regulations implementing TILA and HOEPA. 15 U.S.C. § 1604(a). Responsibility for enforcing TILA and HOEPA, however, is divided among nine federal agencies. 15 U.S.C. §§ 1607(a), (c). *See* Rohner & Miller, *supra* note ____, ¶¶ 6.09[5], 13.02 (2000). State attorneys general are also empowered to enforce HOEPA. 15 U.S.C. § 1640(e). *See* TRUTH IN LENDING, *supra* note ____, §10.6.3.

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

See generally Truth in Lending, supra note, ch. 8.

closing.²¹¹ HOEPA's private remedies include all of the remedies available under TILA, plus special enhanced damages consisting of all finance charges and fees paid by the borrower²¹² and expanded rights of rescission.²¹³

Under RESPA, private damages for erroneous disclosures generally cannot be awarded unless borrowers can prove that lenders: (1) failed to inform them that their loans could be transferred;²¹⁴ (2) received kickbacks;²¹⁵ or (3) steered them to title companies.²¹⁶ Specifically, lenders have no liability under RESPA for errors in GFEs or HUD-1 settlement statements, thereby weakening their incentives for accuracy.

TILA, RESPA and HOEPA all have major weaknesses in what activities they prohibit and the relief that they provide.²¹⁷ TILA has not lived up to its goal of standardizing disclosures on the total cost of credit because a long list of closing costs are currently excluded when

(affirming dismissal of rescission claim under TILA because notice of the right to cancel within three days in the

case complied with TILA).

See generally id. ch. 6. Julia Patterson Forrester has aptly pointed out, however, that often borrowers inadvertently waive this right in fast-moving foreclosure actions because naïve borrowers fail to assert affirmatively their TILA and HOEPA remedies. See Julia Patterson Forrester, Constructing a New Theoretical Framework for Home Improvement Financing, 75 ORE. L. REV. 1095, 1111-26, 1129-31 (1996); see also Associates Home Equity Services, Inc. v. Troup, No. A-3410-00T1F, 2001 N.J. Super. LEXIS 318, at *33-*37 (N.J. App. July 25, 2001)

²¹² 15 U.S.C. § 1640(a)(4). See generally Truth in Lending, supra note ____, § 10.6.

²¹³ 15 U.S.C. § 1635; 12 C.F.R. § 226.23(a)(3). *See generally* Truth in Lending, *supra* note ____, §§ 10.3.3, 10.6.2.

¹⁵ U.S.C. § 2605(f) (authorizing actual damages, statutory damages, costs and attorneys' fees).

²¹⁵ 15 U.S.C. § 2607 (authorizing treble damages and attorneys' fees).

¹⁵ U.S.C. § 2608. The defendant is liable for up to three times the amount that was charged for the title insurance. *Id.* § 2608(b).

HUD and the Federal Reserve Board raised concerns about the efficacy of these statutes in a joint report to Congress. HUD-Fed Joint Report, *supra* note ____, Executive Summary II. For a good description of additional evidentiary and limitations problems impeding relief under TILA and HOEPA, *see* Donna S. Harkness, *Predatory Lending Prevention Project: Prescribing a Cure for the Home Equity Loss Ailing the Elderly*, 10 B.U. PUB. INTEREST L.J. 1, 11-24 (2000).

computing finance charges and annual percentage rates.²¹⁸ These omissions are exacerbated when lenders pad closing fees and engage in insurance packing.

As previously discussed, in addition to deficient private enforcement, RESPA suffers from poorly thought-out timing provisions.²¹⁹ The result is lengthy and confusing GFEs and HUD-1 settlement statements that are too late and too unreliable to be meaningful to the consumers they are meant to serve.

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

Although HOEPA is an improvement over TILA and RESPA, HOEPA is easy to evade because of its narrow coverage. To begin with, HOEPA does not apply to purchase money mortgages, reverse mortgages or open-end credit lines of any kind.²²⁰ Furthermore, for home mortgages within its coverage, HOEPA only applies if at least one of the following triggers is satisfied:²²¹

• the annual percentage rate at consummation exceeds the yield on Treasury securities of comparable maturity plus ten percent; or

See HUD-Fed Joint Report, supra note ____, Executive Summary at VII-XI; notes ____- supra and accompanying text.

See notes _____ supra and accompanying text.

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

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

• the total points and fees exceed eight percent of the total loan amount or \$400 (subject to annual indexing), whichever is greater.

Accordingly, to evade HOEPA, a lender can either style a loan as an open-end extension of credit or keep the interest or total points and fees below the respective ten and eight percent triggers.²²² HOEPA's triggers are so high that most lenders, including predatory lenders, are able to price their loans below the triggers.²²³ Subprime lenders have compensated for the lower resulting interest rates by raising the charges for items excluded from total points and fees.²²⁴

A handful of states have responded to the problem of evading HOEPA by adopting measures, patterned after HOEPA to a large degree, that lower the triggers for lenders in those states. The first such measure was North Carolina's predatory lending statute, enacted in 1999.

John Weicher's data on the average interest rates on subprime loans confirm that lenders can easily make subprime loans that fall below HOEPA's triggers. According to Weicher, subprime rates closely track the interest rates on prime loans. On average, Weicher found that interest rates on B loans were 300 basis points higher than those on prime loans, 450 points higher on C loans and 600 points higher on D loans (D loans being the lowest quality subprime loans). (100 basis points equal one percentage point). *See* WEICHER, *supra* note _____, at 56-57 & table 4.1. Accordingly, even average rates for D loans fall below HOEPA's ten percent trigger.

In December 2000, the Federal Reserve Board proposed a regulation that would lower the APR trigger from ten to eight percent and expand the trigger for points and fees to include premiums paid at closing for optional credit protection products. In addition, the Board requested comments on whether to include all closing costs in the trigger for points and fees. The Board estimates that lowering the APR trigger by two percentage points would expand HOEPA's coverage from one to five percent of subprime mortgages. *See* Federal Reserve, *Truth in Lending, supra* note ____ at 81438.

To avoid HOEPA's disclosure requirements, lenders create lines of credit secured by borrowers' homes and advance the credit lines in their full amounts to the borrowers at closing. Effectively, these spurious "open-ended" mortgages are closed-end mortgages in all but name. See Sturdevant & Brennan, supra note ____, at 39. The Federal Reserve Board proposed rules in December 2000 that would prohibit creditors from including "payment on demand" or "call provisions" in HOEPA loans in order to classify home loans as open-end. See Federal Reserve, Truth in Lending, supra note ____ at 81438.

See, e.g., HUD-Treasury Report, supra note ____, at 81, 85; TRUTH IN LENDING, supra note ____, § 10.1.1; Woodstock Institute Testimony Before the Illinois House of Representatives' Hearing on Predatory Mortgage Lending by Daniel Immergluck, Chicago, Illinois (Oct. 13, 1999) (available at http://nonprofit.net/woodstock/predtest.html); Sturdevant & Brennan, supra note ____, at 36, 39.

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

In the statute, North Carolina retained the federal trigger for APRs of ten percent. The trigger for total points and fees was lowered, however, to five percent for total loan amounts greater than or equal to \$20,000 or the lesser of \$1,000 or eight percent of principal for smaller loans. North Carolina's statute is also broader than HOEPA because it covers home mortgages with prepayment penalties that either exceed two percent of the amount prepaid or are payable more than thirty months after closing.²²⁵ The New York Banking Board followed suit in 2000 by amending Part 41 of its regulations to lower the APR trigger from ten to eight percent and the trigger for total points and fees from eight to five percent.²²⁶

For their part, HUD and the Federal Reserve Board urged Congress in 1998 to enact amendments fine-tuning federal disclosure requirements.²²⁷ Those amendments are long overdue. Nevertheless, increased disclosure is not enough. Lenders will always find ways to evade disclosure requirements. Furthermore, most victims of predatory lending already find the current set of disclosures incomprehensible. For naïve borrowers, piling on more disclosures will not help. The high-pressure nature of closings only exacerbates confusion, by discouraging borrowers from reading loan documents at closing or asking questions when they do. Because most borrowers are not represented at closing, moreover, questions are likely to result in self-serving answers by title company officials or lenders. More disclosure would simply compound the confusion that currently exists.

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N.C.G.S. §§ 24-1.1E(a)(4), (a)(6). North Carolina excludes bona fide discount points, some prepayment penalties and certain other legitimate fees from the definition of total points and fees. Bona fide discount points are specifically defined as "loan discount points knowingly paid by the borrower for the purpose of reducing, and which in fact result in a bona fide reduction of, the interest rate or time-price differential applicable to the loan, provided the amount of the interest rate reduction purchased by the discount points is reasonably consistent with established industry norms and practices for secondary mortgage market transactions." N.C.G.S. § 24-1.E(a)(3).

General Regulations of the New York Banking Board §§ 41.1(d)-(e).

E. Consumer Education And Counseling

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

Under federal law, credit counseling is mandatory only for reverse mortgages for older homeowners under the Home Equity Conversion Mortgage program administered by HUD. 228

Two states have provisions on subprime credit counseling. New York requires high-cost lenders to advise applicants that credit counseling is available and to provide them with a list of counselors. Counseling is not mandatory. North Carolina goes further and requires counseling by state-approved counselors for all high-cost loans. Otherwise, counseling proposals have been rejected in the past, due to industry opposition and also due to concerns about cost.

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

See HUD-Fed Joint Report, supra note ____. In the report, HUD and the Federal Reserve were not able to reach complete agreement and thus issued some recommendations jointly and others individually.

See HUD-Treasury Report, supra note _____, at 92. For a description of this program, see generally Harkness, supra note _____, at 39-41.

General Regulations of the New York Banking Board § 41.3(a).

N.C.G.S. § 24-1.E(c)(1).

information or be able to apply it when predatory lenders come to call.²³¹ Until this country comes to grips with low literacy rates, financial literacy efforts are not likely to succeed.

Counseling also has serious limitations. For those who lack the time, the funds or even the confidence to visit a credit counselor, optional counseling is nothing more than a fig leaf. In contrast, mandatory counseling would require consumers to go to a counselor as a condition of getting a loan. The efficacy of that counseling, however, is questionable.²³² How much use is counseling before closing, when customers do not have loan agreements and final HUD-1 settlement statements in front of them? Who would pay for an edifice of certified, independent credit counselors nationwide who were sufficiently trained in loan analysis and predatory practices to provide customers with adequate advice?²³³ How much specific guidance could counselors give customers about comparison shopping? Could counselors disapprove loan agreements as overreaching or could customers unconditionally reject their advice? And would

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

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

Cf. Federal Reserve, Truth in Lending, supra note ____ at 81438 ("Both consumer and creditor commentators acknowledged the benefits of pre-loan counseling as a means to counteract predatory lending. There was uniform concern, however, about requiring a referral to counseling for HOEPA loans because the actual availability of local counselors may be uncertain."); Harkness, supra note ____, at 43 ("many housing counseling agencies . . . expressed concern about having enough funding to provide basic housing counseling services [such as counseling on landlord/tenant law, foreclosures and fair housing laws], let alone to add to others").

one counseling session be enough to help people who are under severe financial strain to cope with inadequate finances?

Wholly apart from these issues, there is a more basic problem with relying on education and/or counseling. Without more, a solution founded on education or counseling puts the onus on potential victims to avoid predatory loan terms, rather than on the perpetrators. Such reliance is nothing more than *caveat emptor* served up with an informational brochure or loan counseling. Likewise, education and counseling do little to redress the basic inequities in bargaining power that underlie many predatory loans.

F. Price Regulation

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

The recent history of usury limits for residential mortgages in the United States has been one of deregulation, accompanied by the re-imposition of limits on non-interest price terms in high-cost loans. Following high inflation in the 1960s and 1970s, usury limits for home mortgages were largely abolished in the United States. As we discussed *supra*, deregulation in residential mortgages resulted from two federal statutes, DIDMCA²³⁵ and AMTPA,²³⁶ that were enacted in the early 1980s. DIDMCA pre-empted state usury limits on first mortgages and

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Pub. L. No. 97-320, 96 Stat. 1469 (1982).

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

Pub. L. No. 96-221, 94 Stat. 164 (1980).

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AMTPA permitted lenders to make adjustable rate mortgages, mortgages with balloon payments and non-amortizing mortgages.²³⁷

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

HOEPA has been so easy to evade that its practical effect has been negligible.²⁴² In recent years, dissatisfied with HOEPA's narrow coverage, a handful of states adopted further restrictions on non-interest price terms in home mortgage loans. Texas took the lead with an amendment to the Texas Constitution, which took effect on January 1, 1998, prohibiting

See supra notes ____ and accompanying text.

See supra note ____ and accompanying text.

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

In other words, payment schedules that consolidate three or more periodic payments and pay them in advance from the proceeds.

Under HOEPA, however, prepayment penalties are permissible where they may only be imposed in the first five years following consummation of the loan, where the source of the prepayment funds is not a refinancing by the creditor or an affiliate of the creditor and where the consumer's total monthly debts at closing (including the HOEPA loan) do not exceed fifty percent of the consumer's monthly verified gross income. 12 C.F.R. § 226.32(d)(7).

See notes ____ supra and accompanying text.

prepayment penalties and balloon payments on all home equity loans and imposing a three percent cap on points for those loans, regardless of the interest rate.²⁴³

In 1999, North Carolina enacted a sweeping predatory lending law that covers a broader group of high-cost home loans than HOEPA.²⁴⁴ For high-cost mortgages within its coverage, the North Carolina law bans all of the pricing practices banned by HOEPA, plus balloon payments of any type (not just balloon payments under five years) and all fees to modify or defer payments on high-cost loans.²⁴⁵ Other provisions of the North Carolina law ban prepayment penalties for all consumer home loans under \$150,000 whether high-cost or not, except where preempted by federal law.²⁴⁶ Under that law, it is also unlawful to finance any single premium credit life, disability, unemployment, life or health insurance for "consumer home loans" of any size.²⁴⁷ Finally, for most home loans under \$300,000, points may only be paid to reduce the interest rate or time-price differential of money.²⁴⁸

In 2000, the New York Banking Board took a similar tack by lowering HOEPA's coverage triggers for high-cost home loans.²⁴⁹ For loans within those lower triggers, the Board prohibited balloon payments except where due and payable no earlier than seven years following

²⁴³ Tex. Const. Art. 16, § 50(a).

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

N.C.G.S. § 24-1.E(b).

N.C.G.S. § 24-1.1E(b).

N.C.G.S. §§ 24-10.2(b), (e).

N.C.G.S. \S 24-1.1A(c)(1)(f). Home loans under \$10,000 by unapproved lenders may not assess points at all. N.C.G.S. \S 24-1.1A(c1).

See text accompanying note supra.

origination, negative amortization, increased interest rates upon default, advance payment provisions and modification and deferral fees.²⁵⁰

Continued abuses by predatory lenders have fueled calls to extend HOEPA's price controls and those of its state law analogues to subprime loans generally. Some proponents go farther and argue for the re-imposition of usury limits on interest rates and points and fees.²⁵¹ Studies on past interest rate restrictions in the United States indicate, however, that price controls have a direct adverse effect on the availability of credit to LMI borrowers and exacerbate the natural incentives toward credit rationing.²⁵² Most research to date has concluded, for example, that usury laws reduce the quantity of credit that flows to the residential mortgage market. Differences in usury rates have caused loan funds to flow out of states with stricter interest caps to more permissive states. Similarly, usury limits disproportionately hurt the poor. Studies on the distributive effect of usury laws on prime versus subprime borrowers, for example, have concluded that interest ceilings impede weaker loan applicants from obtaining credit because lenders cannot charge sufficient interest to recoup the higher costs of underwriting, collection and possible default. Where usury limits become binding, lenders ration credit by requiring higher down payments, increasing loan fees, shortening loan maturities and restricting the size of loans. The sum effect is to handicap LMI borrowers in competing for loans. ²⁵³

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General Regulations of the New York Banking Board § 41.2.

See, e.g., THE COST OF CREDIT, supra note ____, at 60-64; Mansfield, supra note ____, at 573-75; PREYING ON NEIGHBORHOODS, supra note ____, at 36 (advocating limiting points and fees on all mortgages to three percent of principal when the interest rate on the loan exceeds eight percent).

For thoughtful treatments of this debate, *compare* Drysdale & Keest, *supra* note _____, at 589 (2000) *with* James J. White, *The Usury Trompe l'Oeil*, 51 S.C. L. REV. 445 (2000).

