The CRA Implications of Predatory Lending

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Introduction

Traditionally, policymakers, communities, and industry have regarded the Community Reinvestment Act ("CRA")[1] as a positive mandate for banks and thrifts[2] to do good by increasing investment in low- and moderate-income ("LMI") neighborhoods.[3] The specific purpose of CRA is to encourage federally insured depository institutions "to help meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions."[4]

When Congress enacted CRA in 1977, it was in response to the prevailing belief that under-investment was a root cause of blight in LMI neighborhoods. Congress hoped to reverse this blight by creating incentives for banks to increase their lending activities in low-income communities. At the time, it was inconceivable that LMI neighborhoods might eventually have too much credit in the form of abusive mortgages that would

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[1] 12 U.S.C. §§ 2901-2908 (2001).

[2] Henceforth, we use the term "bank" to denote both banks and thrifts.

[3] For CRA purposes, LMI borrowers are those borrowers whose household incomes are less than eighty percent of the local median family income. LMI neighborhoods are census tracts with median family incomes that are less than eighty percent of the median income in the metropolitan area. **Robert E. Litan et al.**, **The Community Reinvestment Act After Financial Modernization: A Baseline Report** 2 (2000) [hereinafter **Baseline Report**].

[4] 12 U.S.C. § 2901(b) (2001).

trigger a surge in foreclosures. However, by the late 1990s, the unimaginable had happened. Predatory mortgages[5]—exploitative high-cost loans to gullible borrowers—were ravaging inner cities and newspaper headlines across the country were carrying accounts of foreclosures against low-income people of color and the elderly.

In this article, we seek to understand the intersection between CRA and predatory lending by answering the following questions:

- does CRA reward banks for engaging in predatory lending or activities that indirectly support predatory lending?
- do federal subsidies indirectly support predatory lending?
- should CRA create disincentives to banks that engage in or provide indirect support for predatory lending?
- should CRA be extended to impose anti-predatory lending provisions on non-bank lenders,[6] including non-bank affiliates and subsidiaries of banks?
- is there a role for CRA to play in rewarding bank activities that combat predatory lending?

In examining these questions, we are mindful that CRA is a limited and imperfect tool for achieving community reinvestment. In particular, CRA raises controversial

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[5] Elsewhere, we have defined predatory lending as a syndrome of exploitative loan practices involving one or more of the following five problems:

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

Kathleen C. Engel & Patricia A. McCoy, A Tale of Three Markets: The Law and Economics of Predatory Lending, 80 **Tex. L. Rev.** (forthcoming 2002).

[6] Throughout this article, the term “non-bank lenders” refers to lending entities that are not federally insured depository institutions.

issues, regarding the efficient allocation of credit, competitive parity, safety and soundness, and regulatory taxation.[7] Despite its flaws, CRA has established a beachhead for community development finance across the country and has become institutionalized at major banks. Furthermore, having survived the enactment of the Gramm-Leach-Bliley Act of 1999 intact, albeit modified, CRA is here to stay for the time being.[8]

Just as there are challenges to the utility of CRA in general, there are some who contend that CRA is an inappropriate tool to combat predatory lending. Thus, a threshold question is whether there are legitimate justifications for using CRA to address predatory lending. We have identified two such justifications that we develop more fully *infra*. The first justification stems from the CRA's goal of encouraging banks to serve the credit needs of their communities. If CRA is creating incentives for banks to engage in predatory lending, then CRA is actually defeating one of its stated goals. Our second justification arises from the fact that banks are the recipients of special government privileges in the form of exclusive charters, federal deposit insurance and so forth. These subsidies are considered part of the rationale for imposing CRA obligations on banks.[9] If banks use these privileges to harm the communities they serve, there is a role for CRA in scrutinizing bank activities.[10]

We divide this article into three parts. In Part I, we outline the relevant provisions of CRA. In Part II, we consider how CRA-covered lenders may enable predatory

[7] See generally Patricia A. McCoy, Banking Law Manual: Federal Regulation of Financial Holding Companies, Banks and Thrifts § 8.04 (2d ed. 2001 & cum. supps.) [hereinafter Banking Law Manual].
[8] Pub. L. No. 106-102 (codified at 15 U.S.C. §§ 6801-6810 (2001)).
[9] See, e.g., Allen J. Fishbein, The Community Reinvestment Act After Fifteen Years: It Works, But Strengthened Federal Enforcement is Needed, 20 **Fordham Urb. L.J.** 293 (1993).

lending, either directly or indirectly. We also discuss the relationships among CRA, federal subsidies and predatory lending. In Part III, we address whether there are sufficient justifications for employing CRA to penalize lenders that engage in predatory lending. Ultimately, we conclude that CRA involvement is justified and make specific recommendations.

I. Applicable Provisions of the Community Reinvestment Act

CRA requires federal banking regulators "to encourage [federally insured depository] institutions to help meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions."[11] CRA has two principal enforcement mechanisms: CRA examinations and regulatory review of applications for expansion.

The first enforcement mechanism consists of CRA examinations. In CRA, Congress directed federal bank examiners to "assess an institution's record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with the safe and sound operation of such institution."[12] Federal examiners evaluate a bank's community reinvestment efforts in three separate areas: lending (the "lending test"), investments in community development (the "investment test"), and retail depository services (the "service test").[13] Institutions receive CRA ratings that can range from "outstanding" or "satisfactory" to "needs to

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[10] Of course, these justifications apply solely to insured depository institutions.
[11] 12 U.S.C. § 2901(b) (2001).
[12] 12 U.S.C. § 2903(a)(1) (2001).
[13] See, e.g., 12 C.F.R. §§ 228.21(a)(1), 228.22-228.24 (Federal Reserve Board).

improve" or "substantial noncompliance."[14] Those examination ratings, plus the "public" section of the examination report, are available to the public.[15] Unlike depository institutions, non-bank affiliates of banks do not undergo CRA examinations unless they volunteer to do so.

CRA's other enforcement mechanism consists of applications for expansion. These applications are divided into two types: (1) applications for deposit facilities; and (2) applications to become financial holding companies and applications by financial holding companies and national banks to commence new financial activities or acquire companies engaged in financial activities.

Applications for deposit facilities include applications for a bank charter or deposit insurance; applications to open or close a branch; applications to relocate a home office or a branch; applications for a merger, acquisition or consolidation; applications to acquire another bank's liabilities; and applications to acquire an insured bank.[16] When reviewing applications for deposit facilities,[17] federal bank regulators must take institutions' CRA performance into account. The public may lodge CRA protests and agencies have discretion to deny applications or place conditions on approval due to CRA

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[14] 12 U.S.C. § 2906(b)(2) (2001); see also 12 C.F.R. pt. 228 app. A (Federal Reserve Board). Well over ninety-five percent of institutions receive grades of "satisfactory" or "outstanding." **Banking Law Manual**, supra note 7, § 8.03[1][b][i].
[15] 12 U.S.C. § 2906(a)(2), (b)(2) (2001).
[16] 12 U.S.C. §§ 2902(2)-(3), 2903(a)(2) (2001); see also 12 C.F.R. § 228.29(c) (Federal Reserve Board).
[17] Id.

concerns.[18] The public does not have standing to sue to enjoin bank mergers or other applications on CRA grounds.[19]

Applications to become financial holding companies and applications by financial holding companies and national banks to commence new financial activities or acquire companies engaged in financial activities receive different CRA treatment. Under the Gramm-Leach-Bliley Act of 1999, such applications must be denied where any of the holding company's banks or thrifts has a CRA rating of less than satisfactory.[20] Conversely, where a parent company's depository institutions all have CRA ratings of at least satisfactory, such applications cannot be denied on CRA grounds.[21] Regulators have no discretion and CRA does not allow protests by members of the public to such applications.