See notes ____ supra and accompanying text.

These effects are not limited to interest ceilings, but also extend to price controls on points and fees. New York, for example, had a highly restrictive usury law from 1969 to 1976 that capped all loan fees, charges and points for residential mortgage loans. The law, one of the strictest in the country, resulted in higher down payment requirements and reductions in new mortgages. Moreover, the resulting decline in mortgage activity in New York was the most severe in census tracts with lower average income, lower average housing values and higher ratios of rental housing.²⁵⁴ Other research examining usury limits for federally chartered credit unions found that imposition of a twelve percent cap on all credit charges, including service charges and loan origination fees, resulted in substantial declines in lending by federal credit unions after that ceiling became binding.²⁵⁵

Ultimately, price controls are counterproductive. They restrict the flow of credit, thereby hurting the very individuals they are designed to serve. That is true whether price controls take the form of interest rate ceilings or restrictions on non-interest price terms. Furthermore, there is no reason to believe that legislators or regulators will have more success than the market at setting prices that deter predatory lending and do not unduly restrict the availability of capital to borrowers.²⁵⁶

See, e.g., Norman N. Bowsher, Usury Laws: Harmful When Effective, 56 Rev. – Fed. Res. Bank of St. Louis 16, 17-23 (1974); Jaffee & Russell, supra note ____; James McNulty, A Reexamination of the Problem of State Usury Ceilings: The Impact in the Mortgage Market 21-24 (Fed. Home Loan Bank Bd. 1979); Harold C. Nathan, Economic Analysis of Usury Laws, 10 J. Bank Research 200, 202-10 (1980); Ostas, supra note ____; Michael M. Tansey & Patricia H. Tansey, An Analysis of the Impact of Usury Ceilings on Conventional Mortgage Loans, 9 J. Am. Real Estate & Urban Econ. Ass'n 265 (1981); Bruce Yandle & Jim Proctor, Effect of State Usury Laws on Housing Starts, 13 J. Financial & Quantitative Analysis 549, 554-55 (1978).

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

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

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

G. Anti-discrimination Remedies

The evidence suggests that predatory lenders target members of protected groups and that their practices often have a disparate impact on protected groups. Thus, some victims of predatory lending may have disparate treatment,²⁵⁷ disparate impact²⁵⁸ or "pattern and practice"²⁵⁹ claims under the Equal Credit Opportunity Act of 1974 (ECOA) or the Fair Housing Act (FHA).²⁶⁰ ECOA prohibits lenders from discriminating in credit transactions, including mortgages, according to race, color, religion, national origin, sex, marital status, age or receipt of

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

Ronald K. Schuster, *Lending Discrimination: Is the Secondary Market Helping to Make the 'American Dream' a Reality?* 36 GONZAGA L. REV. 153, 163-66 (2000-2001). *See also* Associates Home Equity Services, Inc. v. Troup, No. A-3410-00T1F, 2001 N.J. Super. LEXIS 318, at *7-*20 (N.J. App. July 25, 2001) (permitting African American homeowners to proceed to discovery on reverse redlining claim under the theory of equitable recoupment as an affirmative defense to foreclosure).

Schuster, *supra* note , at 166-68.

Peter P. Swire, *The Persistent Problem of Lending Discrimination: A Law and Economics Analysis*, 73 TEX. L. REV. 787, 832 (1995). *See also Associates Home Equity Services, Inc.*, 2001 N.J. Super. LEXIS 318, at *15*16 (granting borrowers discovery on their claim of "a pattern of discriminatory lending practice in New Jersey's inner cities").

Cf. Lambert, *supra* note ____ at 2181 (discussing the possibility of bringing marketing discrimination claims under FHA and ECOA).

public assistance.²⁶¹ ECOA only gives standing to actual loan applicants.²⁶² Thus, customers who are the victims of credit discrimination prior to the application process fall outside of ECOA's protections. The Fair Housing Act prohibits discrimination in the financing of residential real estate on the grounds of race, color, religion, national origin, gender, handicap and familial status.²⁶³

Although both statutes authorize private damages actions,²⁶⁴ few victims of lending discrimination have brought claims under these statutes.²⁶⁵ There are several explanations for this paucity of claims. Many loan applicants cannot discern lending discrimination because they do not have inside information about the factors that went into lenders' decision-making.²⁶⁶ Even when borrowers do have an inkling that they may have been victims of discrimination, they may not know that the lenders' actions were illegal under the FHA or ECOA. The few consumers who realize that lenders discriminated against them in violation of fair lending laws encounter

²⁶¹ 15 U.S.C. §§ 1601 et seq.

²⁶² 15 U.S.C. § 1691e.

⁴² U.S.C. §§ 3601-3619 (Title VIII of the Civil Rights Act of 1968); see generally Frank Lopez, Note, Using the Fair Housing Act to Combat Predatory Lending, 6 GEO. J. POVERTY LAW & POL'Y 73 (1999).

²⁶⁴ 15 U.S.C. § 1691e; 42 U.S.C. § 3613.

See, e.g., Stephen M. Dane, Eliminating the Labyrinth: A Proposal to Simplify Federal Mortgage Lending Discrimination Laws, 26 U. MICH. J.L. REFORM 527, 549 (1993); Hylton & Rougeau, supra note ____, at 262 ("if discriminating in the allocation of credit is based on [disparate impact], it would be hard to attack through the application of a civil rights statute"); A. Brooke Overby, The Community Reinvestment Act Reconsidered, 143 U. PA. L. REV. 1431, 1505 (1995); Peter P. Swire, Safe Harbors and a Proposal to Improve the Community Reinvestment Act, 79 VA. L. REV. 349, 368-69 & n.62 (1993); Anthony D. Taibi, Banking, Finance, and Community Economic Empowerment: Structural Economic Theory, Procedural Civil Rights, and Substantive Racial Justice, 107 HARV. L. REV. 1463, 1473, 1478 (1994).

Michele L. Johnson. *Your Loan is Denied, but What about Your Lending Discrimination Suit? Latimore v. Citibank Federal Savings Bank*, 151 F.3d 712 (7th Cir. 1998), 68 U. CINN. L. REV. 185, 214-15 (1999).

significant obstacles in proving their discrimination claims.²⁶⁷ In most cases, lenders can point to neutral underwriting criteria and reasons why applicants failed to meet their criteria.²⁶⁸ In addition, loan information pertaining to other applicants, that would assist plaintiffs in establishing discriminatory treatment, is difficult and costly to obtain.²⁶⁹

Testers, who have proven valuable in establishing landlords' and sellers' discriminatory intent in garden variety housing discrimination claims, are rarely used in the fair lending context. This is because testers could be subject to state and federal prosecution if they were to sign false loan applications. Absent use of testers or other proof of intentional discrimination, plaintiffs would have to comb through lenders' individual loan files to locate evidence that the lenders' practices had a disparate impact on members of the plaintiffs' protected class, or to document statistical discrimination, 270 *i.e.*, disparate treatment of similarly situated individuals. Data from individual loan files is not publicly available, however, and aggrieved applicants do not have access to lenders' loan files before they file complaints. Furthermore, even when the information is available, the cost of extensive discovery and expert statistical analysis can be prohibitively expensive.²⁷¹

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

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

Dane, *supra* note _____, at 544.

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

See, e.g., Dane, supra note ____, at 543-44. Professors Keith N. Hylton and Vincent D. Rougeau have furthermore pointed out that disparate treatment for reasons that are economically rational creates an evidentiary

Low and uncertain damages awards further reduce the number of fair lending cases that are filed. Plaintiffs often do not incur significant damages and have difficulty quantifying their damages.²⁷² As a result, they may be reluctant to file suit and may not be able to find attorneys to represent them.²⁷³

Punitive damages awards, which should provide incentives for victims of discrimination, fail to perform their intended function. This is, in part, because the FHA limits punitive awards to \$11,000.²⁷⁴ In addition, the reference points that courts use to determine the reasonableness of punitive awards serve to limit punitive damages in fair lending cases. For example, one guidepost is that punitive awards should bear a reasonable relationship to civil penalties. Under ECOA and the FHA, however, civil penalties are capped, placing a further limitation on punitive damages awards. The relationship between compensatory awards and punitive damages is another criterion that courts consider in determining the amount of punitive awards. To the extent that fair lending plaintiffs recover only small damages awards or non-monetary damages such as rescission, their punitive awards will be limited correspondingly.²⁷⁵ A final factor that reduces the incentive power of punitive awards is the reluctance of courts to impose punitive

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paradox. Where lenders use prohibited factors such as race as cheap proxies for individual determinations of creditworthiness, and those proxies have some predictive value, there may be no evidence of disparate treatment at all because similarly situated applicants will appear to be treated similarly. *See* Hylton & Rougeau, *supra* note ___, at 252.

See Dane, supra note, at 549.

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

²⁷⁴ 42 U.S.C. § 3612(g)(3).

Engel, *supra* note _____, at 1195-97.

damages in the absence of actual damages. Many states and at least two circuit courts have refused to uphold punitive damages awards unless plaintiffs have incurred actual damages.²⁷⁶

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

Putting these enforcement problems aside, a more basic problem exists with relying on the anti-discrimination laws to halt predatory lending. The fair lending laws necessarily are tangential in their focus, because they address differential treatment of customers on prohibited grounds such as race, age or gender, rather than abusive loan terms *per se*. Of course, such targeting is a major tactic of predatory lenders, which is why ECOA and Title VIII will always

Johanna M. Lundgren, As Weakened Enforcement Power: The Fifth Circuit Limits Punitive Damages under the Fair Housing Act in Louisiana Acorn Fair Housing v. LeBlanc, 46 LOYOLA L. REV. 1325, 1329-32 (2001).

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

See, e.g., Willy E. Rice, Race, Gender, "Redlining," and the Discriminatory Access to Loans, Credit, and Insurance: An Historical and Empirical Analysis of Consumers Who Sued Lenders and Insurers in Federal and State Courts, 1950-1995, 33 SAN DIEGO L. REV. 583, 640-42 (1996); Ali Sartipzadeh, Problems Persist in Sub-Prime Loan Area, Minority Denials Still High, DOJ's Lee Says, BNA BANKING REP., Sept. 21, 1998, at 436; Jaret Seiberg, U.S. Imposes Record Fine of \$9 Million In Bias Case, Am. BANKER, Aug. 11, 1997, at 1-2; Taibi, supra note ____, at 1477 & n.53.

Schwemm, supra note ____, at 322-23; see generally Rice, supra note ____, at 638-39.

be useful adjuncts in combating predatory lending. Nevertheless, a direct approach that goes to the heart of predatory lending, *i.e.*, abusive loan terms and practices themselves, offers the greatest potential for stemming predatory loans.

V. SUITABILITY

As we have shown, the law does not afford adequate redress for predatory lending. Contract law, disclosure and consumer counseling fail because they place the onus on highly vulnerable victims to refrain from signing loans, rather than on the lenders and brokers who perpetrate these loans. Fraud laws and anti-discrimination laws are more formidable, but their scope is too narrow and enforcement is sub-optimal.²⁸⁰ The other traditional response, price regulation, has adverse effects on the availability of credit.

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

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

In devising such a remedy, we take a leaf from federal securities law. In the late 1930s, the National Association of Securities Dealers (NASD) first adopted the concept of "suitability."²⁸¹ The idea of suitability is this: a salesperson "should recommend only securities that are suitable to the needs of the particular customer."²⁸² Under this duty, salespeople must take clients' preferences and individual risk thresholds into account when recommending securities.²⁸³ Beginning in the 1940s, the Securities and Exchange Commission (the SEC) fashioned parallel suitability requirements under the antifraud provisions of the securities laws to deal with situations including ones that were closely akin to predatory lending, *i.e.*, high-pressure telephone sales of securities to vulnerable victims by boiler room operations. Suitability protections are so well-settled in securities for ordinary investors that recent debate has centered on whether to extend the same protections to institutional investors in derivatives.²⁸⁴

Nor is the duty of suitability confined to the securities industry. A somewhat narrower version of suitability is found in the commodities industry.²⁸⁵ A duty of suitability is also

See notes _____ infra and accompanying text.

Louis Loss & Joel Seligman, Fundamentals of Securities Regulation 1010 (4^{th} ed. 2001); see generally id. at 1010-19.

See Robert H. Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L.J. 445, 449-50 (1965).

See, e.g., Hu, supra note _____, at 2319; Allen D. Madison, Derivatives Regulation in the Context of the Shingle Theory, 2 COLUM. BUS. L. REV. 272 (1999); Jerry W. Markham, Protecting the Institutional Investor – Jungle Predator or Shorn Lamb?, 12 YALE J. ON REG. 345 (1995); Jason M. Rosenthal, Inc. May Not Mean Sophistication: Should There Be a Suitability Requirement for Banks Selling Derivatives to Corporations?, 71 CHI.-KENT L. REV. 1249 (1996).

Suitability obligations of a somewhat more relaxed nature apply to commodities, *see generally* Hu, *supra* note ____, at 2331, and to over-the-counter derivatives sales. *See, e.g.*, OCC Banking Circular No. 277. *See generally* Hu, *supra*, at 2339-45; Markham, *supra* note ____, at 364-70; George J. Sotos & Kevin F. Bowen, *The Proposed Suitability Standards for the Commodity Industry: "Right Church, Wrong Pew,"* 53 CHI.-KENT L. REV. 289 (1976).

emerging in the insurance field, partly in response to legislation enacted by Congress in 1999.²⁸⁶ Furthermore, in insurance as well as in securities, regulators and the courts have been particularly rigorous when the allegations of violations of suitability relate to lending abuses in the financing of securities and insurance purchases.

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

Importing suitability into the law of predatory lending is not a new idea. Several states and the federal government have adopted variations on suitability in provisions governing high-cost loans.²⁸⁷ For example, HOEPA prohibits lenders from making high-cost home loans to consumers based on their collateral if the consumers cannot afford the scheduled payments.²⁸⁸

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See Section ___ infra.

See generally Daniel S. Ehrenberg, If the Loan Doesn't Fit, Don't Take It: Applying the Suitability Doctrine to Eliminate Predatory Lending, 10 J. AFFORDABLE HOUSING & COMMUNITY DEVELOPMENT LAW 117 (2001); John R. Reed, The Ethical Standard of Suitability in Real Estate (available at www.johnreed.com/suitability.html). Cf. James M. Carson & Mark D. Forster, Suitability and Life Insurance Policy Replacement, 18 J. INS. Reg. 427 (2000).

HOEPA requires that lenders take consumers' current and expected income, current obligations and employment status into account when assessing their ability to make schedule loan payments. 12 C.F.R. § 226.32(e). HOEPA also prohibits certain loan terms, abrogates the holder in due course doctrine for loans within its

North Carolina's predatory lending law contains a comparable provision. ²⁸⁹ In a similar vein, the New York Banking Board authorizes license revocation of mortgage lenders and brokers for "unfair, deceptive or unconscionable practices in making high cost home loans." ²⁹⁰ The FTC has ruled that when subprime lenders make loans to borrowers who cannot afford the monthly payments, they violate the unfair and deceptive acts and practices provisions of Section 5 of the Federal Trade Commission Act. ²⁹¹

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

coverage and bans direct payments of loan proceeds to home improvement contractors for such loans. 12 C.F.R. §§ 226.32(d)-(e).

In December 2000, the Federal Reserve Board proposed a rule that incorporates a version of suitability. Under the proposed rule, if lenders make HOEPA loans without documenting and verifying borrowers' ability to repay the loans, there is a rebuttable presumption that the lenders engaged in a pattern or practice of making HOEPA loans without regard to the borrowers' ability to repay the loans, thereby violating HOEPA. *See* Federal Reserve, *Truth in Lending, supra* note ____, at 81438. The Office of Thrift Supervision is also considering whether to impose a duty of suitability that would ban asset-based lending by thrift institutions. *See* Office of Thrift Supervision, Advance notice of proposed rulemaking, *Responsible Alternative Mortgage Lending*, 65 Fed. Reg. 17811, 17817 (Apr. 5, 2000).