II. Defining the Problem

A. Direct Involvement by Banks in Predatory Lending

Banks can directly participate in predatory lending by originating or brokering predatory loans. Currently, both origination and brokerage activities may qualify for CRA credit even when they involve predatory lending.

There is a great deal of uncertainty regarding the extent to which banks originate predatory loans.[22] As we discuss *infra*, banks have significant disincentives to originating

[18] 12 U.S.C. § 2903 (2001).
[19] See Inner City Press v. Bd. of Governors, 130 F.3d 1088, 1089-90 (D.C. Cir. 1997) (per curiam); Lee v. Bd. of Governors, 118 F.3d 905, 910-11 (2d Cir. 1997).
[20] 12 U.S.C. §§ 1843(1), 2903(c)(1) (2001).
[21] See **Banking Law Manual**, supra note 7, § 8.03[1][b][ii].
[22] There is a pressing need for empirical work on this subject. Without an accurate understanding of the extent and nature of banks' involvement with predatory lending, it is difficult to assess the need for and appropriateness of any remedial proposals.

subprime, including predatory, loans.[23] Although theoretically the disincentives outweigh the incentives, there is anecdotal evidence that certain regulated depository institutions have originated predatory loans. For example, numerous borrowers have sued the failed subprime lender Superior Bank,[24] alleging that the bank engaged in predatory lending.[25] The plaintiffs have alleged that Superior encouraged them to assume loans they did not need or could not afford, and engaged in various forms of fraud.[26] If Superior was

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Analyzing 2000 data reported under the Home Mortgage Disclosure Act (HMDA), the Department of Housing and Urban Development identified 185 lenders whose business focus was subprime mortgage lending. 116 (63 percent) were independent mortgage companies. 31 (17 percent) were non-bank affiliates and only 38 (20 percent) were depository institutions or their direct subsidiaries. 6,423 depository institutions filed HMDA reports in 2000. There are likely other banks in addition to the 38 reported that do some subprime lending, even if it is not their business focus. See Memorandum from Division of Research and Statistics to the Board of Governors of the Federal Reserve System, Jan. 15, 2002, at tbl. 1-4.

[23] In most cases, predatory loans form a subset of the market for subprime loans. The subprime market offers loans with higher interest rates that are suited for individuals with blemished credit, limited income, or unconventional sources of income. Subprime lenders charge higher interest to defray the higher risk of default. See, e.g., **Depts of the Treasury and Hous. and Urban Dev., Curbing Predatory Home Mortgage Lending** 28 (2000) [hereinafter **HUD-Treasury Report**]. Many subprime loans are legitimate. Only those that display one or more of the five characteristics listed in note 5, supra, are predatory in nature.

Predatory loans come in numerous varieties, including high-cost mortgages, auto loans, payday loans, credit card debt, and other unsecured consumer loans. Our focus will be on home mortgages secured by first or junior liens on the borrowers' homes. This is because the consequences to homeowners and society of default and foreclosure are particularly devastating.

[24] Federal regulators seized Superior Bank in July 2001. See Hearing on the Failure of Superior Bank, FSB, Hinsdale, Illinois: Hearing Before Senate Comm. on Banking, Housing and Urban Affairs, 107th Cong. (2001) (statement of John Reich, Director, Federal Deposit Insurance Corporation) [hereinafter Reich Testimony]; Kathleen Day, A Practice That Lends Itself to Trouble; Superior's Failure Spotlights Banks That Court High-Risk Borrowers, **Wash. Post**, Aug. 21, 2001, at E1.

[25] See Reich Testimony, supra note 24. It is difficult to know whether Superior was an outlier or if, in fact, banks are originating predatory loans across the board.

[26] See id.

making predatory loans, it could have received CRA credit for these loans under the lending test.

When banks serve as loan brokers, they take borrowers' applications and perform various settlement functions, without assessing the creditworthiness of the applicants. Sometimes broker banks fund subprime loans for a brief period before assigning the loans to the originating lenders. Other times the broker banks do not fund the loans at all.[27] For the purpose of the CRA lending test, banks can ask examiners to take into account the loans that they brokered and briefly funded. Likewise, banks whose brokerage activities are limited to accepting applications and performing settlement functions can include these activities under the CRA service test. Lastly, banks can ask that their mortgage brokerage services be considered part of their community development service.[28]

B. Indirect Involvement by Banks in Predatory Lending

There are numerous ways in which banks can indirectly support predatory lenders. They can purchase predatory loans as investments, either as assignments of loans originated elsewhere or by buying securities backed by predatory loans.[29] If and when banks purchase predatory loans, they may be entitled to CRA credit under the lending test if the loans fall within CRA guidelines.[30] Similarly, when banks purchase

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[27] See Federal Financial Institutions Examination Council, Community Reinvestment Act: Interagency Questions and Answers Regarding Community Reinvestments; Notice, 66 Fed. Reg. 36,620, 36,628 (July 12, 2001) [hereinafter Interagency Questions].

[28] See id.

[29] See also **HUD-Treasury Report**, supra note 23, at 37, 45-46 (citing the various roles that regulated institutions can play in subprime lending).

[30] See Community Reinvestment Act Regulations, 66 Fed. Reg. 37,602, 37,604 (Dep't of Treasury et al. July 19, 2001) (joint advance notice of proposed rulemaking) [hereinafter **CRA ANPR**]. It is possible for banks to originate predatory loans and then sell the

securities backed by predatory loans made to LMI borrowers, they may receive credit under the investment test.[31]

Banks also finance non-bank subprime lenders, through warehouse lending facilities and other working capital loans[32] and through loan guarantees in the form of letters of credit. In addition, banks serve as underwriters, trustees, registrars and paying agents for securitizations of subprime loans, some of which may be predatory.[33] These bank activities raise CRA implications because some of the activities receive explicit federal guarantees, while others may benefit more generally from federal subsidies. Explicit subsidies arise, for example, when subprime lenders obtain financing through

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predatory loans among themselves, which would enable them to be considered for CRA credit for originating the original predatory loans and then for purchasing predatory loans originated by other institutions. Id.

[31] See Interagency Questions, supra note 27, at 36,635.

[32] See, e.g., First Union Corp., Charlotte, N.C.; Wachovia Corp. Winston-Salem, N.C., 87 Fed. Res. Bull. 683, 696 (Oct. 2001); Firstar Corp., Milwaukee, Wis.; U.S. Bancorp, Minneapolis, Minn., 87 Fed. Res. Bull. 236, 248 n.64 (Apr. 2001); The Chase Manhattan Corp., New York, N.Y.; J.P. Morgan & Co., New York, N.Y., 87 Fed. Res. Bull. 76, 87 n.36 (Feb. 2001); Mizuho Holdings, Inc. (In Formation), Tokyo, Japan, 86 Fed. Res. Bull. 776, 780 n.24 (Nov. 2000); see also **Mark A. Pinsky & Valerie L. Threlfall, Nat'l Community Capital Corp.**, **The Parallel Banking System and Community Reinvestment** 7-8 (1996); **Jane D'Arista & Tom Schlesinger, Econ. Pol'y Inst., The Parallel Banking System** 25 (1993); Hala Habal, As Conti's Loans Come Due, Bankruptcy Seen on Horizon, **Am. Banker**, Aug. 19, 1999, at 3 (describing bank letters of credit and other credit facilities to Contifinancial and rival United Companies Financial Corp.); Heather Timmons, Debt Clock Running as Contifinancial Seeks Equity, **Am. Banker**, May 13, 1999 (same).