N.C.G.S. § 24-1.E(c)(2). This standard is presumed to be met where the borrower's total monthly debts, including the high-cost home loan, do not exceed fifty percent of the borrowers' verified monthly gross income. *Id.* North Carolina also restricts: (1) refinancing charges that are designed to strip equity; (2) direct payments of loan proceeds to home improvement contractors; and (3) and a variety of predatory loan terms. N.C.G.S. §§ 24-1.E(b)-(c).

General Regulations of the New York Banking Board § 41.5. The Board also prohibits a broad panoply of predatory loan terms and practices. *See id.* §§ 41.2-41.3.

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

will decline to engage in any subprime lending for fear that they will unintentionally run afoul of the suitability standard.

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

- A. A Brief Overview Of Suitability In Securities And Insurance
 - 1. Suitability In The Securities Industry
 - a. The Duty And Its Source

The suitability doctrine originated in the securities industry and dates back to the late 1930s. Far from being monolithic in nature, suitability has numerous strands, consisting of different rules adopted by different bodies for different purposes. In the securities industry, where the doctrine is most developed, suitability requirements appear in the disciplinary rules of industry self-regulatory organizations (SROs), *i.e.*, the stock exchanges and the NASD. They also appear in the regulations and holdings of the SEC, as well as in court decisions in private securities fraud claims under Section 10(b) of the Securities Exchange Act of 1934 (the Exchange Act)²⁹² and Rule 10b-5.²⁹³

²⁹² 15 U.S.C. § 78j(b).

¹⁷ C.F.R. § 240.10b-5. Suitability is not restricted to corporate securities. Suitability duties in one form or another also exist in the area of municipal securities. MSRB Rule g-19, MSRB MANUAL, Exchange Act Rel. No. 33,869, 56 SEC Docket (CCH) 1062, 1064 (Apr. 7, 1994).

i. The NASD And The Stock Exchanges

The first suitability rules appeared in the disciplinary rules of the NASD and the securities exchanges, which are subject by law to review, revision and approval by the SEC.²⁹⁴

The best-known suitability rule, the NASD's suitability requirement, was adopted in response to the Maloney Act of 1938.²⁹⁵ In the Maloney Act, Congress authorized the SEC to register national securities associations, subject to the condition that such associations adopt rules designed, among other things, "to prevent fraudulent and manipulative acts and practices [and] to promote just and equitable principles of trade."²⁹⁶

NASD, the only national securities association that registered with the SEC, adopted a suitability requirement as part of its original 1939 Rules of Fair Practice.²⁹⁷ Today's version appears in Rule 2310 of the NASD's Rules of Fair Practice and provides:

[i]n recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situations and needs.²⁹⁸

See, e.g., Manuel F. Cohen & Joel J. Rabin, Broker-Dealer Selling Practice Standards: The Importance of Administrative Adjudication in Their Development, 29 L. & CONTEMP. PROBS. 691, 707 (1964); Exchange Act §§ 15A(k)(1), (k)(2), 19(b), former 15 U.S.C. §§ 780-3(k)(1), (k)(2), current 15 U.S.C. § 78s(b).

Act of June 25, 1938, ch. 677, § 1, 52 Stat. 1070 (1938).

²⁹⁶ 15 U.S.C. § 78*o*-3(b)(6).

NASD, Certificate of Incorporation and By-Laws, Rules of Fair Practice, and Code of Procedure for Handling Trade Practice Complaints 39 (1939) (cited in Arvid E. Roach II, *The Suitability Obligations of Brokers: Present Law and the Proposed Federal Securities Code*, 29 HASTINGS L.J. 1069, 1074 n.22 (1978)). *See also* SEC, The Work of the Securities and Exchange Commission 8 (1974) (the only national securities association that registered is the NASD); Mundheim, *supra* note ____, at 450-51.

NASD Rules of Fair Practice, NASD MANUAL (CCH) ¶ 2310(a), IM 2310-2; *see also id.* ¶ 3110 (books and records rule). *See generally* Roach *supra* note ____, at 1073-78. The NASD and the New York Stock Exchange have special suitability rules for options. *See* NASD MANUAL, *supra* at ¶ 2860(b)(16)(B); New York Stock Exchange Rule 723.

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

- (1) the customer's financial status;
- (2) the customer's tax status;
- (3) the customer's investment objectives; and
- (4) such other information used or considered to be reasonable by such [broker-dealer] in making recommendations to the customer.²⁹⁹

The New York Stock Exchange has a Know-Your-Customer rule, Rule 405³⁰⁰ that courts routinely have interpreted³⁰¹ to impose a suitability requirement.³⁰² The American Stock Exchange and the regional stock exchanges have similar Know-Your-Customer rules.³⁰³

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

2 NY Stock Exch. Guide (CCH) ¶ 2405.

Rule 405 does not mention suitability *per se*, but courts derive a suitability requirement from the conjunction of Rules 405 and 401. Rule 401 states:

Every member, applied member and member organization shall at all times adhere to the principles of good business practice in the conduct of his or its business affairs.

2 NY Stock Exch. Guide (CCH) ¶ 2401.

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

Rule 405 provides:

See, e.g., Janet E. Kerr, Suitability Standards: A New Look at Economic Theory and Current SEC Disclosure Policy, 16 PAC. L.J. 805, 810-11 (1985); Mundheim, supra note _____, at 463 n.54; Roach, supra note _____, at 1082-85.

³⁰³ See Roach, supra note ____, at 1086-87.

ii. The Securities And Exchange Commission

The SEC has not adopted an across-the-board suitability regulation. Rather, beginning in the 1940s, the SEC has interpreted the antifraud provisions of the federal securities laws to impose a suitability requirement and has applied this duty of suitability principally through decisions by the agency and courts in enforcement and private remedy actions.³⁰⁴ As then-SEC Commissioner Manuel Cohen explained, "[b]ecause of the unlimited variety of opportunities for unethical practices presented in sales transactions, the Commission has relied heavily upon adjudication in the development of standards for selling practices," including suitability rules.³⁰⁵

A. Adjudicatory Decisions

In its adjudicated suitability cases, the SEC's initial task has been to articulate how the duty of suitability arises from the antifraud provisions of the federal securities laws. Under established SEC precedents, securities fraud extends beyond common-law fraud to include "acts that violate the obligation of fair dealing" by "professional broker-dealers and their salesmen." Based on that principle, the SEC has held that recommending unsuitable securities to customers "violate[s] the obligation of fair dealing." ³⁰⁷

The Commission variously has relied on two different theories, the "shingle theory" and the "trust and confidence" theory to find that breaches of the duty of suitability constitute securities fraud. Under the shingle theory, the SEC has argued that by hanging out shingles and

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Despite the SEC's preference for developing suitability through adjudicated decisions, in certain narrow areas the Commission has promulgated formal suitability regulations. *See* discussion *infra* at _____.

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

Cohen & Rabin, *supra* note ____, at 702. *See also, e.g.*, Louis Loss, *The SEC and the Broker-Dealer*, 1 VANDERBILT L. REV. 516, 517 (1948).

See Mundheim, supra note ___, at 470-71.

making their services available to the public, broker-dealers implicitly represent that they "will deal fairly with . . . customers in accordance with the standards of the profession," and that violations of the implied representation of fair dealing constitute fraud. Under the SEC's alternative theory, the "trust and confidence" theory, broker-dealers who cultivate the trust and confidence of their customers thereby become fiduciaries and owe a duty to act in the customers' best interests. Under both theories, securities fraud is actionable both for affirmative misrepresentations and where broker-dealers who enlist trust violate that trust by not revealing that securities they recommend are unsuitable.

Under either or both of these theories, the SEC has condemned securities sales as unsuitable in a variety of circumstances.³¹² Above all, a broker-dealer cannot "recommend a security unless there is an adequate and reasonable basis for such recommendation."³¹³ In order for a reasonable basis to exist, broker-dealers must do a reasonable investigation and base their

Even more typically, of course, the customer does not come in off the street but is actively solicited by a salesman, who will almost inevitably render some advice as an incident to his selling activities, and who may go further to the point where he instills in the customer such a degree of confidence in himself and reliance upon his advice that the customer clearly feels – and the salesman knows the customer feels – that the salesman is acting in the customer's interest. When you have gotten to that point, you having nothing resembling an arm's-length principal transaction regardless of the form of the confirmation. You have what is in effect and in law a fiduciary relationship.

Loss, *supra* note ____, at 529.

³⁰⁸ Cohen & Rabin, *supra* note ____, at 702-03.

³⁰⁹ *Id. See, e.g.*, Mac Robbins & Co., SEC Securities Exchange Act Release No. 6846, at 3 (July 11, 1962); Carl J. Bliedung, 38 S.E.C. 518, 521 (1958); E.H. Rollins & Sons, Inc., 18 S.E.C. 347, 362 (1945). *See also* Roach, *supra* note ____, at 1091-95.

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

See Mundheim, supra note ____, at 470-71.

For a comprehensive overview, *see, e.g.*, Roach, *supra* note ____, at 1123-58; Mundheim, *supra* note ____, at 453.

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

recommendations on the results of the investigations.³¹⁴ They must also take the risk thresholds of their customers into account when recommending securities.³¹⁵ That said, suitability is not a guarantee of future performance and broker-dealers are not liable for securities that were suitable when purchased but that later suffered disappointing results for reasons beyond the salesperson's control.³¹⁶

One issue that has arisen in securities suitability cases is the role of customer consent to unsuitable stock purchases. The SEC has found brokers liable under the suitability doctrine for buying speculative securities for customers whom the broker knew could not afford the risks presented or that were counter to the customer's stated needs³¹⁷ even when the customer consented to the purchase.³¹⁸ In the controversial case of *Philips & Co.*,³¹⁹ for example, the SEC held that a "broker is obliged to observe [the suitability requirement] regardless of a customer's wishes."³²⁰ In *Philips*, the agency affirmed a NASD finding that a broker violated the NASD's suitability rule by advising people of limited means to buy oil stock that he knew was too

314 *Id.*

See Mundheim, supra note ____, at 449.

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

See, e.g., Century Sec. Co., 43 S.E.C. 371, 377 (1967), aff'd on other grounds sub nom. Nees v. SEC, 414 F.2d 211 (9th Cir. 1969); Irving Friedman, 43 S.E.C. 314, 316 (1967); J. Logan & Co., 41 S.E.C. 88, 99 (1962), aff'd sub nom. Hersh v. SEC, 325 F.2d 147 (9th Cir. 1963), cert. denied, 377 U.S. 937 (1964); Ramey Kelly Corp., 39 S.E.C. 756, 759 (1960); Hammill & Co., 28 S.E.C. 634, 637 (1948); Herbert R. May, 27 S.E.C. 814, 824 (1948). But see Hammill & Co., [1966-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,799, at 90,887-90 (S.D.N.Y. 1976) (risk level of investors irrelevant to a finding of suitability).

³⁷ S.E.C. 66 (1956).

³¹⁹ *Id*.

Roach, *supra* note ____, at 1126.

speculative for their financial circumstances, even though the customers voluntarily consented to the purchases.³²¹

Similarly, over time, the SEC rejected the view that disclosure can cure suitability violations. For example, in *Powell & McGowan, Inc.*, ³²² the SEC found violations of suitability where a salesperson sold speculative securities to a senile customer through a "persistent and aggressive sales campaign." The Commission went further to hold that disclosures would not have exempted the broker from liability because no amount of disclosure would have enabled the customer to evaluate the merits of the securities on a reasoned basis. ³²⁴ Subsequently, the Commission suggested that even when customers are fully competent, disclosures might not be sufficient to cure suitability violations. ³²⁵ Thus, the Commission's stance has evolved to embrace a suitability requirement that cannot be waived by disclosures or customer consent.

In a further extension of the doctrine with particular relevance to predatory lending, the SEC has applied the suitability requirement to boiler room sales of penny stocks where brokers recommend stocks without obtaining information on their customer's financial circumstances or risk preferences. Boiler room operations refer to high-pressure sales of low-cost, speculative securities through cold calls over the telephone to unfamiliar and naïve customers. In boiler

Philips & Co., 37 S.E.C. at 67-70. Accord In the Matter of the Application of Stephen Thorlief Rangen for Review of Disciplinary Action Take by the New York Stock Exchange, Inc., SEC Rel. No. 38486, Admin. Proc. File No. 3-8994 (Apr. 8, 1997) (upholding New York Stock Exchange's liability findings and sanctions); In re Application of Eugene J. Erdos, 47 S.E.C. 985, 989 (1983), aff'd, 742 F.2d 507 (9th Cir. 1984). But see Phillips v. Reynolds & Co., 294 F. Supp. 1249 (E.D. Pa. 1969) (rejecting claims by affluent and experienced investors, even though they alleged that the broker had actual knowledge of unsuitability).

³²² 41 S.E.C. 933 (1964).

³²³ *Id.* at 934-935.

Id.; see also Roach, supra note, at 1127-29.

See Whitman & Stirling Co., 43 S.E.C. 181, 182-83 (1966); see also Harold R. Fenocchio, SEC Securities Exchange Act Release No. 12194, 9 SEC DOCKET 146, 148 (1976).

room cases such as *Mac Robbins & Co.*, ³²⁶ the Commission has repeatedly held that it is fraud for a broker-dealer "to induce a hasty decision by the customer" where "no effort [was] made by the salesman . . . to determine whether the security recommended [was] suitable for the customer."

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

B. SEC Suitability Regulations

In addition to fashioning the suitability doctrine through adjudication, the SEC has promulgated formal suitability regulations with respect to the sales of certain highly speculative securities. The most important SEC rule in that regard, Rule 15g-9, requires brokers to restrict their sales of speculative low-priced securities to individuals who have (or whose investment advisers have) "sufficient knowledge and experience in financial matters" to be "reasonably . . .

SEC Securities Exchange Act Release No. 6846 (July 11, 1962); Best Securities Inc., 39 S.E.C. 931 (1960); Gerald M. Greenberg, 40 S.E.C. 133 (1960).

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

³²⁸ Roach, *supra* note ____, at 1140.

capable of evaluating the transactions in penny stocks."³²⁹ For all other investors, penny stocks are *per se* unsuitable.

Similarly, in Exchange Act Rule 15c2-5, adopted in 1962, the SEC adopted a suitability requirement for "equity funding programs" involving lending abuses. In the equity funding programs at issue, broker-dealers convinced "persons of modest means and little financial experience" to purchase mutual fund shares and to pledge those shares to secure personal loans, the proceeds of which were used to pay for insurance policy premiums. In essence, equity funding programs were schemes to sell insurance policies on financing terms that many customers could not afford. The SEC "discovered that in many cases [the programs] were being offered to persons for whom they were wholly inappropriate." In response, in Rule 15c2-5, the Commission announced that henceforth it would be a "fraudulent, deceptive, or manipulative act or practice" under Section 15(c)(2) of the Exchange Act for a broker or a dealer to assist in arranging credit to a purchaser of securities (other than routine margin borrowing) without first ascertaining suitability. Specifically, the Rule requires broker-dealers who wish to arrange such loans to:

obtain from such person such information concerning his financial situation and needs, reasonably determine that the entire transaction, including the loan arrangement is

³³² 15 U.S.C. § 78*o*(c)(2).

¹⁷ C.F.R. § 15g-9(b)(2). The NASD's parallel penny stock suitability rule appears at NASD Rules of Fair Practice, NASD MANUAL (CCH) ¶ 2310-1, IM 2310-1.

Mundheim, *supra* note ____, at 454.

³³¹ *Id*.

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

suitable for such person, and retain in his files a written statement setting forth the basis upon which the broker . . . made such determination.³³⁴

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

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

reasonable grounds to believe that the recommendation [was] not unsuitable for such customer on the basis of information furnished by such customer after reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other information known by such broker.³³⁵

The SEC adopted this rule, known as the SECO (SEC-registered Only) suitability rule, pursuant to the Securities Acts Amendments of 1964,³³⁶ which authorized direct SEC regulation of registered brokers who were not members of the NASD.

Finally, the SEC's "accredited investor" rules form a variation on the suitability doctrine.

Under Regulation D, limited offerings and other securities offerings that qualify for an exemption from Securities Act registration are exempt from full disclosure so long as broker-dealers only market exempt offerings to sophisticated investors (or, in SEC jargon, "accredited"

³³⁴ 17 C.F.R. § 240.15c2-5. *See* Cohen & Rabin, *supra* note ____, at 700; Mundheim, *supra* note ____, at 454-55; Roach, *supra* note ____, at 1087-91, 1152-53; Anderson v. Knox, 297 F.2d 702 (9th Cir. 1961), *cert. denied*, 370 U.S. 915 (1962).