[33] See, e.g., First Union Corp., Charlotte, N.C.; Wachovia Corp. Winston-Salem, N.C., 87 Fed. Res. Bull. 683, 696 n.64 (Oct. 2001); Firstar Corp., Milwaukee, Wis.; U.S. Bancorp, Minneapolis, Minn., 87 Fed. Res. Bull. 236, 248 n.64 (Apr. 2001); The Chase Manhattan Corp., New York, N.Y.; J.P. Morgan & Co., Inc., New York, N.Y., 87 Fed. Res. Bull. 76, 87 n.36 (Feb. 2001); Wells Fargo & Co. San Francisco, Cal., 86 Fed. Res. Bull. 832 (Dec. 2000); Mizuho Holdings, Inc. (In Formation), Tokyo, Japan, 86 Fed. Res. Bull. 776 (Nov. 2000); Order Approving an Application to Become a Bank Holding Company and Notices to Acquire Nonbanking Companies (Deutsche Bank AG, Frankfurt am Main, Germany), 85 Fed. Res. Bull. 509 (July 1999).

commercial paper placements guaranteed by letters of credit issued by banks.[34] Conventional letters of credit issued by insured banks qualify for up to $100,000 in federal deposit insurance.[35] Past failed bank resolution methods that protected uninsured creditors in bank insolvencies, send an additional signal that the uninsured balances of bank letters of credit may receive de facto protection as well.[36] Banks can accordingly charge lower fees for those letters of credit. The possibility that banks are receiving CRA credit for indirectly supporting predatory lending, and that federal subsidies may be facilitating predatory lending, requires that we consider utilizing CRA to deter abusive lending practices.

C. Steering of Prime Borrowers to Subprime and Predatory Loans

One of the most troubling conclusions to emerge from the research on the subprime market is that substantial numbers of customers who qualify for prime loans are steered to costlier subprime loans that should be reserved for customers with weak credit ratings.[37] Mortgage brokers have strong incentives to engage in steering due to "yield

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[34] **Pinsky & Threlfall**, <u>supra</u> note 32, at 13.

[35] <u>See</u> FDIC v. Phila. Gear Corp., 476 U.S. 426, 430-40 (1986) (explaining that standby letters of credit, however, do not qualify for deposit insurance); **Banking Law Manual**, <u>supra</u> note 7, § 11.06[2][a].

[36] <u>See</u> **Banking Law Manual**, <u>supra</u> note 7, §§ 15.05[3][a][i], 15.06[2].

[37] For instance, in 1996, Freddie Mac concluded that ten to thirty-five percent of subprime borrowers qualified for prime-rate loans. <u>See</u> **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**], www.freddiemac.com/corporate/reports/moseley/mosehome.html. Fannie Mae's President Franklin Raines has said that up to half of all subprime mortgages are eligible for purchase by Fannie Mae as prime mortgages. <u>See</u> HUD's Regulation of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), 65 Fed. Reg. 65,044, 65,053 (Oct. 31, 2000) [hereinafter HUD Housing Goal Rules].

Steering could also take place within the various subcategories of subprime loans, which are rated along a spectrum of A-, B, C and D loans. <u>See</u> HUD Housing Goal Rules, spread premiums."[38] These are premiums lenders pay mortgage brokers if they persuade borrowers to accept higher interest rates even though the lenders would, if pressed, grant the loan at lower rates.[39] Unsuspecting borrowers typically never know that they are paying these premiums. Under the Truth in Lending Act,[40] for example, lenders do not have to include yield spread premiums in the calculation of finance charges, even though the cost of the premiums is passed on to the borrowers.[41] Similarly, even when loan

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supra, at 65,053. Because the dividing lines among those subcategories are not as well-defined as the dividing line between A and A- loans, however, our sole focus here is on steering of prime-eligible customers to subprime loans.

[38] Cf. Real Estate Settlement Procedures Act (RESPA), Statement of Policy 1999-1 Regarding Lender Payments to Mortgage Brokers, 64 Fed. Reg. 10,080 (Mar. 1, 1999) (noting that yield spread premiums might be illegal where mortgage brokers receive additional fees for convincing borrowers to accept higher rates).

[39] See, e.g., HUD-Treasury Report, supra note 23, at 40; **Nina Simon, Predatory Lending From Around the Country: A Broad Range of Tools** 22-23. In a recent economic analysis, Professor Howell Jackson concluded that yield spread premiums "serve only to [benefit] mortgage brokers," not consumers, and levy "implicit interest rates [that] are absolutely outrageous." See Hearing on "Predatory Mortgage Lending Practices: Abusive Uses of Yield Spread Premiums" Before the Senate Comm. on Banking, Housing, and Urban Affairs, 107th Cong., 2d Sess. 3 (2002) (testimony of Prof. Howell E. Jackson) [hereinafter Jackson Testimony], available at banking.senate.gov/02_01hrg/010802/jackson.htm (last viewed Mar. 27, 2002); see generally Howell E. Jackson & Jeremy Berry, Kickbacks or Compensation: The Case of Yield Spread Premiums (Jan. 8, 2002), available at www.law.harvard.edu/faculty/hjackson/jacksonberry0108.pdf (last viewed Mar. 28, 2002).

[40] 15 U.S.C. §§ 1601-1667f (2001).

[41] See, e.g., **Ralph J. Rohner & Fred H. Miller**, **Truth in Lending** 121, 187-88 (2000); Kenneth M. Lapine, Referral Fees and Other Compensation Issues Under the Real Estate Settlement Procedures Act of 1974, in **William H. Schlichtling et al., Banking Law** (1998). Courts are divided over whether yield spread premiums are prohibited kickbacks or legitimate payments for goods and services under the Real Estate Settlement Procedures Act (RESPA), 12 U.S.C. §§ 2601(b)(2), 2607(a), (c) (2001). Compare Culpepper v. Irwin Mortgage Corp., 253 F.3d 1324 (11th Cir. 2001) (upholding class certification in case challenging yield spread premiums as RESPA violations), cert. denied, 122 S. Ct. 930 (2002); Culpepper v. Inland Mortgage Corp., 132 F.3d 692 (11th Cir. 1998) (reversing grant of summary judgment for lender and finding that yield spread premiums are prohibited kickbacks); DuBose v. First Sec. Sav. Bank, 974 F. Supp. 1426 (N.D. Ala. 1997) (denying lenders' motion for summary judgment on grounds that yield

disclosure documents list yield spread premiums, relatively few borrowers recognize that these premiums will cause them ultimately to pay higher interest rates.[42] Similar problems are posed by overages, which are incentive payments to loan officers in the form of negotiable interest and fees over and above the minimum rates lenders would be willing to accept to close the loans.[43]

In the bank context, there are two ways that lenders can induce prime loan customers to take out subprime loans. First, banks that offer both subprime and prime loans can steer prime-eligible borrowers to inappropriate subprime products. Second, where banks make prime loans directly, but segregate subprime lending in non-bank

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spread premiums may be illegal referral fees); Mentecki v. Saxon Mortgage, Inc., No. 96-1629-A, 1997 U.S. Dist. LEXIS 1197, at *10 (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); and Martinez v. Weyerhaeuser Mortgage Corp., 959 F. Supp. 1511 (S.D. Fla. 1996) (denying lenders' motion for summary judgment on grounds that yield spread premiums may be illegal referral fees) 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 Leonard A. Bernstein, RESPA Invades Home Equity, Home Improvement and Mobile Home Financing, 48 **Consumer Fin. L.Q. Rep.** 194, 197 (1994) (questioning legality of yield spread premiums under RESPA); Robert M. Jaworski, Overages: To Pay or Not to Pay, That is the Question, 113 **Banking L.J.** 909, 911 (1996) (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. 10,079 (Mar. 1, 1999). HUD clarified its policy statement in 2001. Statement of Policy 2001-1, 66 Fed. Reg. 53,052 (Oct. 18, 2001). Instead of treating yield spread premiums as illegal per se, HUD predicates legality on the answer 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? 64 Fed. Reg. at 10,085-86; 66 Fed. Reg. at 53,052-54.