Former 17 C.F.R. § 240.15b10-3. *See also* SEC Securities Exchange Act Release No. 8136, [1966-67 Transfer Binder] FED. SEC. L. REV. (CCH) ¶ 77,459 at 82,890 (1967) (interpreting Rule 15b10-3); Kerr, *supra* note ____, at 809-11; Roach, *supra* note ____, at 1078-81.

Pub. L. No. 88-467, § 1, 78 Stat. 565 (1964). In 1983, Congress amended the Exchange Act to require that all registered brokers in the over-the-counter securities business join the NASD, thereby subjecting them to the NASD's suitability requirements. Pub. L. No. 98-38, § 3(a)(8), 97 Stat. 205 (1983). As a consequence, the SEC rescinded the SECO suitability rule. 48 Fed. Reg. 53688 (Nov. 29, 1983). *See also* Kerr, *supra* note ____, at 809 n.22.

investors").³³⁷ Under Rule 501(a), accredited investors are limited to institutional investors and individuals with net worths in excess of \$1 million or annual incomes for the past two years in excess of \$200,000 individually or \$300,000 when combined with the income of a spouse.³³⁸ These net worth and income screens serve as filters that prohibit the marketing of more speculative securities to unsophisticated investors.

b. Enforcement

In the securities industry, there are several avenues for enforcing suitability. SROs can initiate disciplinary proceedings against their members or associates for violating SRO suitability rules or those of the SEC. In SRO proceedings, the SROs can either expel respondents who are found in violation or impose lesser sections, such as suspensions or fines. In addition, the SEC can adjudicate suitability through two separate avenues. The first is through appeals of SRO disciplinary proceedings to the SEC. The second is in direct SEC disciplinary proceedings against broker-dealers³³⁹ for alleged Exchange Act antifraud violations. Similarly, injured investors can bring suit for suitability violations. Violations involving fraud are actionable under the implied private right of action for securities fraud in Section 10(b) (either in court or in arbitration proceedings).³⁴¹ In addition, securities arbitration proceedings initiated by

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

³³⁸ See 17 C.F.R. § 230.501(a).

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

See generally Cohen & Rabin, supra note ____, at 702, 707-08; Roach, supra note ____, at 1119-22, 1135, 1140-44.

See, e.g., Rolf v. Blyth Eastman Dillon & Co., 424 F. Supp. 1021, 1036-37 (S.D.N.Y. 1977), aff'd, 570 F.2d 38 (2d Cir. 1978). See also Roach, supra note ____, at 1143-55.

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

c. Industry Implementation

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

Plaintiffs also have urged the courts to recognize an implied cause of action under the NASD's suitability rule and the New York Stock Exchange Rule 405. They have met with limited success because of judicial reluctance to recognize new implied private rights of action under the securities laws. *See, e.g.*, F. Harris Nichols, *The Broker's Duty to His Customer Under Evolving Federal Fiduciary and Suitability Standards*, 26 BUFF. L. REV. 435, 438-445 (1977) ("private enforcement of the NASD suitability and stock exchange 'Know Your Customer' rule has not fared well in some circuits"); Roach, *supra* note _____, at 1122-23, 1145-46, 1148-49, 1185-95.

See, e.g., <www.quick-reilly.com/ipo/ipo_suit.html> (requiring IPO customers to complete a questionnaire as to their suitability); John R. Reed, *The Ethical Standard of Suitability in Real Estate* (available at <www.johnreed.com/suitability.html>); *Suitability* (available at <www.factmaster.com/About/suit.html>).

See, e.g., Investor Suitability (available at <www.sbonet.com/siteinfo/sutability.html>) (describing one firm's review process).

consent.³⁴⁴ In other circumstances, SEC rules flatly prohibit waiver of suitability claims, particularly with respect to sales of penny stocks.

2. Suitability In The Insurance Industry

A duty of suitability has taken root in insurance sales as well. As insurance products began incorporating investment features, particularly variable annuity policies and variable life insurance, the suitability standard that applied to securities was extended to apply to these new insurance products.³⁴⁵

Before the 1970s, investments in securities were largely the preserve of the wealthy. For middle- and lower-income people, simpler and safer financial products such as life insurance and bank accounts, certificates of deposit and government bonds were the savings vehicles of choice. Due to the resulting market segmentation, insurance companies enjoyed a captive market and did not face serious competition from the securities industry.

With the popularization of mutual funds, however, the insurance industry faced new competition from securities firms. Individuals of modest means began shifting their savings out of life insurance policies and bank accounts into mutual funds that offered the risks and rewards of equities. In order to stave off competition from securities, insurers developed variable annuities that featured investment risks, including possible loss of principal. In a development that paralleled the emergence of complex subprime loans for LMI borrowers, these new and "more complex" insurance products were "marketed to consumers that include[d] the same segment of customers that previously limited their purchases to the traditional, uncomplicated

See note ____ supra and accompanying text.

For descriptions of variable policies, *see* Robert H. Jerry, II, UNDERSTANDING INSURANCE LAW §§ 13A[b][1], [b][3] (2d ed. 1996); NationsBank of North Carolina, N.A. v. VALIC, 513 U.S. 251 (1995).

life insurance products."³⁴⁶ Due to concerns that "[c]omplex hybrid products [were being] offered to customers in all walks of life and of all financial means," the "expansion of the market . . . created suitability issues that did not exist in the past."³⁴⁷

The seminal decision that expanded the securities suitability doctrine to insurance products was *SEC v. VALIC*, ³⁴⁸ where Supreme Court ruled that variable annuities were subject to federal securities regulation. In *VALIC*, the Court noted that while variable annuities are "issued by insurance companies [that] are subject to state insurance regulation," they "also contain investment risks." Since *VALIC*, the SEC has regulated variable insurance products as securities and the NASD has imposed a duty of suitability in the sale of these products. In a series of recent enforcement actions and Notices to Members, the NASD has specifically emphasized that NASD Rule 2310 on suitability applies to the sale of variable life insurance and annuities.

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

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

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

³⁴⁸ 359 U.S. 65 (1959).

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

³⁵⁰ *Id.*

³⁵¹ See id. at 22.

See NASD Notices to Members 00-44 (July 2000), 99-35 (May 1999) and 96-86 (Dec. 1996) (advising that NASD members have been fined and disciplined by NASD for selling unsuitable variable life insurance products to customers); Pruco Sec. Corp. Letter of Acceptance Waiver and Consent, NASD No. CAF990010 (July 8, 1999) (finding that NASD member violated the duty of suitability in the sale of variable life insurance); In the Matter of District Business Conduct Committee for District No. 8 v. Miguel Angel Cruz, NASD No. C8A930048 (Oct. 31, 1997) (same). See generally Jeffrey S. Puretz, Insurance Products as Securities, in Understanding Securities Products of Insurance Companies 2001 (Practising Law Institute PLI Order No. A0-007T Jan. 2001).

suitability requirement in insurance. Under contract and/or tort law, insurers have to act in good faith and deal fairly when they respond to settlement offers.³⁵³ Beginning in the early 1970s, this duty of good faith and fair dealing was expanded from third-party claims³⁵⁴ to first-party claims as well,³⁵⁵ including claims by owners of variable annuities and life insurance policies with investment features.

One of the earliest cases in which the courts imposed suitability in insurance was *Anderson v. Knox.*³⁵⁶ In *Anderson*, the Ninth Circuit imposed a duty of suitability in the financing of life insurance that saddled the insured with a \$125,000 loan.³⁵⁷ The insured, Roger Knox, bought the insurance after an insurance salesman advised him that bank-financed insurance "was a suitable program for plaintiff and his family and fitted their needs." Affirming judgment for Knox, the Ninth Circuit held that Knox had justifiably relied on the salesman's assurances that financed insurance was suitable because the salesman held himself out as an expert and knew that Knox did not understand the program.³⁵⁸ Furthermore, the appeals court agreed that the insurance program was unsuitable for Knox, both because it eliminated insurance

See, e.g., Jerry, supra note ____, §§ 25G, 112 [b][1] and cases cited therein. In most states the duty arises from contract law, while a handful of states also recognize the duty in tort. See id. §§ 25G, 112[c]; Crisci v. Security Ins. Co., 426 P.2d 173 (Cal. 1967).

See Jerry, supra note ____, § 25G[b]; Comunale v. Traders & General Ins. Co., 328 P.2d 198, 200 (Cal. 1958); Brown v. Guarantee Ins. Co., 319 P.2d 69 (Cal. App. 1957). Third-party claims involve liability insurance that protects the interests of third parties injured by the insured's conduct. See Jerry, supra § 13A[e].

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

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

³⁵⁷ *See id.* at 705; *see generally id.* at 703-05, 713.

³⁵⁸ *Id.* at 707-11.

protections Knox already had and because Knox could not afford it. The program was similarly unsuitable because it was inappropriate for individuals in plaintiff's tax bracket, did not provide the investment savings or retirement benefits that Knox needed and was not worth what it cost.³⁵⁹

In *Knox*, the court noted expert testimony to the effect that "the usually accepted practice among good life insurance underwriters was not to permit a policy holder to contract for more insurance than he could comfortably afford."³⁶⁰ Nevertheless, with three dependents to support on a salary of \$8100 per year and no more than \$1600 in investment income annually, Knox's net interest payments on the insurance policy for 1960 "would have been . . . \$4106.40, 40% of his gross annual income."³⁶¹ Under the circumstances, the Ninth Circuit held, the lower court "could properly hold that [the program] was not suitable for a man of [Knox's] earning capacity."³⁶²

In more recent years, about one-fifth of the states have adopted express suitability requirements in insurance by statute or rule. Currently, six states have statutes or regulations that prohibit the sales of specified insurance products (normally including life insurance and annuities) absent reasonable grounds to believe that the sales would be suitable for the customers.³⁶³ These provisions differ in how much guidance they afford insurers as they evaluate

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Id. at 711-20.

³⁶⁰ *Id.* at 714.

³⁶¹ *Id.* at 715.

³⁶² *Id*.

See IOWA ADMIN. CODE r. 191-15.8, 191.15.11 (applying to producers of life insurance policies and annuities); KAN. ADMIN. REGS. § 40-2-14(c)(5) (applying to purchase or replacement of life insurance and annuities); MINN. STAT. ANN. §§ 60K.14, 72A.20 (applying to sales by agents of life, endowment, individual accident and sickness, long-term care, annuity, life-endowment and Medicare supplement insurance); S.D. ADMIN. R. §§ 20:06:14:03(7) (applying to agent sales of individual life and all health insurance policies), 20:06:13:43 et seq. (applying to all health insurance sales to senior citizens); S.D. CODIFIED LAWS §§ 58-17-87 (applying to suitability

the suitability of a particular product for an individual customer. Some provisions provide no guidance whatsoever³⁶⁴ or require only a general duty of inquiry.³⁶⁵ Others mandate that insurers consider customers' insurance objectives, financial situations, needs and age when recommending products.³⁶⁶ At least three other states have statutes, rules or rulings that impose suitability obligations of a more limited nature on some segment of insurance sales.³⁶⁷ Other state insurance commissioners have called for suitability standards in insurance, especially with respect to seniors.³⁶⁸ In the meantime, one industry trade association, the Insurance Marketplace

of individual health benefit plans), 58-18B-35 (suitability for stop loss, multiple employer trusts and MEWAs); VT. STAT. ANN. tit. 8, § 4724 (applying to all insurance products; expanding the Vermont UDAP statute to make unsuitable sales an unfair or deceptive trade practice); WIS. ADMIN. CODE INS. § 2.16(6) (applying to insurers or intermediaries who market the purchase or replacement of individual life insurance or annuities).

Incorporation of a suitability standard into state UDAP provisions that apply to insurance, as in Vermont, tracks expansion in the definition of unfair and deceptive acts and practices in insurance over the past few decades.

See Vt. Stat. Ann. tit. 8, § 4724; see generally James A. McGuire & Kristin Dodge McMahon, Bad Faith, Excess Liability and Extracontractual Damages: Counsel for the Excess Carrier Looks at the Issues, 72 U. Det. Mercy L. Rev. 49, 60 (1994); Willy E. Rice, Judicial Bias, the Insurance Industry and Consumer Protection: An Empirical Analysis of State Supreme Courts' Bad Faith, Covenant-of-Good-Faith and Excess-Judgment Decisions, 1990-1991, 41 Cath. U. L. Rev. 325, 379-382 (1992).

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

See IOWA ADMIN. CODE r. 191-15.8 (also directing producers to consider "other relevant information" known to them). See also KAN. ADMIN. REGS. § 40-2-14(c)(5) (requiring regulated entities to make suitability recommendations "on the basis of information furnished by [the customer], or otherwise obtained"); MINN. STAT. ANN. §§ 60K.14 (agents must consider "the totality of the particular customer's circumstances, including, but not limited to, the customer's income, the customer's need for insurance, and the values, benefits and costs of the customer's existing insurance program, if any, when compared to the values, benefits and costs of the recommended policy or policies"); S.D. ADMIN. R. 20:06:14:03(7) ("agents must examine the totality of the consumer's circumstances including their financial condition and need for insurance at the time").

See N.M. ADMIN. CODE tit. 13 § 10.8.50 (requiring agents to "make reasonable efforts to determine the appropriateness of a recommended purchase or replacement" of a Medicare supplement policy or certificate); OHIO BULL. 92-1, Memorandum from Harold T. Duryee, Director of Ohio Dep't of Insurance (Mar. 1, 1992) (construing the Ohio UDAP statute, Ohio Rev. Code Ann. § 3901.20, to require insurance agents to "determine the status and suitability of any and all products he or she markets"); UTAH CODE ANN. § 31A-23-303 (authorizing the state insurance commissioner to find certain products "inherently unsuitable").

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

Standards Association (IMSA), has imposed a suitability requirement on its members for life insurance and annuity sales.³⁶⁹

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

In the most significant development to date, in 2000, the National Association of Insurance Commissioners (NAIC) formally recommended that all states adopt a suitability requirement for the sale of life insurance and annuity products.³⁷² The recommendation grew out of a white paper earlier that year by the Suitability Working Group of the Life Insurance and Annuities Committee of the NAIC that explored standards for the suitability of sales of life

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See IMSA, Principles and Code of Ethical Market Conduct with Commentary, Principle 1 (available at <www.imsaethics.org/pages/opt2.htm>).

Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 106th Cong., 1st Sess., Title III, Subtitle C, § 321(a).

³⁷¹ *Id.* Title III, Subtitle C, §§ 321(a), (b)(4).

See NAIC, SUITABILITY OF SALES OF LIFE INSURANCE AND ANNUITIES 23-24 (Pub. No. SOS-LI 2000). See also James M. Carson & Mark D. Forster, Suitability and Life Insurance Policy Replacement, 18 J. Ins. Reg. 427 (2000).

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

[d]isclosure requirements are no longer sufficient consumer protection in such an environment. . . . [Similarly, w]hile the working group applauds the initiatives embodied in . . . voluntary measures many companies and firms have taken, the working group does not feel that these initiatives are an adequate or sufficient substitute for suitability rules. The IMSA program, certainly a step in the right direction, is voluntary and not enforceable by regulators. Likewise, other voluntary measures cannot substitute for requirements. 373

The NAIC formally adopted the white paper in June 2000 and NAIC is now drafting model legislation.³⁷⁴

B. Theoretical Bases For Suitability In The Subprime Market

The duty of suitability, by shifting responsibility for safeguarding customers' interests from the customers to insurers, and securities dealers and brokers, rejects the prevailing paradigm of *caveat emptor* and forces these providers to internalize the harm that they cause when they exploit information asymmetries to the detriment of customers. Suitability can serve the same purpose in the context of home mortgages. The theoretical justifications for the adoption of suitability in the insurance and securities markets apply equally to the home

The current draft model language would provide:

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

³⁷³ *Id.* at 23.