[42] See Jackson Testimony, supra note 39, at 2 (asserting that "borrowers are simply told that their loans will have a certain interest rate, and they never understand that the interest rate is higher than it needs to be or that the higher interest rate is used to finance a payment to the mortgage broker").

[43] See, e.g., James Brodsky & Rugenia Silver, Nontraditional Home Loans: Compliance Pitfalls, **Credit Union Executive**, Sept. 19, 1996, at 16.

affiliates or subsidiaries, the subprime entities may refrain from referring prime-qualified applicants to the banks where they could obtain prime loans.[44] Alternatively, banks may discourage some prime-eligible applicants from securing prime loans by, for example, imposing onerous documentation requirements. Ironically, banks can receive CRA credit for making subprime loans to LMI borrowers even when the borrowers are eligible for prime loans.

Steering by non-bank affiliates rarely even appears on the radar screen of federal bank regulators. The activities of affiliates are not subject to CRA scrutiny unless parent companies voluntarily submit to it. Although mortgage lending by non-bank affiliates (like banks themselves) is subject to the reporting requirements of the Home Mortgage Disclosure Act ("HMDA"),[45] until recently HMDA's regulations did not require reporting of annual percentage rate ("APR") data, which made it difficult to identify subprime loans, let alone steering.[46]

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[44] In a 2001 report prepared for the Department of the Treasury, Robert E. Litan and others reported that several banks they interviewed "indicated that 'graduating' customers to the best credit product for which they qualified was a priority for them, but that they had not yet worked out the internal procedures to accomplish this goal. One institution indicated that it did not have such procedures in place and did not have plans to put them into effect, in part, because of the difficulty of managing across business lines." **Robert Litan et al., The Community Reinvestment Act After Financial Modernization: A Final Report** 20 (2001).

[45] 12 U.S.C. §§ 2801-2810 (2001). See also **Banking Law Manual**, supra note 7, § 8.03[2][a].

[46] In February 2002, the Federal Reserve amended HMDA's regulations to require reporting of the interest rate spreads between APRs and yields on comparable Treasury securities for certain originated mortgages that are subject to Regulation Z, 12 C.F.R. pt. 226. Lenders must report spreads for first mortgages with APRs of at least three percent over comparable Treasury securities and for junior mortgages with like spreads of at least five percent. Board of Governors of the Federal Reserve System, Home Mortgage Disclosure, 67 Fed. Reg. 7,222, 7,228, 7,237 (Feb. 15, 2002) (to be codified at 12 C.F.R. § 203.4(a)(12)). Simultaneously, the Fed elicited public comment on whether the three-

CRA examiners do consider steering when there are allegations that lenders have discriminated by charging higher rates to minorities or other protected groups.[47] Such discrimination claims are relatively rare, and are difficult and costly to prove.[48]

Due to heavy press coverage and in-depth studies by the agencies themselves,[49] federal banking regulators are cognizant that steering is a problem. Since December 2000 or so, the Federal Reserve has expected applicants for approval of deposit facilities to represent that they will review their subprime loan applications for prime-eligible applicants and offer those customers prime products.[50]

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and five-percent reporting triggers should be changed. Board of Governors of the Federal Reserve System, Home Mortgage Disclosure, 67 Fed. Reg. 7,252 (Feb. 15, 2002).

[47] The U.S. Department of Justice brought fair lending actions against Fleet Mortgage Corp. and Huntington Mortgage Corp. for allegedly charging higher rates or fees to minorities than similarly situated nonminorities. DOJ also sued or intervened in suits against Delta Funding Corp.; Long Beach Mortgage Company; Capitol City Mortgage Corp.; First National Bank of Vicksburg, Mississippi; the Security State Bank of Pecos, Texas; Blackpipe State Bank; Nissan Motor Acceptance Corporation; General Motors Acceptance Corporation; and the First National Bank of Gordon, Nebraska on similar charges. In some of those cases loan officers had discretion to charge "overages," which are interest and points in addition to the minimum price the lender was willing to accept. DOJ alleged that the loan officers disproportionately charged overages to minority borrowers in comparison to white borrowers with comparable levels of risk. See, e.g., Jo Ann S. Barefoot, What's a fair price?, **ABA Banking J.**, June 1, 1995, at 28; Steve Cocheo, Will Predatory Lending Shift Fair-Lending Enforcement?, **ABA Banking J.**, July 2000, at 8; Christina M. Gattuso, Fair Lending: Compliance After Chevy Chase, 10 **Rev. of Banking & Fin. Servs.** 141 (1994); Brian Collins, . . . so does DOJ, **Origination News**, Apr. 2000, at 1; Maynard M. Gordon, Law Suits Focus on Loan Markups, **Ward's Dealer Bus.**, Dec. 1, 2000, at 50; Bias in the Auto Showroom, **Chicago Trib.**, Nov. 4, 2000, at 24; Brodsky & Silver, supra note 43, at 16; U.S. Department of Justice, Civil Rights Division, Housing and Civil Enforcement Section, Cases, available at www.usdoj.gov/crt/housing/caselist.htm#lending (last viewed Mar. 28, 2002).

[48] See, e.g., Engel & McCoy, supra note 5.

[49] See, e.g., **HUD-Treasury Report**, supra note 23.

[50] See The Chase Manhattan Bank, New York, N.Y., 87 Fed. Res. Bull. 626 (Sept. 2001) (Chase agreed that it would "review subprime mortgage applications and inform applicants who might qualify for a prime loan or other available mortgage products."); Countrywide Credit Indus., Inc., Calabasas, Cal., 87 Fed. Res. Bull. 419 (June 2001) (Countrywide "provided information about steps taken by [its subprime] subsidiaries to

CRA examinations, however, are a different matter. In contrast to the Fed's new approach to deposit facility applications, federal banking regulators have not provided guidance to CRA examiners on how to curb steering. In two advance notices of proposed rulemaking, one by the Office of Thrift Supervision in April 2000 and the other by federal banking agencies jointly in July 2001, the agencies solicited public comment on how best to respond to this problem.[51]

D. The Paucity of Legitimate Subprime Lending by Banks

Although CRA-covered lenders originate the greatest number of loans in LMI neighborhoods and to LMI borrowers, these lenders focus primarily on prime lending. As a result, LMI borrowers with impaired credit often turn to non-bank lenders—some of whom are predatory lenders—for subprime loans. Between 1993 and 1998, there was a tremendous surge in lending to LMI borrowers. CRA-covered institutions accounted for eighty-three percent of the growth in prime loans to these borrowers.[52] In contrast, CRA-covered institutions were responsible for only fifteen percent of the increase in subprime loans during the same period.[53] Subprime lenders not covered by CRA accounted for

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ensure that individuals who qualify for conventional loans are informed about prime credit products."); Fifth Third Bancorp, Cincinnati, Ohio, 87 Fed. Res. Bull. 330 (May 2001) ("Old Kent has implemented a procedure for referring borrowers that appear to qualify for traditional 'prime' home mortgage loans to [the] prime lending division."); The Chase Manhattan Corp., New York, N.Y.; J.P. Morgan & Co., Inc., N.Y., New York, 87 Fed. Res. Bull. 76 (Feb. 2001) ("Chase reviews subprime mortgage applications to inform applicants if they may qualify for a prime loan."); Wells Fargo & Co. San Francisco, Cal., 86 Fed. Res. Bull. 832 (Dec. 2000).

[51] See Community Reinvestment Act Regulations, 66 Fed. Reg. 37,602 (July 19, 2001) (joint advance notice of proposed rulemaking) (to be codified at 12 C.F.R. pt. 563e); Responsible Alternative Mortgage Lending, 65 Fed. Reg. 17,811 (Apr. 5, 2000) (to be codified at 12 C.F.R. pt. 560).

[52] Baseline Report, supra note 3, at 70-72 & chart 14.

[53] Id.

two-thirds of the increase in subprime mortgages.[54] The failure of CRA-covered institutions to meet the demand for subprime loans in LMI neighborhoods runs counter to CRA's goal for banks to "serve the credit needs of their entire communities."[55]

As community institutions with valuable reputations to maintain, banks may be disinclined to lend to customers with impaired credit because they risk criticism if they increase their rejection rates, charge higher interest rates, or have to foreclose on people's homes. Similarly, banks may be concerned that CRA and bank examiners will look askance if they engage in higher risk lending.[56] Because banks do not know how CRA and fair lending examiners[57] will treat even legitimate subprime lending, they may fear that if they begin making subprime loans to borrowers with elevated levels of default risk, examiners will lower their CRA ratings on grounds of prohibited discrimination.

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[54] Id. at 71-72.
[55] Id. at 13.
[56] For a fuller discussion of the disincentives to banks of engaging in subprime lending, see Kathleen C. Engel & Patricia A. McCoy, Changes in the Financial Services Market, Predatory Lending, and the Community Reinvestment Act, in **Financial Modernization After Gramm-Leach-Bliley** 273 (Patricia A. McCoy ed., 2002) (forthcoming) [hereinafter **Financial Modernization**]; see also Engel & McCoy, supra note 5.
[57] Federal regulators have recognized that offering an array of loan products based on borrowers' risk, when properly used, can benefit both lenders and borrowers. See, e.g., Alan Greenspan, The Challenge of Central Banking in a Democratic Society, **Bloomberg News**, Nov. 30, 1994. Just the same, neither CRA's implementing regulations nor the annual interagency question-and-answer guidances on CRA compliance have addressed the issue of subprime lending. See 12 C.F.R. pts. 25, 228, 345, 563e; Interagency Questions, supra note 27, at 36,620; Interagency Questions and Answers Regarding Community Reinvestment, 65 Fed. Reg. 25,088 (Apr. 28, 2000); Interagency Questions and Answers Regarding Community Reinvestment, 64 Fed. Reg. 23,618 (May 3, 1999); Interagency Questions and Answers Regarding Community Reinvestment, 62 Fed. Reg. 52,105 (Oct. 7, 1997); Interagency Questions and Answers Regarding Community Reinvestment, 61 Fed. Reg. 54,647 (Oct. 21, 1996).
In informal discussions with CRA examiners and CRA officers of banks in different regions around the country, most individuals with whom we talked confirmed that subprime lending usually is not a topic in CRA examinations. The sole exception was a

Likewise, banks may be leery of lending to higher risk customers because of the possibility that examiners could raise safety and soundness concerns.

The absence of legitimate bank lending in LMI neighborhoods creates significant market opportunities for predatory lenders. These lenders can capitalize on unmet demand among higher risk borrowers and lack of competition from banks. Thus, the reluctance of banks to make subprime loans not only conflicts with the goals of CRA, but also enables predatory lenders to flourish.

E. Bank Marketing Efforts Fail to Reach Potential Victims of Predatory Lending

Competition in markets where predatory lenders have taken hold differs from competition in conventional markets for home mortgage loans. Typically, prime borrowers approach a number of different lenders and negotiate the best terms for their loans. As a result of this "shopping," prime lenders usually offer prime borrowers the equilibrium prime market rate. This is not the case, however, in communities where predatory lenders reign. Competition in these communities hinges on which lenders can most quickly identify potential borrowers and entice them to commit to loans before other lenders approach them. As a result, the rates that these borrowers pay are not equilibrium market rates. Rather, they pay the highest rates their brokers or lenders can extract. In some cases, this means that prime-eligible borrowers take on loans that are subprime or predatory. In other situations, people who are higher risk and therefore ineligible for prime rates enter into predatory loans.[58]

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bank holding company that reported inquiries into subprime lending due to predatory lending claims against one of its non-bank subprime subsidiaries.

[58] See Engel & McCoy, supra note 5, Section III.C.

The obvious question is why borrowers ever enter into predatory loans. Borrowers who fall prey to predatory lenders tend to have been excluded from the home mortgage market due to discrimination, historical restraints on credit, and lack of sophistication relative to their more affluent counterparts.[59] In addition, they tend to feel intimidated by banks and loan officers, especially if it means going to a bank's large, downtown office. These borrowers often have immediate needs for loans, but are not aware that they are eligible for credit. Similarly, they do not know how to shop for credit, and when presented with an opportunity to borrow money, believe the opportunity is fleeting. When predatory lenders approach them, they are quick to commit even though they have not done comparison-shopping and do not understand their loan terms.[60]

It is easy for predatory lenders to select their targets. They locate communities, often communities of color,[61] where there has been no or minimal lending activity.[62] Within those communities, they identify people who have substantial equity in their homes and who may be in need of loans. For example, lenders use publicly available information to learn of borrowers whose homes are in disrepair, or who owe back taxes or have been cited for housing code violations. Armed with this information, the predatory lenders approach the borrowers and persuade them to commit, using charm and the explicit threat that their offers could vanish in a flash.[63]

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[59] **HUD-Treasury Report**, supra note 23, at 18.
[60] See id.
[61] Census data assists them in identifying minority and LMI census tracts.
[62] Predatory lenders can use data collected under the Home Mortgage Disclosure Act to find neighborhoods where prime lenders are not active. See **HUD Treasury Report**, supra note 23, at 47 (describing concentration of subprime lending in LMI and minority neighborhoods).
[63] See Engel & McCoy, supra note 5, Section III.C.

In contrast to predatory lenders, banks do not employ personal marketing pitches. Instead, they use mass media to solicit customers. Mass marketing has only limited success because it fails to attract borrowers who believe that they are ineligible for loans from banks and who are reluctant to interact with banks.