See Summary: Life Insurance and Annuities Suitability Model Regulation (Draft 3/6/01) (available at <www.naic.org/1papers/models/0301docs/lifeins-annsuitabilsummary.htm>); NAIC, SUITABILITY OF SALES OF LIFE INSURANCE AND ANNUITIES (Pub. No. SOS-LI 2000).

mortgage market where disclosure and industry self-regulation do not provide sufficient protection for consumers, and financial services providers use marketing strategies that deliberately inculcate consumer confidence and trust.³⁷⁵

One rationale for the suitability doctrine is that disclosure does not provide adequate protection to investors. In the seminal case of *Phillips & Co.*,³⁷⁶ the SEC imposed a suitability requirement because "disclosure requirements and practices alone [had] not been wholly effective in protecting the investor."³⁷⁷ Virtually all commentators now agree that current securities disclosures – most notably offering prospectuses under the Securities Act of 1933 and annual and quarterly reports under the Exchange Act – are too arcane, complex and laden with disclaimers to provide meaningful guidance to individual investors.³⁷⁸ As Professor Henry Hu has pointed out with respect to mutual funds, mandatory disclosures do not necessarily provide the precise information that is most essential to investment decisions, especially information necessary for evaluating probabilistic future outcomes.³⁷⁹ In insurance, the NAIC has reached the same conclusion, *i.e.*, that disclosure is inadequate.³⁸⁰

A second justification for suitability in securities rests on findings that "the public has been encouraged to – and has – relied on the superior skill of the broker-dealer community in its

NAIC, LIFE INSURANCE AND ANNUITIES SUITABILITY MODEL ACT, § 2(A) (May 11, 2001 draft).

See, e.g., Langevoort, supra note _____, at 627; Mundheim, supra note ____, at 450; NAIC, SUITABILITY OF SALES OF LIFE INSURANCE AND ANNUITIES 23 (Pub. No. SOS-LI 2000).

³⁷⁶ 37 S.E.C. 66 (1956).

³⁷⁷ *Id.* at 68.

See, e.g., Kerr, supra note ____, at 831.

See Hu, supra note _____, at 2325.

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

securities transactions."³⁸¹ As is true in the insurance industry, broker-dealers and their firms consciously employ marketing strategies that are designed to elicit consumer trust. Not only is reliance encouraged, often it is necessary because disclosure documents are incomprehensible. As a result, ordinary consumers are forced to look to their brokers and dealers for advice.³⁸²

A third, equally compelling, justification for the imposition of securities suitability rests upon the work of Coase, who posited that the party who is in the best position to avoid the harm at the least cost should bear the cost of avoiding the harm.³⁸³ In securities, broker-dealers can avoid the harm of unsuitable recommendations more cheaply than their customers. Broker-dealers and their firms specialize in acquiring information about individual issuers, market trends and portfolio decisions that are appropriate for specific customers. In contrast, requiring every individual investor to acquire that same level of expertise about securities would not be cost-effective. Furthermore, given the aggressive marketing practices by securities firms, it is not clear that requiring consumers to acquire the same level of knowledge that their brokers-dealers possess would lead to a reduction in harm.³⁸⁴ To the contrary, imposing liability on broker-dealers who sell unsuitable products has a much greater likelihood of avoiding harm.

The same economic rationales for suitability apply to the subprime mortgage market.

Disclosure has proven useless, and financial literacy is hopelessly costly and highly unlikely to succeed. In addition, just as with boiler room securities operations, the extreme sales tactics of

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Mundheim, *supra* note , at 450.

³⁸² See Kerr, supra note ____, at 830.

Ronald Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1 (1960).

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

predatory lenders specifically are designed to overcome borrowers' better judgment. Finally, turning to the third rationale for suitability -- Coase's theory -- lenders often are in a better position than borrowers to predict the amount of debt that borrowers can manage.³⁸⁵ Lenders can draw on extensive proprietary databases with past repayment histories of borrowers to predict borrowers' risk thresholds and ability to repay. For decades, lenders have relied on underwriting guidelines that are based on similar predictions in deciding whether to make loans. Certainly, they can use those same guidelines to determine whether borrowers can afford their repayment obligations.

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

Confronted with these odds, placing the onus on LMI borrowers to protect themselves is not cost-effective. Lenders can avoid the harm from predatory lending in a cost-effective

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

manner by using traditional underwriting processes and guidelines to assess the suitability of customers' loans.

C. Adapting Suitability To Subprime Mortgage Lending

1. Structure And Enforcement Channels

In the securities industry, private individuals, government, and industry all enforce the duty of suitability.³⁸⁶ This multiple gatekeeper approach has numerous benefits,³⁸⁷ the most important being vigorous enforcement and establishment of a formal forum for industry input and rules. If a multiple gatekeeper system is to be achieved in subprime mortgage lending, a cause of action for breach of suitability that is enforceable by private individuals and government is necessary but not sufficient.³⁸⁸ A vehicle for mandatory self-regulation by industry is also required.

To date, voluntary self-regulation has been virtually non-existent in subprime mortgage lending.³⁸⁹ The subprime industry has little incentive to institute compliance mechanisms

One subprime lender, Ameriquest Mortgage Company, has gained attention for adopting "best practices" designed to avoid predatory lending practices. Examples of their guidelines include a requirement that the company

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

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

See Sections _____ infra for our proposal recommending such a cause of action.

The Mortgage Bankers Association of America is the one industry association that has recommended best practices guidelines for subprime mortgage lending. *See* Mortgage Bankers Association of America, *The Non-Conforming Credit Lending Committee Working Group Report/Subprime Lending and High Cost Mortgages: Recommended "Best Practices" & "Legislative Guidelines"* (available at http://www.mbaa.org/resident/lib2000/0525b.html). Those guidelines are strictly voluntary, however, and are not binding on individual lenders or brokers. *Cf.* NAIC, SUITABILITY OF SALES OF LIFE INSURANCE AND ANNUITIES 23 (Pub. No. SOS-LI 2000) (recommending suitability laws in insurance because industry measures are "voluntary and not enforceable by regulators").

because subprime lenders and mortgage brokers are either unregulated or under-regulated.³⁹⁰ Furthermore, subprime lenders have reduced incentives to eliminate exploitative practices individually because they stand to lose business or funding sources if they do. For example, subprime lenders who eliminate yield spread premiums will reduce the income of their brokers and face losing their brokers to other lenders. Subprime lenders who drop prepayment penalties may have difficulty selling their loans on the secondary market, losing crucial financing sources. Their competitors, who retain prepayment penalties, can then capture more of the secondary market. Even if some lenders were inclined to self-regulate, the subprime market has thousands of lenders, making it impossible to mobilize market participants for self-regulation.

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

2. An SRO Requirement

In the securities industry, Congress achieved industry self-regulation by enacting federal laws requiring every broker-dealer to join a federally registered exchange or a national self-

assess whether borrowers can afford to repay their loans, prohibitions on mandatory arbitration clauses, and bans on the financing of single credit life insurance. Ameriquest, Ameriquest Mortgage Company Retail Best Practices (November 1, 2001); see also Lew Sichelman, Mortgage firm has good model for subprime lending, CHICAGO Tribune, July 29, 2001, at 7F. In addition, in letters to potential borrowers, Ameriquest advises the borrowers to "[c]onsult with other lenders, including banks and savings and loans, to confirm the terms we offer are acceptable to you Do not let anyone pressure you into obtaining a loan"). See Lew Sichelman, A Lender Advises Clients to Shop Around Before Signing – Imagine That, L.A.TIMES, July 29, 2001, at K7.

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

regulatory organization in order to conduct business. Under those laws, each exchange and SRO has to adopt disciplinary rules for members that are subject to SEC review, revision, public comment and approval. Members must comply with the rules on pain of expulsion or other sanctions.³⁹¹

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

We propose a federal law that would require subprime mortgage lenders and brokers to form a self-regulatory organization and to join that organization in order to conduct business on pain of direct federal regulation.³⁹² The government would have to approve the SRO, at which point the SRO would be empowered to supervise the conduct of its members pursuant to government oversight. In order to win government approval, the new SRO would have to satisfy several requirements. It would have to have the purpose and capacity to enforce compliance with its own rules and standards as well as laws governing the conduct of the subprime mortgage industry. Membership would have to be open to all subprime lenders and mortgage brokers or, at a minimum, to *licensed* lenders and brokers in states that require licensing.

Exchange Act §§ 5, 6(b), 15A, 19(b)-(c). *See generally* VI LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 2653-57, 2670-69, 2787-2830 (3d ed. 1990).

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

Additionally, the SRO would be required to adopt rules requiring its members to refrain from deceptive or exploitative lending practices and to promote, in the words of the Exchange Act, "just and equitable principles of trade." As part of that requirement, Congress could specifically require that the rules contain a suitability requirement. In order to assure enforcement, the SRO also would have to adopt disciplinary rules and procedures to enable it to discipline members for violations of the rules or companion laws. All SRO rules would be subject to government review, amendment, public comment and approval. Finally, federal legislation should prohibit the SRO from imposing any burden on competition that is not necessary or appropriate to accomplish borrower protection.³⁹⁴

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

> 3. A New Cause Of Action For Breach Of The Duty Of Suitability

While industry self-regulation is essential, it does not force predatory lenders and brokers to internalize the cost of the harm that they cause because it does not necessarily result in

³⁹³ Exchange Act § 15A(b)(6).

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

recompense to victims.³⁹⁵ Consequently, we recommend legislation creating a new cause of action against subprime mortgage lenders and brokers for breach of a duty of suitability in the making of loans secured by borrowers' homes. We further propose that Congress empower both injured borrowers and the government to bring suitability claims.

a. Dual Federal/State Jurisdiction

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

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

States also can play a critical role in combating predatory lending. They can pass state analogues to the federal suitability legislation that we propose. Similarly, where state UDAP

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

statutes are sufficiently broad, state attorneys general and private individuals can rely on those statutes to bring suitability-type claims. Any federal suitability legislation should not limit the states' ability to enact stronger predatory lending laws.³⁹⁶

For a number of reasons, federal preemption in predatory lending would be highly undesirable. First, it would destroy the ability of the states to serve as laboratories for developing regulatory techniques. Regulation of predatory lending has been largely ineffective to date and it is not yet always clear where to draw the regulatory line to deter predatory lending without restricting legitimate subprime credit. As the states implement various approaches to redressing predatory lending, their efforts could yield new innovations and valuable insights. Indeed, the North Carolina and New York experiences are expected to yield information on the effect of their particular anti-predatory lending efforts on predatory lenders and the availability of mortgage capital. In a similar vein, state legislation would strengthen the multiple gatekeeper system by empowering state attorneys general and state agencies to enforce predatory lending laws. For these reasons, we strongly oppose federal preemption in the area of predatory lending.³⁹⁷

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

We recognize that stronger state laws might counteract national uniformity to some extent. However, we believe that the extent to which that could occur would be minimal. In all likelihood, relatively few states would be able to pass stronger predatory lending laws, due in part to the formidable lobbying force of the financial services industry. Indeed, that has been the experience in the area of financial privacy under Title Vo of the Gramm-Leach-Bliley Act of 1999. Title V imposed federal regulation but allowed states to pass stricter financial privacy laws. 15 U.S.C. §§ 6801-6809. Notwithstanding Congress' decision not to impose federal preemption, few, if any, states have enacted stricter financial privacy laws to date. *See, e.g.,* LeBoeuf, Lamb, Greene & MacRae, L.L.P., *State Regulations/Legislation on Gramm-Leach-Bliley Privacy Provisions* (available at <www.insurelegal.com/20001116PrivacyStateRegChart.html>); Adam Wasch, *Session's Bill Preempts States from Tougher Position Than Current Law, BNA BANKING REP., Aug. 13, 2001 (noting state attempts to pass stricter privacy laws but no enactments).*

b. Agency Enforcement

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

At the federal level, agency oversight authority should be located in one agency.³⁹⁸
Agency jurisdiction could be vested either in the Board of Governors of the Federal Reserve
System or the FTC. Each choice has its advantages and disadvantages. The FTC has specific
experience in applying suitability to predatory lending cases.³⁹⁹ In addition, unlike the Federal
Reserve, the FTC is not distracted by competing agency goals such as systemic safety and
soundness. On the other hand, the Federal Reserve Board has greater independence from
political shifts in administrations than the FTC. Similarly, the Federal Reserve brings experience
with predatory lending concerns to the table through its administration of HOEPA, although, in
contrast to the FTC, the Federal Reserve has not yet embraced suitability as a concept.

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

³⁹⁹ *See* note ____ *supra*.

Vesting rulemaking authority in a government agency can raise enforcement concerns where the agency declines to exercise its authority, whether for political reasons or otherwise. The Federal Reserve engaged in this type of foot-dragging when it delayed using its authority under HOEPA for several years, until December 2000, to strengthen rules against predatory lending. Congress could reduce the risk of potential inaction in a number of ways. In the statute, it could enumerate problematic loan terms and practices and require the agency to promulgate regulations on those subjects by specified deadlines. Congress could also require the agency to report back annually or biannually to explain any statutory item that it had declined to regulate. Lastly, Congress could require the implementing agency to issue advance notices of proposed rulemaking by dates certain in order to solicit public comment on the need for additional changes.

c. Defining Suitability

i. Rules Versus Standards

In federal securities regulation, suitability is a remarkably vague standard and has best been described as the duty to have "a reasonable basis for recommending a security or investment strategy." While debate has centered around predicating suitability on modern portfolio theory or older views singling out individual securities as unsuitable, 401 there has been relatively little call to reduce the duty of suitability in securities to a set of more particularized conduct rules. 402 Using a general reasonableness standard rather than specific rules has had benefits in securities. On the one hand, courts have interpreted the reasonableness standard

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Mark J. Astarita, *Brokers Have to be Their Own Judge* (available at <www.seclaw.com/docs/397.htm>).

See, e.g., Kerr, *supra* note _____, at 805.

See, e.g., Cass R. Sunstein, Problems With Rules, 83 CALIF. L. REV. 953 (1995).

broadly to give deference to recommendations by brokers-dealers that are controversial, but arguably suitable. On the other hand, the broad and flexible nature of a reasonableness standard has served to deter new suitability abuses.

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

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

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

One way to avoid general price regulation in subprime mortgage lending is to reduce the duty of suitability to specific rules. Avoiding general price regulation does not mean that pricing

See, e.g., HOEPA, 15 U.S.C. §§ 1601 et seq.; General Regulations of the New York Banking Board, Part 4; N.C.G.S. §§ 24-1.1E et seq.

practices and terms invariably should be free from regulation. To the contrary, it may be appropriate to regulate pricing terms or practices where those terms or practices send inaccurate price signals, 404 hinder market efficiency or inflict large, unnecessary negative externalities such as asset-based lending that result in foreclosure. Accordingly, in the following suitability standards, we attempt an initial definition of the boundary line between across-the-board price regulation and inefficient pricing practices.

- (1) Subprime mortgage lenders and brokers would be prohibited from selling subprime loans that borrowers could not repay out of current income, based on reasonable investigation and consideration of all material facts known to the broker or lender at the loan's inception. Under this standard, lenders would have to lend according to underwriting guidelines and refrain from asset-based lending on owner-occupied properties.
- All loan fees and charges would have to be transparent and conform to legitimate pricing functions, as defined by the implementing agency. Yield spread premiums, for example, are contrary to legitimate pricing practices because they impose fees on borrowers for higher interest rates than lenders are willing to accept, thereby sending incorrect price signals. Similarly, consistent with the function of points, lenders and brokers should be required to document that points assessed represent a tradeoff for interest, as is true in the prime market. Similarly, charges for periodic services, such as insurance premiums, should be assessed per unit of time over the life of the loan, instead of in a lump sum at closing. Fraudulent pricing practices, of course, would be unlawful.
- (3) Refinancings would have to have an economic rationale for borrowers. This standard would specifically address abuses such as flipping and refinancing at higher interest rates with no discernable benefit to the borrower.
- (4) Subprime mortgage lenders and brokers would be prohibited from selling loans to borrowers who qualify for prime rates.

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

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

ii. Problematic Lending Practices And Per Se Rules

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

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

In the case of problematic terms or practices that are not unsuitable *per se*, an outright prohibition could have the undesirable effect of restricting the flow of legitimate credit.