CRA does not have explicit requirements regarding the marketing of bank products. Under the service test, however, the effectiveness of the methods that banks employ to solicit customers could arguably be a factor in CRA evaluations.[64]

F. Predatory Lending by Non-bank Subsidiaries and Affiliates of Banks and Independent Lenders

Although there is evidence that some banks engage in subprime lending, most banks are not subprime lenders.[65] Rather, an overwhelming proportion of subprime lenders are non-bank mortgage lenders or finance companies.[66] Some of those lenders are independent companies;[67] others are non-bank affiliates or subsidiaries of insured banks.[68]

[64] **CRA ANPR**, supra note 30, at 37,605 (discussing a proposal that the service test consider the extent that services offered as part of CRA programs are actually used by low- and moderate-income persons).

[65] Normally, bank holding companies with subprime lenders reap the benefits of their subprime operations while safeguarding the reputations of their banks by conducting their subprime operations under entirely different names than the names of their banks. At least one commentator has expressed concern that bank holding companies that bifurcate their consumer lending, with prime lending within the bank and subprime lending in a non-bank affiliate, may be seeking to dampen competition in the subprime market through market segmentation. See Cassandra Jones Havard, Credit Democracy: What's Sub-Prime Lending Got To Do With It?, in **Financial Modernization**, supra note 56, at 251.

[66] Cf. **Litan et al.**, supra note 44, at 32 ("As with home purchase loans, CRA lenders and affiliates are much less likely than non-CRA lenders to specialize in subprime and manufactured home refinance lending to LMI borrower[s] or area[s].").

[67] Given that CRA in its current form does not cover independent lenders, we defer discussion of independent lenders to Section III, infra, where we address the advisability of extending CRA to those entities.

[68] See **HUD Treasury Report**, supra note 23, at 43 (describing the entrants into the subprime lending market).

Of the ten largest subprime lenders in 2000, eight were non-bank entities owned by bank holding companies.[69] Among the various types of subprime lenders, some limit their lending to subprime loans and others make subprime and predatory loans.

1. The Existence of a Federal Subsidy

The lending activities of non-bank subsidiaries and affiliates of banks are relevant to our inquiry because the federal safety net that protects banks may facilitate predatory lending by banks' subsidiaries and affiliates. This federal safety net includes government charters that confer quasi-oligopolistic power, deposit insurance benefits, and frequent protection of uninsured depositors and other creditors through the federal government's bank resolution techniques. It also includes access to the discount window and the Federal Reserve's payments system (including Fed guarantees of interbank payments made on Fedwire).[70]

The subsidy concern is as follows: federal deposit insurance and associated benefits may subsidize banks because banks pay less to attract depositors' funds than they would if they had to pay a risk premium. In turn, depositors are willing to accept low interest rates on their bank deposits because the Federal Deposit Insurance Corporation ("FDIC") guarantees return of principal and interest up to $100,000 per

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[69] See Robert Julavits, Subprime Risks Extending Beyond Borrowers, **Am. Banker**, Mar. 27, 2000, at 9 (naming Bank of America Corp., First Union Corp., Wells Fargo & Co., and Citigroup, Inc.); see also David Russell, Citigroup, Bank of America Hold Subprime Loans, WSJ Reports, **Bloomberg News**, Aug. 9, 2001 (recognizing that "[n]ow 10 of the 25 biggest subprime lenders are parts of banks.").

[70] See, e.g., Arthur E. Wilmarth, Jr., How Should We Respond To The Growing Risks Of Financial Conglomerates?, in **Financial Modernization**, supra note 56, at n.42. See also **Banking Law Manual**, supra note 7, §§ 15.05, 15.06 (discussing failed bank resolution methods generally).

depositor per bank.[71] As a result, bank holding companies and their non-bank subsidiaries may have incentives to tap into these inexpensive funds by pressing their sister banks for affiliate loans on below-market terms.[72] Presumably, the proceeds of these loans could be used to finance affiliates' predatory lending activities.

The very existence of a positive net federal subsidy after taking into account the regulatory costs borne by banks remains a topic of sharp debate. Although banks receive a gross subsidy, they also have high regulatory compliance costs, including examination and reporting requirements, reserve requirements, and risk-adjusted deposit insurance premiums (although risk-adjusted premiums have been essentially toothless in recent years because most banks pay zero premiums).[73] In view of these costs, some studies have concluded that the net subsidy is zero or even slightly negative for most banks, at

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[71] On the mechanics of federal deposit insurance, see **Banking Law Manual**, supra note 7, § 11.06[2].

[72] Such loans are subject to legal limits. Aggregate loans to and other "covered transactions" with an individual non-bank affiliate by a sister bank may not exceed ten percent of the bank's capital stock and surplus. A bank's total covered transactions with all of its affiliates may not exceed twenty percent of its capital stock and surplus. 12 U.S.C. § 371c(a)(1), (b)(7) (2001). All such loans must be fully collateralized with readily marketable collateral, 12 U.S.C. § 371c (c)(1)-(c)(2) (2001), and made on market terms, 12 U.S.C. § 371c-1(a)(1)(A)-(a)(1)(B) (2001). For large banks, the legal limits are correspondingly large.

[73] See, e.g., Bernard Shull & Lawrence J. White, The Right Corporate Structure for Expanded Bank Activities, 115 **Banking L.J.** 446, 466 (1998). In the Deposit Insurance Funds Act of 1996, Congress repealed the previous $2000 annual minimum assessment for deposit insurance. Deposit Insurance Funds Act of 1996, Pub. L. No. 104-208, § 2708, 110 Stat. 3009-497 (1996). In addition, FDIC generally may not charge premiums in excess of the amount needed to maintain full capitalization (otherwise known as the "designated reserve ratio"). 12 U.S.C. § 1817(b)(2)(A)(iii) (2001). Currently, both deposit insurance funds are fully capitalized. Hence, the strongest institutions (comprising well over ninety percent of both banks and thrifts) currently pay premiums of zero. See generally **Banking Law Manual**, supra note 7, § 11.06[4].

least in favorable economic times. Additional studies have indicated that the net deposit insurance subsidy is more likely to become positive during times of financial stress.[74]

Notwithstanding this debate, banks and bank holding companies behave in ways that suggest a positive net subsidy. It is striking that virtually no bank holding company has ever "debanked" by surrendering all of its bank and thrift charters or divesting itself of its depository institutions.[75] Similarly, in the savings and loan crisis of the 1980s and early 1990s, non-bank affiliates took advantage of the federal subsidy when borrowing from their sister banks. In that crisis, poorly underwritten loans by banks to their sister non-bank affiliates played a role in the massive bank and thrift failures of the era.[76]

A second example that suggests a positive net subsidy arises from the fact that bank holding companies have devised novel ways of using federal deposit insurance

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[74] For competing views in this debate, see, for example, Allen N. Berger, Richard J. Herring & Giorgio P. Szegö, The Role Of Capital In Financial Institutions, 19 **J. Banking & Fin**. 393, 400-06 (1995); Kenneth Jones & Barry Kolatch, The Federal Safety Net, Banking Subsidies, and Implications for Financial Modernization, 12 **FDIC Banking Rev.** 1, 2-12 (1999); Myron L. Kwast & S. Wayne Passmore, The Subsidy Provided by the Federal Safety Net: Theory and Evidence, 16 **J. Fin. Serv. Res.** 35 passim (1999); Bevis Longstreth & Ivan E. Mattei, Organizational Freedom for Banks: The Case in Support, 97 **Colum. L. Rev.** 1895, 1918 (1997); Alfred Pollard, Exploding the Subsidy Myth, 72 **Banking Rep.** (BNA) 83 (1999); John R. Walter, Can a Safety Net Be Contained?, 84 **Fed. Res. Bank Richmond Econ. Q.,** Winter 1998, at 1, 2-11; Frederick Furlong, Federal Subsidies in Banking: The Link to Financial Modernization, **FRBSF Econ. Letter** No. 97-31 (Federal Res. Bank of San Francisco, Oct. 24, 1997).

[75] See, e.g., Olaf de Senerpont Domis, Debunking Debanking: Idea Sounds Interesting But Examine the Costs, **Am. Banker**, Sept. 29, 1997, at 1, 4 (noting that a bank that surrendered its charter would lose "[t]he ability to quickly and efficiently move large amounts of money" through the Fed's payments system; would pay "more to attract funds" due to loss of deposit insurance; and "would risk losing customers looking for safety").

[76] See, e.g., Kathleen Day, S&L Hell 24 (1993); Lawrence J. White, The S&L Debacle: Public Policy Lessons For Bank And Thrift Regulators 45, 115-16 (1991); Nat'l Comm'n on Fin. Inst. Reform, Recovery and Enforcement, Origins and Causes of the S&L Debacle: A Blueprint for Reform 37, 46-48 (1993). See generally Banking Law Manual, supra note 7, § 4.02 & n.14, for a discussion of related holding company incentives.

guarantees to attract higher flows of low-cost funds, which may then be used to fund non-bank subsidiaries' subprime and/or predatory lending operations. The prime example is Citigroup's new program, instituted in 2000, which allows Citigroup's securities customers with uninsured brokerage accounts to "sweep" their funds in those accounts into FDIC-insured bank accounts at one or more of Citigroup's banks (now ten in number), thereby obtaining up to one million dollars in deposit insurance.[77] With the added funds that Citigroup is able to attract through the sweep accounts, some fear that Citigroup will use the new deposits to fund CitiFinancial/Associates, its non-bank subprime subsidiary[78] that has been accused of past predatory lending practices.[79]

To summarize, if non-bank affiliates and subsidiaries benefit from federal subsidies, we need to consider whether banks should be penalized for using subsidies to finance predatory lending. Similarly, subsidy concerns arise when banks use creative vehicles such as brokerage sweep accounts to expand deposit insurance coverage and thereby multiply the low-cost funds available to fund predatory lenders.

2. Current Treatment under CRA

CRA typically does not require scrutiny of the subprime lending activities of non-bank finance companies. Independent mortgage companies are exempt from CRA for all purposes. Non-bank subprime affiliates of insured banks are also exempt from CRA examinations unless they volunteer for examination.

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[77] Rob Blackwell, Solly's Sweeps Show FDIC Fund Worries Still Apply, **Am. Banker**, Oct. 29, 2001, at 1.

[78] See Richard Melville, Preferred Issues: Deposit Power: Where Merrill, B of A, Citi Agree, **Am. Banker**, Dec. 18, 2000, at 1. See also Blackwell, supra note 77, at 1 (noting how Citigroup extended its sweeps coverage to ten subsidiary banks); Wilmarth, supra note 70.

CRA does demand scrutiny of non-bank subprime affiliates when banks file applications for deposit facilities. Historically, the Fed had a "hands-off" policy with respect to protests alleging predatory lending by bank affiliates, sometimes accompanied by the bromide that "subprime lending is a permissible activity and provides needed credit to consumers who have difficulty meeting conventional underwriting criteria."[80] If applicants said that they did not have a role in the lending practices or credit review processes of the subprime affiliates, the Fed would not pursue allegations of lending abuses, and, at most, would refer discrimination charges to the agencies in charge of fair lending enforcement.[81] Similarly, charges that a bank financed a subprime lender through loans were dismissed as not germane so long as the bank represented that it did not have a role in the lending practices and review processes of the subprime lender nor any knowledge of the subprime entity's lending practices.[82] In one case, the Board refused to

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[79] See Sandra Fleishman, FTC Sues Lending Unit of Citigroup; Associates Accused 'Abusive' Acts, **Wash. Post**, Mar. 7, 2001, at E01.
[80] Fifth Third Bancorp, Cincinnati, Ohio, 87 Fed. Res. Bull. 330 (May 2001).
[81] <u>See</u> First Union Corp. Charlotte, North Carolina; Wachovia Corp. Winston-Salem, N.C., 87 Fed. Res. Bull. 683, (Oct. 2001).
[82] <u>See</u> Firstar Corp., Milwaukee, Wis.; U.S. Bancorp, Minneapolis, Minn., 87 Fed. Res. Bull. 236 (Apr. 2001); Order Approving an Application to Become a Bank Holding Company and Notices to Acquire Nonbanking Companies (Deutsche Bank AG), 85 Fed. Res. Bull. 509 (July 1999). In dismissing similar claims in Mizuho Holdings, Inc. (In Formation), Tokyo, Japan, 86 Fed. Res. Bull. 776 (Nov. 2000), the Board also belittled the amount of the financing, noting that the applicant's two subsidiaries had "only" provided credit facilities to subprime lenders totaling $180 million. Similarly, with respect to Republic Bank's purchases of mortgage-backed securities issued by Delta Funding Corporation, which faced highly publicized accusations of predatory lending, the Board simply said that it had "considered [the fair lending issues raised] in reviewing the convenience and needs factors in this case," before approving the application with no further discussion of the allegations. HSBC Holdings plc, London, United Kingdom, 86 Fed. Res. Bull. 140 (Feb. 2000). Finally, in Countrywide Credit Indus., Inc., Calabasas, Cal., 87 Fed. Res. Bull. 419 (June 2001), the Fed approved the application of Countrywide Credit Industries, Inc., to acquire Treasury Bank, Ltd., and thereby become

extend the brief public comment period for additional investigation into prices charged by the subprime lenders in question.[83]

In its 2001 review of FleetBoston's merger with Summit Bancorp., the Fed waved aside abusive lending charges on somewhat different grounds.[84] When a commenter suggested that FleetBoston might be engaged in subprime lending that was harmful to minority borrowers, the Fed remarked that FleetBoston "currently conducts no lending activities that are subject to Home Ownership and Equity Protection Act ("HOEPA"), and that controls are in place to ensure that no HOEPA-covered transactions are initiated."[85] What the decision did not say is that nearly ninety-eight percent of subprime loans escaped HOEPA's coverage at the time.[86]

Lately, however, the Fed has obtained greater assurances from applicants that due diligence procedures and internal controls are in place against lending abuses. For example, in the 2001 Wachovia-First Union merger, First Union provided a detailed description of its due diligence procedures in financing and underwriting securitizations of subprime loans.[87] With respect to the origination activities of its own subprime affiliate, First Union stated that it had established a program to address customer

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a bank holding company with only cursory review of Countrywide's subprime operations.

[83] See Norwest Corp., Minneapolis, Minn.; Wells Fargo & Co., San Francisco, Cal., 84 Fed. Res. Bull. 1088 (Dec. 1998). This request had special currency given the Board's decision in 1997 to shorten the period for considering certain kinds of CRA protests. See 62 Fed. Reg. 9,290 (1997) (codified at 12 C.F.R. pt. 225).

[84] See FleetBoston Fin. Corp., Boston, Mass., 87 Fed. Res. Bull. 252 (Apr. 2001).

[85] Id.

[86] Recently, the Fed promulgated a new rule expanding HOEPA's coverage, but that rule extends HOEPA only to five percent of subprime first mortgages. See Federal Reserve System, Truth in Lending, Final Rule 8-9 (Dec. 12, 2001).