Accordingly, the challenge is to identify regulatory tools that can pinpoint when those loans result in harm. Legal presumptions are one way of doing that, *i.e.*, certain terms might be presumptively unsuitable unless the lender is able to provide additional documentation that would rebut the presumption. Safe harbors might provide another way of accomplishing the same goal. It is also possible to permit loan terms that could be predatory, but that are not

unsuitable *per se*, if the loans are made to people who have high incomes and/or significant assets. Akin to the accredited investor rules in securities, the assumption is that these borrowers have the resources to protect themselves against predatory lenders.

iii. Avoiding Regulatory Arbitrage

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

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

iv. Who Decides? Proceeding By Agency Rulemaking

The question of who decides what suitability means is foundational and is critical to the success of the new duty. In securities, suitability derives from multiple, overlapping definitions by multiple decision-makers in multiple fora. The SEC defines suitability in agency adjudication and rulemakings, courts do so in Rule 10b-5 cases, and the NASD and exchanges make their

own definitions in disciplinary cases. As a result, there has been some degree of uncertainty and inconsistency in the application of suitability to securities sales.⁴⁰⁵

There is reason to believe that in subprime mortgage lending, however, a decentralized definitional framework like the one that has evolved in securities would be cause for concern.

Unless the power to define suitability is carefully cabined, there is a danger that courts making suitability determinations would cross over the line into government price regulation. Moreover, courts lack the expertise to engage in economic analysis or solicit public input, both of which are needed to craft rules that work.

For these reasons, the power to define which terms or practices are "unsuitable" in subprime mortgage lending should be limited to the federal oversight agency, at least for purposes of private relief and government enforcement. Courts specifically would be prohibited from condemning loan terms or practices as unsuitable unless those terms or practices were already prohibited by statute or by rule.⁴⁰⁶

Within the agency, furthermore, definitions should be issued through the formal rulemaking process, not through agency adjudication. Formal rulemaking would have four advantages over agency adjudication. It would make more effective use of agency expertise. It would enlist invaluable input from the general public. It would provide greater consistency than case holdings. Finally, it would afford prior notice to lenders.⁴⁰⁷

made all the time in securities and have become routine.

The extent of such uncertainty and inconsistency has been subject to debate. *Compare, e.g.*, Kerr, *supra* note ____ at 811-12 ("[t]he NASD and NYSE suitability standards are very vague and adjudicated case-by-case") *with* Madison, *supra* note ____, at 286 ("it would be difficult . . . to argue that a suitability requirement is a burdensome imposition"). Whatever the consequences, they have not proven fatal. Suitability determinations are

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

Although the SRO for the subprime mortgage industry might adopt a different definition of suitability for purposes of disciplining members, that definition would probably not diverge sharply from the agency's own definition because the SRO's definition would be subject to agency review and approval.

d. Waiver

In requiring suitability, a question arises whether borrowers should be allowed to waive suitability protections. In other words, if lenders were to determine that mortgages were unsuitable for particular loan applicants and advise the applicants to that effect, should the applicants be allowed to waive their right to claim breach of suitability?⁴⁰⁸

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

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

lending, which is better suited to bright-line rules.

In securities, commentators have questioned whether suitability determinations should be subjective or objective. *See*, *e*, *g*., Roach, *supra* note ____, at 1174-79, 1181-85. The subjective/objective dichotomy may be more appropriate to suitability in securities, which employs a relatively vague standard, than in subprime mortgage

The more fruitful approach is to weigh the costs and benefits of waiver. In analyzing the effect of a no-waiver rule, it is helpful to think about the application of such a rule to different groups of borrowers: (1) borrowers who obtain subprime loans but actually qualify for prime loans; (2) borrowers who cannot repay their loans under any circumstances on the terms proffered; (3) borrowers who obtain loans that they can afford to repay but that contain terms that are unsuitable; and (4) borrowers who could repay their loans but who are denied credit nevertheless due to an overly restrictive reading of suitability. With respect to the first group, prime-eligible borrowers, there is little harm if subprime lenders deny them credit because of a no-waiver rule. These borrowers could qualify for cheaper credit in the prime market. In fact, a no-waiver rule for prime-eligible borrowers would have the salutary effect of creating an incentive for subprime lenders to refer prime applicants to their prime affiliates, if they have them. In that setting, the small cost of a no-waiver rule – some inconvenience to the loan applicant – would far outweigh the potential harm to borrowers in the form of needlessly costly credit.

For the second group, borrowers who cannot repay their loans, a no-waiver rule would decrease the likelihood that subprime lenders would make loans to them in the first place. Some loans should not be made and mortgages to borrowers who cannot afford the repayments are among them. These loans injure the borrowers by draining money required for other necessities and often leading to impaired credit, bankruptcy and foreclosure. They also impose heavy external costs on society because they can lead to homelessness, dependence on the state and neighborhood decline due to abandoned properties. While such a rule may be paternalistic, borrowers and lenders are not the only ones with interests at stake. So does society.

Furthermore, in some cases the borrowers may qualify for credit elsewhere on more affordable

terms. If a no-waiver rule restricts these borrowers access to lenders who make loans that the borrowers cannot afford, the borrowers might look elsewhere for credit, which ultimately could help create a more efficient market.

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

The hardest case to evaluate involves borrowers who could repay the loans but who are denied credit due to over-regulation. This could happen if government regulations imposed bright-line rules that were broader than they needed to be to achieve suitability. Alternatively, lenders might give an overly strict reading to a government rule that contains some play, in which case the no-waiver rule could discourage lenders from making legitimate loans to eligible borrowers for fear of running afoul of the suitability standards. For example, under a government rule that prohibits subprime lenders from making loans that borrowers cannot repay out of current income, lenders would have to institute loan underwriting guidelines. A lender with particularly conservative guidelines might deny borrowers credit because of suitability concerns and the inability to contract for waiver. Of course, if a borrower in this situation did not qualify under one lender's guidelines, the borrower could still apply to other lenders whose guidelines would allow the loan. Even in the case of bright-line government rules that are overly harsh, the borrower might be able to qualify for a different loan with different loan terms such as

lower principal. Nevertheless, in some situations, a no-waiver rule likely would mean that creditworthy borrowers could not qualify for mortgages at all.

The question, then, is whether waiver should ever be allowed. The problem with waiver is that it opens a back door through which lenders and brokers can engage in the same abuses that militated in favor of regulation in the first place. Waiver would give a green light to lenders to tempt borrowers who were susceptible to abuse into waiving their rights. This would be true even if waiver provisions were accompanied by disclosures because, as we have discussed, disclosures fail to perform their intended purpose. More importantly, waiver would interfere with the evolution of a truly efficient subprime market. To encourage an efficient market, borrowers need incentives to shop and lenders need incentives to make loan terms more transparent. If no-waiver rules help discourage subprime lenders from making unsuitable loans, e.g., to prime-eligible borrowers who can qualify for better rates and to borrowers who cannot repay on the terms that they are offered, borrowers will shop elsewhere for credit on more appropriate terms and from lenders who make loan terms transparent.

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

The harmful effects of unwise waivers redound to the harm of society, not just borrowers. Given that external harm, lenders and borrowers should not be permitted to exercise waivers in ways that would foist external injury on third parties. When balancing the risk of loss of credit

to the over-regulated against the tremendous social and individual costs of predatory lending, the balance tips in favor of a no-waiver rule.

e. Defining "Subprime:" Re-examining HOEPA's Triggers

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

To date, HOEPA and most other legislation and administrative rules governing subprime loans (usually called "high-cost loans") rely on "trigger" systems, whereby only loans that exceed certain floors on interest rates or points and fees are regulated. There are two different triggers that have been used to identify high-cost loans subject to regulation: (1) loans with APRs that exceed the yield on Treasury securities of comparable maturity by a set percentage; or (2) loans whose total points and fees exceed some percentage of the total loan amount or some fixed sum, whichever is greater.⁴⁰⁹

HOEPA, which uses both interest, and points and fees triggers, creates perverse incentives for lenders to restyle interest as non-interest charges in order to fall beneath HOEPA's triggers. HOEPA is so easily evaded that an estimated 98 percent of subprime mortgage loans fall below its triggers. HOEPA's points and fees triggers have another unfortunate, unintended result that has not been appreciated. As already discussed, HOEPA's definition of

See, e.g., HOEPA, 15 U.S.C. §§ 1602(aa)(1)-(aa)(4); 12 C.F.R. 226.32 §§(a)(1), (b)(1); N.C.G.S. §§ 24-1.1E(a)(4), (a)(6); General Regulations of the New York Banking Board §§ 41.1(d)-(e).

John Weicher's data suggests, for example, that HOEPA triggers for interest rates might have to be lowered to three percent. *See* note ____ *supra*.

total points and fees omits certain major price terms. As a result, subprime lenders, who want to evade HOEPA, write loans that contain price terms that do not fall within HOEPA's total points and fees calculation. These price terms tend to be more complex than the terms contained in traditional prime products. In this respect, the trigger system works against transparency in pricing in the subprime market.

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

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

See note ____ supra.

See Michael E. Staten & Gregory Elliehausen, *The Impact of the Federal Reserve Board's Proposed Revisions to HOEPA on the Number and Characteristics of HOEPA Loans* 13-14 (working paper July 24, 2001) (studying the effect of North Carolina's predatory lending legislation and finding that there was a reduction in the supply of mortgage credit in the state around the same time that the legislation was enacted); *but see Data on Predator Law Impact Cause a Stir*, Am. Banker, August 22, 2001, at 13 (citing criticisms regarding the methodology and conclusions in the Staten and Elliehausen study).

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

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

One yardstick that could be employed to identify borrowers as prime or subprime is

Fannie Mae's and Freddie Mac's underwriting criteria for their purchase of home loans. Both

Fannie Mae and Freddie Mac use automated underwriting systems, respectively called Desktop

Underwriting and Loan Prospector. The clear advantage of using Desktop Underwriting

FICO scores are statistically generated credit scores that lenders use to evaluate borrowers' creditworthiness. Fair, Isaac and Co. developed the FICO scoring model and makes it available to lenders through credit bureaus. *See* <www.fair.isaac.com.>.

See Keith D. Harvey, et al., Disparities in Mortgage Lending, Bank Performance, Economic Influence and Regulatory Oversight (Working Paper May 2000) (documenting that borrowers' risk classifications vary depending on the risk assessment model employed).

See, e.g., Product Profiles (available at http://www.newamer.com/profiles.htm#FANNIE MAE PRODUCTS>); Fannie Mae, Announcement 00-03, Attachment 1 (available at http://www.efanniemae.com/singlefamily/forms guidelines/guide announcements/db guide announcements.jhtml

and/or Loan Prospector would be greater consistency in borrowers' classifications as prime or subprime. In addition, lenders who sell their loans to Fannie Mae and Freddie Mac already have access to the GSEs' underwriting systems. 417

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

The key question is this: would a market-based definition be less vulnerable to evasion than a system of triggers? Under a market-based approach, lenders would have incentives to manipulate the line between prime and subprime by treating the best subprime borrowers as prime customers in order to escape regulation. To some extent, of course, the market would act

?role=#00-03>); Freddie Mac, AUTOMATED UNDERWRITING, *supra* note _____, ch. 4. Fannie Mae and Freddie Mac also do some manual underwriting based on FICO scores. *See*, *e.g.*, Kim R. Anderson, *GSEs See Automation as*

Spurring Low-Mod Housing, NATIONAL MORTGAGE NEWS, June 12, 2000, at 22; Brian Angell, A Score to Settle; Consumer demand is high for credit scores. What is the holdup?, US BANKER, Aug. 2000, at 34.

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

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

as a brake on such evasion, because the marginal cost of making prime loans to subprime borrowers likely would exceed the marginal profit. On the other hand, a market-based definition of subprime might have negative consequences for the prime market that we cannot anticipate.

There are political, philosophical, and regulatory issues that arise in any effort to define the loans to which suitability should apply. Triggers are close cousins to price controls and can be evaded. Relying on the GSEs underwriting systems to classify borrowers has certain advantages over triggers; however, if Congress were to adopt Desktop Underwriting and Loan Prospector as the tools for classifying borrowers, it effectively would be legislatively authorizing the GSEs to define the subprime market. Another potential problem could arise, if as some commentators predict, 418 risk-based pricing becomes the norm, in which case neither borrowers nor their loans will be classified as prime or subprime and the underwriting tools would be of no help in determining which loans would be subject to suitability. In sum, both approaches are imperfect, but each is adequate to the regulatory task if properly tailored.

f. Relief

One major justification for a new cause of action for breach of suitability is that it could provide remedies that are tailored to the specific harm that borrowers suffer. Victims of predatory lending can suffer two types of harm: retroactive harm and prospective harm.

Borrowers may have paid illegal charges in the past, for example or, in the worst case, may have

Bogdon & Bell, *supra* note _____, at 23-27.

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It is also possible that an industry standard would have the effect of limiting LMI borrowers access to capital because they would not fall neatly within the operative parameters. *See supra*, pages _____ (discussing the virtues of relationship-based banking for LMI borrowers); Tommy Fernandez, *Is Personal Touch Vanishing with Credit Agencies?*" Am. BANKER, JULY 18, 2001, AT 12 ("[s]ome lenders warn that the demise of manual underwriting has bred a growing class of credit-impaired borrowers who are being shunned by small [lending] firms").

lost their homes to foreclosure. Prospectively, borrowers who are still in their homes may be facing foreclosure or an obligation under their loan agreements to pay future charges that the law deems illegal. Accordingly, remedies for breach of suitability need to address both past and future harm. In addition, the scheme for relief should redress any additional unjust enrichment that accrues to predatory lenders and brokers when the benefits of engaging in predatory lending practices exceed the harm to the plaintiffs. ⁴²⁰

For illegal charges already paid, the statute should authorize relief in the form of damages or disgorgement with interest. For past foreclosures, the statute should create a right of redemption if lenders still own the property. With respect to prospective relief, breach of suitability should be an absolute defense to foreclosure. In addition, Congress should give courts equitable power to reform loans to conform to the law and to strike down illegal terms. In some situations, it may be appropriate to permit borrowers to rescind their loans. In steering cases, courts should be empowered to order refinancing at then prevailing prime rates or reformation of loans. Injunctions should be available to reschedule loan payments, to enjoin illegal lending practices, to require reporting of timely mortgage payments, ⁴²³ to reschedule missed payments to the end of the loan and to correct erroneous credit records.

See L.L. Fuller & William R. Perdue, *The Reliance Interest in Contract Damages: 1*, 46 YALE L.J. 52, 53-54 (1936); see generally L.L. Fuller & William R. Perdue, *The Reliance Interest in Contract Damages 2*, 46 YALE L.J. 373 (1937). For example, if a lender received a kickback to make a predatory loan, the kickback should be subject to disgorgement.

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

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

Some predatory lenders refuse to report timely mortgage payments to credit bureaus because they fear that borrowers will refinance with other companies as their payment histories improve. *See, e.g., New assault on your*

Finally, the new right of action should include a substantial statutory penalty that would serve to deter predatory lending, to encourage victims to vindicate their legal rights and to attract representation by the private bar. 424 At this point, we oppose open-ended punitive damages due to the risk of excess deterrence.⁴²⁵ Instead, we propose that all victims of suitability violations receive treble damages or statutory damages, whichever is higher, regardless of the lenders' or brokers' intent or the egregiousness of their conduct. In computing treble damages, actual damages plus any amounts subject to disgorgement should be included. Statutory damages are necessary as a deterrent because, in many cases, the borrowers' relief will be injunctive only, in which case there will not be any actual damages to treble. The amount of the statutory damages should depend on the number of times defendants have been found liable for suitability violations in general, i.e., for each violation the statutory damages should rise. In addition, to avoid obsolescence over time, statutory damages should be indexed to inflation. Finally, the statute should authorize reasonable attorneys' fees and costs in order to attract able representation. These fees and costs should be available regardless whether the cases are resolved through settlement, arbitration or final judgment. 426

In all likelihood, the most satisfactory resolution of predatory lending cases will come about through private settlements, particularly where lenders are worried about reputational concerns. Settlements offer the flexibility to forge creative solutions that are tailored to the loans

credit rating, CONSUMER REPORTS, Jan. 2001, at 20; Geoffrey M. Connor, Banking Law -- How to Be a Predatory Lender and how banks can put an end to the practice, N.J. L.J., Sept. 4, 2000.

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

⁴²⁵ Cf. Engel, supra note _____ at 1192 (discussing the risk of excess deterrence in discrimination cases).

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

and the borrowers in question. To encourage settlements and avoid undue litigation costs,

Congress might wish to require court-ordered mediation as a prerequisite to litigation.

g. *Defendants*

The utility of a suitability requirement depends critically on the ability to enforce it against predatory lenders and brokers, some of who have fly-by-night operations with little capitalization. They can dissolve and reincorporate, sometimes in other states, practically overnight. Their lack of capitalization coupled with the ease with which they can dissolve enables predatory lenders and brokers to evade liability for the harm that they cause borrowers.

Accordingly, we propose disregarding the corporate form under highly limited circumstances in order to impose personal liability for predatory lending against shareholders, officers or directors. Personal liability would only attach where the corporate lender or broker:

(1) was judgment-proof due to undercapitalization; or (2) dissolved in order to evade liability.

If either one of those threshold requirements was met, then any shareholder, officer or director of the lender would be personally liable for monetary, injunctive and equitable relief.

Accordingly, we propose disregarding the corporate form under highly limited circumstances.

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

Among other things, evidence of later re-incorporation or resumption of business through a non-corporate entity could provide evidence of intent.

Cf. Holley v. Crank, No. 99-56611, 2001 U.S. App. LEXIS 17031 (9th Cir. July 31, 2001) (holding owners and officers of corporation vicariously liable for an employee's violation of the Fair Housing Act).

lenders and brokers. This is because loan purchasers do not have access to original loan documentation and other information that would enable them to determine whether loans meet all the requirements for suitability.

Just the same, there are two circumstances in which injured borrowers should be able to raise suitability violations by lenders or brokers against secondary purchasers. First, breach of suitability should be an absolute defense to foreclosure actions by secondary market owners of notes. HOEPA already incorporates this notion by abrogating the holder-in-due-course rule for HOEPA loans. At a minimum, the holder-in-due rule course likewise should be abrogated when subprime borrowers raise lack of suitability as a defense to foreclosure. Second, borrowers should be allowed to bring affirmative suitability claims against secondary market participants who do not have basic internal controls⁴²⁹ and written policies against buying loans with illegal predatory features.

h. Arbitration

For the reasons that we have already discussed, 430 oppressive mandatory arbitration clauses have been a major obstacle to predatory lending relief. However, we are reluctant to condemn arbitration outright. Potentially, a cause of action for breach of suitability could create hundreds of thousands of relatively small claims, which would be well-suited for alternative dispute resolution. Arbitration normally costs less than litigation and results in swifter outcomes, both of which could be valuable to cash-strapped plaintiffs. 431 Finally, political realities must be

For evaluating such internal controls, In Re Caremark Int'l Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996, would provide an appropriate standard.

⁴³⁰ See Section ____ supra.

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

taken into account. Congress is unlikely to ban arbitration clauses altogether in subprime loan agreements, in part due to federal policy favoring arbitration under the Federal Arbitration Act. 432

Accordingly, our task is not to reject arbitration, but to craft an arbitration scheme that is effective. In our view, the key to making arbitration work in subprime lending is threefold. First, arbitration should be strictly optional and not mandatory. Currently, there is no proof that arbitration in subprime lending is fairer or more efficient than litigation in courts and victims should not be denied judicial redress, at least until such proof exists. Second, any arbitration should be conducted under the SRO's auspices or those of the American Arbitration Association (AAA). Finally, the code of arbitration developed by the SRO should be subject to review, revision and approval by the federal oversight agency.

See, e.g., Moses H. Cone Memorial Hospital v. Mercury Constr. Co., 460 U.S. 1, 24-25 (1983).

⁴³³ Cf. Richard E. Speidel, Contract Theory and Securities Arbitration: Whither Consent?, 62 BROOK. L. REV. 1335, 1360-61 (1996) (arguing the same with respect to securities).

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

Cf. Shell, *supra* note ____, at 1366 ("the only realistic way for the securities arbitration system to reform itself is via governmental regulatory action in cooperation with self-regulatory organizations").

In securities, the SEC oversees SRO arbitration rules and must approve any changes in light of the requirements of the Exchange Act. 15 U.S.C. §§ 78s(b)(2), (c).

arbitrators could award relief based not only on suitability as defined by the federal regulations, but also based on the SRO's disciplinary rules governing suitability.⁴³⁵

We again turn to the securities industry to craft safeguards for the arbitration of suitability claims. In cases brought by public customers, mandatory NASD arbitration uses panels of professionally trained arbitrators, a majority of whom must be "public arbitrators" who lack recent ties to the securities industry. NASD arbitral awards are now published online and the NASD will suspend member firms for failing to pay arbitral awards pending appeal in federal appeals courts. We advocate a similar scheme of supervised arbitration for mortgage lending in the subprime market. In particular, we recommend that the SRO be required to institute the minimum, non-waivable on safeguards listed below.

• Customers should have a right to arbitrate either before the SRO or the AAA.

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

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

Obtain NASD Arbitration Awards Online (available at <www.nasdadr.com/arb_awards.asp>). See also NASD To Make Arb Results Available Via Web, Financial Net News, May 21, 2001, at 2; NASD Set to List Arbitration Cases on the Internet, L.A. Times, May 17, 2001, § 3, at 4.

See NASD Code of Arbitration Procedures § 10330(h); NASD Notice to Members 00-55 (Sept. 18, 2000) ("if arbitration awards are not complied with in a timely manner, NASD Dispute Resolution currently institutes suspension proceedings"). See also Don Bauder, Investors score rare win in battle with brokerage, SAN DIEGO UNION-TRIBUNE, May 12, 2001, at C-2 (April 26, 2001 ruling by NASD hearing officer suspended member firm for refusing to pay award to investors after it lost an appeal in federal district court); Gretchen Morgenson, Putting Some Weight Behind Arbitration, N.Y. TIMES, June 10, 2001, § 3, at 10.

The NASD Code of Arbitration Procedure, the arbitration rules of the New York Stock Exchange, the rules of the AAA and the Statement of Principles of the National Consumer Dispute Advisory Council provide good initial reference works for crafting appropriate guidelines. The Statement of Principles is available at http://www.adr.org/education/education/consumer_protocol.htm. See also Martin H. Malin, Privatizing Justice but by How Much? Questions Gilmer Did Not Answer, 16 Ohio State Journal on Dispute Resolution 589 (2001) (arguing for various protections in employment arbitration proceedings); Shelly Smith, supra note ______, at 1222-35 (discussing the need for safeguards in arbitration proceedings involving consumer contracts).

- All arbitration clauses in subprime mortgage loan agreements would have to specify
 that arbitration would be conducted arbitrators certified by the SRO or the AAA
 operating under the auspices of that certifying body.
- The public should be given an opportunity for notice and comment on the oversight agency's review of SRO arbitration rules and amendments to those rules.
- Aggrieved borrowers should have a meaningful role in selecting the panel's arbitrators, under a system such as the AAA's "list method" of selecting arbitrators.
- Every arbitrator on an arbitration panel must be a public arbitrator without significant ties to the mortgage industry. 440
- Every arbitrator should have a law degree in order to ensure adequate analysis of the legal claims.
- Arbitration panels should be required to apply all statutory and common law that is applicable to the claims presented.⁴⁴¹
- Arbitration panels must issue short written opinions, signed by the arbitrators who concur, that summarize the material issues in controversy, how those issues were resolved, the reasons for the decision and the relief sought and awarded.⁴⁴² In addition, the panel should certify that it resolved all claims presented by the claimant.
- All arbitration awards should be published.⁴⁴³
- Arbitration panels must have authority to award all remedies authorized by law, including statutory damages, as well as reasonable attorneys' fees and costs.
- Arbitration agreements may not include any condition that limits the ability of a party to file any claim in arbitration or the ability of arbitrators to make any award.

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

See Edward Brunet, Toward Changing Models of Securities Arbitration, 62 BROOK. L. REV. 1459, 1490-92 (1996); Therese Maynard, McMahon: The Next Ten Years, 62 BROOK. L. REV. 1533, 1555-56 (1996).

See Brunet, supra note ____, at 1488–90.

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

- Mandatory arbitration clauses must not forbid participation in class action lawsuits.
- Arbitral awards must be promptly paid to plaintiffs pending appeals.
- Federal courts should be authorized to review arbitral awards for errors in applicable law. 444 in addition to the more circumscribed scope of review that is authorized in the Federal Arbitration Act. 445

D. Critiques Of Suitability In Subprime Mortgage Lending And Responses

The principal thrust of this Article is to settle the question whether additional relief is necessary to combat predatory lending. As we have shown, information asymmetries allow predatory lenders to thrive and the current patchwork of remedies has been wholly ineffective in combating predatory lending.⁴⁴⁶ In the absence of a new remedy, borrowers and society continue to suffer and this harm will only worsen in a weakening economy.⁴⁴⁷

We do recognize, however, that there are numerous arguments against intervening to curb predatory lending at all, as well as criticisms of our particular proposal. 448 In this section of the paper, we identify and respond to these criticisms.

1. Normative Objections

Some oppose a suitability standard in subprime lending on moral grounds, akin to the debate over bankruptcy reform. They contend that borrowers should take personal responsibility for the loans they decide to accept. After all, the argument goes, no one is forcing them to take out loans.

⁴⁴⁴ See Speidel, supra note _____, at 1362 (recommending addition of the same standard in securities).

⁴⁴⁵ 9 U.S.C. §§ 10(a)(1)-(a)(5).

See Section ____ supra.

See, e.g., Analysts say mortgage fraud rises as economy slows, SUNDAY STAR-NEWS (Wilmington, N.C.), Apr. 1, 2001, at 2B ("'The reason is, the lenders have to keep feeding the monster to pay the overhead, so they might push a loan through, even though it doesn't fit or they might just phony up some documents"").

Arguments of this sort are about free choice and the responsibility to accept the consequences of one's decisions. However, predatory lending is not about free choice, it is about the suppression of free choice. When predatory lenders target vulnerable homeowners who do not understand what they are signing, and then deny these borrowers access to vital information about their loans and hurry them into signing, free choice is nowhere to be seen.

Compounding matters, the financial straits of LMI borrowers frequently put them in a classic double bind. The building code inspector, the debt collector, the bondsman, or the IRS may be knocking at the door. The roof may be leaking or the car they need for transportation to work may have broken down. Their child may need costly medical care, but they have no medical insurance. In cases such as these, the choice is between two evils, one of which is certain and the other of which is ill understood. Thus it is not surprising, as behavioral economists have found, that people who are facing crises are more likely to take risks.⁴⁴⁹

Critics counter that many victims of predatory lending refinance their mortgages to buy luxury items such as TVs, stereos and cars, not to pay for emergencies or home repairs. In their view, the law should not reward profligate conduct by providing borrowers redress for predatory loans, the proceeds of which they used inappropriately to purchase luxury goods.

Concerns about profligate use of loan proceeds are present regardless whether borrowers are low income, middle class or affluent;⁴⁵⁰ however, the social consequences of LMI borrowers

See, e.g., David Wessel, An Inner-City Predator Needs a New Leash, WALL St. J., Apr. 19, 2001, at A1.

See, e.g., Amos Tversky & Daniel Kahneman, Advances in Prospect Theory: Cumulative Representation of Uncertainty, 5 J. RISK & UNCERTAINTY 297 (1992); Amos Tversky & Daniel Kahneman, Rational Choice and the Framing of Decisions, 59 J. Bus. S251 (1986). See also Roger G. Noll & James E. Krier, Some Implications of Cognitive Psychology for Risk Regulation, 19 J. LEGAL STUD. 747 (1990); Langevoort, supra note ____ at 637.

See, e.g., Understanding Cash Out Refinancing, Bankrate, Aug. 24, 2001 (available at <www.thebankingchannel.com/comm/story.jsp?story=TBCK5J5OYOC>); Freddie Mac, Press Release, Loan Refinancings That Took Equity Out of Houses Rose in Second Quarter of 2001 (Aug. 21, 2001) (available at <www.freddiemac.com/news/archives2001/2qupb01.htm>). More affluent borrowers refinance loans or take out

entering into predatory loans and engaging in profligate spending⁴⁵¹ are more severe. The borrowers can go bankrupt, and become homeless.⁴⁵² When they go bankrupt, their other creditors are hurt. When they become indigent, taxpayers are called on to support them. The severe external effects of default and foreclosure on society justify predatory lending protections, even when home equity is used to finance luxury purchases.

Another, related argument that critics make it response to anti-predatory lending proposals is that any protections are paternalistic and interfere with borrowers' exercise of free choice. The argument is that predatory lending legislation will prevent borrowers from obtaining loans that contain terms that are acceptable to both lenders and borrowers, but that the law deems predatory or, with our proposal, unsuitable. We recognize that there is a paternalistic element to the suitability requirement. But we contend that the burden of limited restrictions on free choice is outweighed by the severe negative effects of predatory loans on borrowers and on society. In addition, as we discuss, suitability may make it possible for many of these borrowers to obtain loans from other lenders on better terms.

2. *Market Arguments*

There are a number of market-based arguments that critics have advanced in support of their position that predatory lending legislation is unnecessary and/or counterproductive. One argument is that predatory lending protections create incentives for borrowers to "game the system," by taking out loans that they know they cannot repay and then seeking loan forgiveness,

second mortgages to finance needed or desired expenditures with their untapped equity, including renovations or home repairs, college education, medical bills, taxes, credit card debts or vacations. *See, e.g.*, Teresa A. Sullivan *et al.*, THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT 225 (2000).

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There are no sound data indicating the extent to which borrowers use loan proceeds to engage in profligate spending.

See supra notes ____ and accompanying text (discussing why borrowers put their homes at risk).

claiming that their loans were unsuitable. This argument might have credence for unsecured loans when borrowers are judgment-proof, but would not apply here where borrowers' homes are at stake. Very few homeowners can afford to engage in that type of brinksmanship, particularly not LMI borrowers, because if they are wrong, they will lose their homes to foreclosure.⁴⁵³

The most oft-heard criticism is that a suitability rule would result in credit constraints. ⁴⁵⁴
To the extent that this criticism refers to loan denials because the borrowers cannot repay their loans out of current and expected income, we endorse this outcome because these loans should not be made in the first place. Furthermore, it is possible that these borrowers will not be shut out of the credit market altogether. Rather, many of these borrowers may qualify for legitimate subprime or even prime loans elsewhere with better, more affordable terms. ⁴⁵⁵ As for other problematic terms and practices, the operative question is not whether narrowly targeted regulations would have some constraint on credit. Instead, the question is whether the potential harm from carefully crafted, targeted regulations outweighs the harm of maintaining the status quo. Thus, what is called for is a cost-benefit analysis to determine what suitability rules would best address the harm that occurs from predatory lending without inordinately limiting the availability of credit. We believe that our proposal for an SRO that can develop best practices rules, a federal rulemaking process with full public input and a feedback loop for revision of rules is best-suited to perform that cost-benefit analysis.

Of course, if borrowers materially mislead lenders as to their ability to repay their loans, lenders would have a defense to any suitability claims.

See, e.g., Charles W. Calomiris & Robert E. Litan, *Homeownership That's Too Important to Risk*, N.Y. TIMES, Aug. 20, 2001, at A21 ("[n]ew laws on the pattern of some already passed at the state and local level could do great harm by discouraging lenders from making any subprime loans at all").

See notes _____ supra and accompanying text.

Some critics of suitability and other efforts to combat predatory lending take the position that recent losses in the subprime market⁴⁵⁶ indicate that predatory lending is not profitable and that the market will "correct" itself and predatory lending will cease. We disagree with this conclusion on several grounds. First, no one has established a correlation between reduced profitability in the subprime market and predatory lending. The losses in the subprime market could be attributable to the overall economic slowdown,⁴⁵⁷ inadequacies in the risk assessment models used by subprime lenders, or a host of other economic or institutional factors.

As we discussed previously, the market, as it is currently structured, will not curb predatory lending. In short, secondary market actors can protect themselves against the risk of default by inserting recourse provisions when they purchase packages of loans. Predatory lenders insulate themselves from losses when they originate loans by making loans at high interest rates to borrowers with significant equity in their property. In addition, they finance huge fees, often repeatedly. At foreclosure, these lenders, even those who end up holding loans pursuant to recourse provisions, can recoup the unpaid interest and fees.

It is possible that, in the absence of interventions to curb predatory lending, legitimate subprime lending will decrease. If predatory brokers are deceiving legitimate subprime lenders, causing the lenders to suffer losses, predatory lenders will gain a larger market share.⁴⁵⁸
Legitimate subprime lenders, many of which are major institutional lenders who have to answer

See, e.g., Paul Beckett & John Hechinger, Subprime Loans Could Be Bad News for Banks, WALL ST. J., Aug. 9, 2001, at C1 ("[t]hat subprime has been deteriorating is clear. In May [2001], . . . the percentage of subprime

mortgages nationwide that were seriously delinquent rose to 6.37% from 5.55% at the end of the last year").

⁴⁵⁷ *Id.*

See, e.g., Laura Mandaro, Wamu Primed For More Subprime, AM. BANKER, Aug. 20, 2001, at 1 (discussing Bank of America's decision to exit subprime mortgage lending); Riva D. Atlas, Bank to Drop 2 Businesses To Tighten Up Its Operations, N.Y. TIMES, Aug. 16, 2001, at C1 (same).

to shareholders and often regulators, cannot sustain losses for long. The substantial goodwill and long-term reputational interests of these firms, moreover, mean that they cannot simply dissolve and reincorporate under different names. In contrast, fly-by-night predatory lenders do not have these constraints. If they suffer losses that they cannot absorb, they can file for bankruptcy or simply dissolve. The principals can then go underground for awhile, form a new corporation and resume predatory lending anew.

It is also possible that publicity about unchecked predatory lending may make legitimate subprime lenders wary of making high-risk loans and thereby reduce the options for high risk borrowers who are seeking credit.⁴⁵⁹ If shareholders and regulators put pressure on legitimate subprime lenders to avoid even the appearance of predatory lending, these lenders will adopt more conservative lending practices, which would have the effect of enlarging the market for predatory lenders.⁴⁶⁰

3. *Concerns About Frivolous Litigation*

Some concede that additional remedies are needed, but oppose the creation of a private cause of action.⁴⁶¹ We strongly believe that private relief is necessary for three reasons. First and foremost, a private cause of action is economically efficient because it places liability on the parties who are able to avoid the harm of predatory lending with the least cost, *i.e.*, predatory

⁴⁵⁹ Cf. John Hechinger & Patrick Barta, supra note ____ at A1 (citing examples of banks that have dropped their subprime units because of fear of charges of predatory lending).

See, e.g., Michele Heller, FTC Veteran: Keep the Heat On Predators, Am. Banker, Aug. 17, 2001 (quoting former FTC official David Medine to the effect that if "legitimate lenders leav[e] that market, it's going to leave it wide open for predatory lenders to continue to dominate it.").

Litan, *Prudent Approach*, *supra* note _____, at 2 ("[t]he more prudent course is for policy makers at all levels to wait for more data to be collected and reported by the Federal Reserve so that enforcement officials can better target practices that may be unlawful under existing statutes. In the meantime, Congress should provide the federal agencies charged with enforcing existing statutes with sufficient resources to carry out their mandates, as well as to support ongoing counseling efforts") (emphasis omitted).

lenders and brokers. Second, the compensatory aspect of the private right of action is important because it requires lenders and brokers to internalize the cost of the harm that they cause, thereby undercutting their incentives to engage in predatory lending. Third, we strongly advocate private relief because the government often lacks the resources and the will to pursue civil claims when it has enforcement authority. If the government were given the sole power to enforce suitability and the designated agency, for financial, bureaucratic or political reasons, failed to fully exercise its power, tens of thousands of predatory lending victims nationwide would have no or only limited recourse.

One argument in opposition to establishing a private cause of action is that it might spawn frivolous lawsuits. The concern is that dishonest borrowers will enter into legitimate, suitable loans and then challenge the loans because they regret having taken them out in the first place. Our response is that bright-line suitability rules or presumptions in lieu of fuzzy standards, plus adequate documentation by lenders of compliance, should keep frivolous lawsuits to a minimum.

Some critics focus on class actions and contend that attorneys will bring frivolous strike suits in order to extract settlements and/or will settle meritorious claims on terms that benefit themselves at plaintiffs' expense. We believe that these concerns about class action abuses are overstated. To begin with, class actions are not necessarily easy to certify in predatory lending cases. For instance, in damages class actions under Fed. R. Civ. P. 23(b)(3), plaintiffs must show that the common issues predominate over the individual ones in order to win certification.

Michael Selmi, *Public vs. Private Enforcement of Civil Rights: The Case of Housing and Employment*, 45 U.C.L.A. Rev. 1401, 1438 (1998) (in referring to enforcing the fair housing and employment discrimination laws, stating that "the government's enforcement efforts have largely failed").

Loan underwriting decisions often turn on facts that are unique to the borrowers, making commonality difficult to prove.⁴⁶³

To the extent that class actions can be certified in predatory lending suitability cases, the goal should be on limiting the possibilities for abuse, and not on denying class actions claims wholesale. With respect to the risk that attorneys will bring frivolous suits, we note that counsel must already certify under Rule 11⁴⁶⁴ that the claims they are pursuing are non-frivolous, have evidentiary support and are not being presented for harassment or delay. Making Rule 11 sanctions for frivolous filings mandatory for class counsel in predatory lending cases would give that provision real force, although we strongly advise against mandatory sanctions for plaintiffs.

With respect that class counsel will enter into exploitative settlements of meritorious claims, some of the safeguards in the Private Securities Litigation Reform Act of 1995 (PSLRA) should be extended to suitability claims for predatory lending. Named class plaintiffs could be required to swear that they reviewed the complaint and authorized its filing, and that they will

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See United Cos. Lending Corp. v. Sargeant, 20 F. Supp. 2d 192, 210 (D. Mass. 1998) (declining to certify a class in a predatory lending case because "individual factual questions predominate over those common to the class"); Peters v. Cars To Go, Inc., 184 F.R.D. 270, 277-80 (W.D. Mich. 1998) (court certified one class, but denied certification for another due to lack of commonality). *Cf.* Hoffman v. Grossinger Motor Corp., 218 F.3d 680, 683 (7th Cir. 2000) (refusing to construe TILA in a subprime auto loan case in a way that "would make the class action a truly fearsome instrument of consumer-finance litigation").

In part for these reasons, securities class actions rarely assert breach of suitability. For instance, a study of securities class actions filed in 1999 found that the most prevalent claims were for improper revenue recognition and overstated assets. According to the study, "[o]ther prevalent areas included purchase accounting, liabilities and accounting estimates." Suitability was not mentioned. *See* PRICEWATERHOUSECOOPERS, 1999 SECURITIES LITIGATION STUDY 2-3 (1999) (available at

http://securities.stanford.edu/research/reports/19990801pwc103000.pdf); see also Mukesh Bajaj et al., Securities Class Action Settlements: An Empirical Analysis 3-4, 15 (2000) ("the vast majority of cases involved allegations concerning corporate disclosures") (available at

http://securities.stanford.edu/research/studies/20001116_SSRN_Bajaj.pdf). The prevalence of mandatory arbitration clauses governing suitability claims in securities also explains the paucity of securities class actions.

⁴⁶⁴ Fed. R. Civ. P. 11(b).

not accept added payments for serving as named plaintiffs without court approval.⁴⁶⁵ In addition, total attorneys' fees should be limited by statute to a reasonable percentage of the actual recovery to the class (including statutory damages) and settlements under seal should be barred.⁴⁶⁶

D. Other Needed Areas Of Regulatory Attention

Our proposal relies on governmental, SRO and private enforcement of suitability.

Designing a cause of action and an array of enforcement mechanisms was our top priority because our purpose was to address the core incentive structures that fuel predatory lending. We do not wish to downplay the fact, however, that other aspects of subprime mortgage lending contribute to predatory lending and require attention. We have not discussed those problem areas in detail because they fall outside the scope of the Article. Nevertheless, a comprehensive approach to predatory lending will need to come to grips with these problems.

1. Regulation Of Mortgage Brokers

In the abstract, one might think of mortgage brokers as professionals who help borrowers find loans on the best terms. In practice, mortgage brokers serve a very different function because of the incentive structure in the industry. Brokers work for and are paid by loan originators, not borrowers. Brokers can facilitate predatory lending by scouting out unsophisticated borrowers and convincing them to pay the highest possible prices. While these

We note that formerly it was easy to manufacture securities fraud class actions by having a staff member in class counsel's firm buy stock of every company in the S&P 500 or another broad index of stocks. The PSLRA contains a number of provisions that are designed to curb those abuses and ensure the independence of named class plaintiffs. *See generally* 15 U.S.C. § 78u-4. In contrast, the danger of manufactured suitability claims in the home mortgage area of this type is quite low. Manufacturing a claim would require class counsel to take the absurd and unethical step of convincing an employee or another unsuspecting individual to go out and obtain a predatory loan secured by his or her home.

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see 15 U.S.C. § 78u-4(a)(2)(A).

See 15 U.S.C. §§ 78u-4(a)(5)-(a)(6).

mortgage brokers have financial incentives to deceive lenders as well as borrowers, 467 in the final analysis they have no incentive to protect borrowers, but do care about their relationships with lenders, who provide them with repeat business. Our proposal seeks to realign those incentives by requiring brokers to take suitability into account. In addition, mortgage broker licensing, capital or bonding requirements and sanctions could be useful in remedying these problems. 468

2. Regulation Of Appraisers

Inflated appraisals often lie behind predatory loans. 469 Like mortgage brokers, real estate appraisers have perverse incentives to inflate property values. Lenders, who sell loans on the secondary market, want appraisals that will satisfy secondary market purchasers. Appraisers who can produce such appraisals will be the most valued and utilized by lenders. In 1989, Congress required federal banking regulators to tighten federal regulation of appraisers used by federally insured banks and thrifts. 470 At a minimum, those provisions should be extended to appraisers of subprime mortgage properties generally. In addition, appraisers who are guilty of inflated appraisals should be subject to suit under state UDAP statutes.

3. Due Diligence By The Secondary Market

Due diligence by the secondary market, particularly by the private secondary market, has been lax to date and has failed to deter capital flows to predatory lenders. It is unreasonable to expect secondary market purchasers to unbundle mortgage-backed securities and examine every single mortgage. However, we recommend the adoption of minimum standards for secondary

See notes _____ supra and accompanying text.

See e.g., N.C.G.S. §§ 53-243.01- 243.15 (North Carolina's Mortgage Lending Act).

See note supra.

See 12 U.S.C. §§ 3331, 3339, 3341; 12 C.F.R. §§ 34.41-34.47, 225.61-225.67, 323.1-323.7, 564.1-564.8; McCoy, *supra* note ____, § 6.04[4].

market purchasers, which could have the effect of filtering out predatory loans, for example, by prohibiting secondary market purchasers from purchasing loans that include the financing of single premium credit life insurance.⁴⁷¹ In addition, it is reasonable to require that secondary market purchasers require periodic audits of loans purchased from originators with high loss ratios in an effort to uncover predatory lending.

4. CRA Credit For Predatory Loans

In a similar vein, banking organizations should be barred from receiving CRA credit for predatory loans.⁴⁷² Banking entities that originate subprime mortgages should not get CRA credit unless their subprime loans meet the best practices standards of the SRO and the enforcement agency's suitability guidelines. Banking organizations that purchase subprime mortgages, either individually or in bundles, should not receive CRA credit unless they have instituted due diligence provisions along the lines suggested above.

5. Federal Agencies Need To Responsibly Exercise Their Preemption Privilege

In the American dual banking system, ⁴⁷³ federal preemption is a long-held and jealously guarded prerogative. As we discussed *supra*, in the area of mortgage lending federal preemption could have the unfortunate effect of hampering state predatory lending reforms that are stronger than their federal counterparts. The most prominent example is challenges to state laws on grounds that state prohibitions against subprime terms and practices such as loan flipping,

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Cf. Office of Thrift Supervision, Advance notice of proposed rulemaking, Responsible Alternative Mortgage Lending, 65 Fed. Reg. 17811, 17818 (Apr. 5, 2000) (seeking comment on whether OTS should "encourage thrifts to inquire whether securitizers from whom they purchase interests in loan pools have conducted their own due diligence efforts with regard to the underlying loans").

See HUD-Treasury Report, supra note ____, at 106.

negative amortization, financing of points and fees and balloon payments are federally preempted under AMTPA.⁴⁷⁴ Recently, for instance, the Fourth Circuit held that AMTPA preempted a Virginia statute limiting the size of prepayment penalties in home loans.⁴⁷⁵ Similarly, OCC expansion of national bank powers to issue credit life insurance under expansive readings of the National Bank Act⁴⁷⁶ may have inadvertently set the stage for certain credit life insurance abuses.

Federal banking regulators that enjoy the privileges of federal preemption need to exercise those privileges responsibly. The Office of Thrift Supervision, for instances, administers AMTPA and has authority to modify its implementing regulations to permit state regulation of non-price terms. In April 2000, OTS issued an advanced notice of proposed rulemaking seeking comment on whether, due to predatory lending concerns, AMTPA's regulations should be modified.⁴⁷⁷ OTS should complete that task and modify AMTPA's rules, to the extent possible, to permit regulation of non-price terms in subprime mortgages by the

For a general description of the dual banking system, see McCoy, supra note ____, § 3.02.

See, e.g., Michael Bologna, Mortgage Brokers' Suit Says U.S. Law Preempts Illinois Predatory Lending Rules, BNA BANKING REP., July 30, 2001, at 201 (describing Illinois Ass'n of Mortgage Brokers v. Office of Banks and Real Estate, No. 01-C5151 (N.D. Ill. filed July 13, 2001)); Predatory Lending Regulations, Laws Spread Across the Nation, BNA BANKING REP., Apr. 30, 2001, at 776. For a description of AMTPA, see notes _____ supra and accompanying text.

See National Home Equity Mortgage Ass'n v. Face, 239 F. 3d 633 (4th Cir. 2001).

Similar preemption challenges might be possible under the DIDMCA. For a description of the DIDMCA, see notes _____ supra and accompanying text. In addition, special usury provisions in the National Bank Act and the Federal Deposit Insurance Act preempt state usury laws for national and state banks and permit these banks to export high interest rates from states where they are located to other states. See 12 U.S.C. §§ 85, 1831d(a); Smiley v. Citibank (South Dakota), 517 U.S. 735 (1996); Marquette Nat'l Bank v. First of Omaha Serv. Corp., 439 U.S. 299, 301 (1978). Cf. Paul Beckett, Why Patricia Heaton Could Cause Problems For a GE-Owned Bank, WALL ST. J., Mar. 30, 2001, at A1 (discussing lawsuit contending that a credit card bank formed by GE was a "state bank" that took deposits and therefore was eligible to export high interest rates to more protective states).

⁴⁷⁶ 12 U.S.C. § 24 (Seventh); see generally McCoy, supra note ____, § 5.02[5][b][i][A].

Office of Thrift Supervision, Advance notice of proposed rulemaking, *Responsible Alternative Mortgage Lending*, 65 Fed. Reg. 17811, 17815-17 (Apr. 5, 2000).

states. Similarly, the Office of the Comptroller of the Currency should regulate exploitative terms in credit life insurance and similar products.

6. *Marketing Abuses*

Predatory lenders locate their prey through aggressive telemarketing and door-to-door solicitation. Aggressive regulation of both types of marketing, within the bounds of the First Amendment, could help shut off this vital pipeline for new customers to predatory lenders.

7. SEC Material Litigation Disclosures

If shareholders and people contemplating stock purchases learn that a stock issuer has significant suitability claims pending, they may divest or elect not to purchase stock. This risk creates an incentive for firms to develop mechanisms to detect predatory lending. Under SEC regulations implementing the Securities Act of 1933, issuers of securities must disclose all material pending legal proceedings to which they are party. Litigation is not "material" unless similar claims, taken together, seek damages exceeding ten percent of the issuer's current assets. In suitability claims, where injunctions may form the primary relief or the damages sought are small, the ten percent trigger may not be satisfied. Amending the SEC rule to add a trigger for a large number of small claims would address that problem. In addition, amending the definition of "material pending legal proceedings" to include arbitrations and agency proceedings, at least for subprime mortgage claims, would be advisable.

VI. CONCLUSION

Predatory lending is more than a fleeting problem. As foreclosures and bankruptcies mount, and neighborhoods decay, predatory lenders and brokers continue their practices

Regulation S-K, Item 103.

unabated and, more importantly, virtually free of sanctions. Our study of the forces that have contributed to the emergence of predatory lending and of the extant remedies available to victims of predatory lending has led us to conclude that without government intervention to impose a suitability standard, predatory lending will persist with devastating social consequences.