[87] First Union Corp. Charlotte, North Carolina; Wachovia Corp. Winston-Salem, N.C., 87 Fed. Res. Bull. 683 (Oct. 2001).

complaints, broker relationships, and servicing.[88] Similarly, in Firstar Corporation's merger with U.S. Bancorp, U.S. Bancorp furnished the Fed with information on the lending practices of a subprime lender in which it owned a minority interest, including information on compliance procedures, the methodology used in setting interest rates, and the lender's relationship with loan brokers and correspondents.[89]

These two cases pale in comparison, however, with the Fed's scrutiny of two Citigroup applications in mid-2001, one to acquire the European American Bank ("EAB") and the other to acquire Grupo Financiero Banamex Accival, S.A. de C.V. and Banco Nacional de Mexico, S.A. ("Banamex").[90] Both applications set off huge protests due to Citigroup's recent acquisition of the subprime lender Associates, which had been vilified in the press for alleged predatory lending.[91] In the interim, the Federal Trade Commission had sued Associates and Citigroup for predatory lending abuses under the Federal Trade Commission Act.[92]

In the EAB decision, in contrast with its prior decisions, the Fed acknowledged that "[b]orrowers do not benefit from expanded access to credit if the credit involves

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88 Id.; see also The Chase Manhattan Corp., New York, N.Y., J.P. Morgan & Co., Inc., New York, N.Y., 87 Fed. Res. Bull. 76 (Feb. 2001) (stating that applicants made representations to the Fed about their due diligence and oversight with respect to warehouse financing and/or securitization services to subprime lenders); Mizuho Holdings, Inc. (In Formation), Tokyo, Japan, 86 Fed. Res. Bull. 776 (Nov. 2000) (somewhat weaker representations).
89 See Firstar Corp., Milwaukee, Wis.; U.S. Bancorp, Minneapolis, Minn., 87 Fed. Res. Bull. 236 (Apr. 2001). See also Mizuho Holdings, Inc. (In Formation), Tokyo, Japan, 86 Fed. Res. Bull. 776 (Nov. 2000).
90 Citigroup Inc., New York, N.Y., 87 Fed. Res. Bull. 600 (Sept. 2001) (EAB); Citigroup Inc., New York, N.Y., 87 Fed. Res. Bull. 613 (Sept. 2001) (Banamex).
91 Id.
92 See note 79 supra.

abusive lending practices."[93] Although the Fed approved the application, it recited lengthy representations by Citigroup about the due diligence measures implemented by its securities subsidiary, which had served as underwriter for subprime securitizations, as well as by its mortgage warehouse-lending subsidiary.[94] Additionally, the Fed described in exhaustive detail the internal controls and underwriting practices of Citigroup's various subprime lending units, particularly those of CitiFinancial (the successor to Associates).[95] CitiFinancial's assurances to the Fed included restrictions on prepayment penalties; use of testers; compliance training; stricter oversight of loan brokers; prohibitions against refinancing of Habitat for Humanity and other zero-interest loans; limits on points; and safeguards against loan flipping (i.e., repeated refinancings in order to charge high fees or points.)[96] After a lengthy recitation of these assurances, the Board announced that it would conduct "a thorough examination" to verify implementation and would require Citigroup to submit quarterly reports on all major litigation involving subprime lending and compliance with any resulting court orders or court-approved settlements.[97] The Banamex case contained a parallel discussion.[98]

In the merger context, the Federal Reserve has been a Johnny-come-lately to the issue of subprime abuses. The type and extent of due diligence procedures and internal controls that it expects from applicants have varied widely from case to case. Nevertheless, the Federal Reserve's most recent cases show distinct progress and provide a framework for a more general response under CRA.

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93 See Citigroup Inc., New York, N.Y., 87 Fed. Res. Bull. 600 (Sept. 2001) (EAB).
94 Id.
95 Id.
96 Id.
97 Id.

III. How Should CRA Respond?

A. Sanctioning Banks for their Direct Involvement in Predatory Lending

Some may argue that banks should receive CRA credit for originating or brokering predatory loans because they are serving the credit needs of their communities. The reality is, however, that when banks make loans that borrowers cannot afford to repay, banks are not meeting the credit needs of the communities they serve. Instead, they are contributing to the further marginalization and decline of the communities and sometimes receiving CRA credit in the process. Federal bank regulators recognized this irony in their most recent CRA Advance Notice of Proposed Rulemaking:

> some are concerned that the regulations generally seem to provide consideration of loans without regard to whether the lending activities are appropriate. They recommend that a CRA examination also should include consideration of whether certain loans contain harmful or abusive terms and, therefore, do not help meet community credit needs.[99]

For these reasons, it is important to consider whether CRA should be employed to deter banks from engaging in predatory lending.

A threshold question is whether CRA is a workable tool for regulating the substance of loan terms and practices. CRA and fair lending examiners already review banks' lending practices and loan terms to insure that banks comply with discrimination laws.[100] There is no reason why CRA examiners could not also review loans to insure

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[98] Citigroup Inc., New York, N.Y., 87 Fed. Res. Bull. 613 (Sept. 2001) (Banamex).
[99] CRA ANPR, supra note 30, at 37,604.
[100] Banking regulators will lower banks' CRA ratings where banks have discriminated against customers on prohibited grounds. See Marion A. Cowell, Jr., & Monty D. Hagler, The Community Reinvestment Act in the Decade of Bank Consolidation, 27 **Wake Forest L. Rev.** 83, 98 (1992) (concluding that it "is absolutely clear that any institution which has engaged in discrimination in its lending activities simply will not pass a CRA evaluation.").

that they are not predatory. From the regulators' perspective, there would be some additional costs associated with expanding the scope of CRA exams: examiners might need additional training and CRA exams would be lengthier. From banks' perspective, it is unlikely that having examiners review loans for abusive lending would increase their burden. Presumably, the loan files that banks already provide for examiners would form the bulk of the materials that examiners would need to spot abusive lending practices. In sum, the regulatory burden of expanding CRA exams to identify banks that engage in predatory lending does not appear onerous.

Given that predatory lending undermines the goals of CRA, and that the structure of CRA exams could easily incorporate review for predatory loans, the next question is: what loan terms and practices constitute predatory lending for CRA exam purposes? This question is critical because examiners must have a uniform and clear understanding of the terms and practices that federal regulators deem predatory. We recommend that regulators start by reviewing all subprime loans for the prohibited practices outlined in HOEPA and its regulations, as amended,[101] whether or not those loans are covered by HOEPA. The regulations include prohibitions against loan flipping, asset-based lending, negative amortization, advance payments, and increased interest rates after default, as well as limitations on balloon payments, prepayment penalties, and payments to home improvement contractors.[102] We also suggest that regulators add a residual income test to the loan eligibility criteria.[103] Residual income is the amount of money borrowers have

[101] 15 U.S.C. §§ 1604, 1637(c)(5) (2001); 12 C.F.R. §§ 226.32(d), 226.34 (2002); see also Truth in Lending, 66 Fed. Reg. 65,604, 65,617 (2001).
[102] 12 C.F.R. §§ 226.32(d), 226.34 (2002).
[103] This idea has been advanced by Cassandra Jones Havard. See Havard, supra note 65, at 251.

left after taking into account the cost of living in their communities and the number of people who rely on their income.[104] Banks should not make loans to applicants whose residual incomes are insufficient to meet their mortgage loan obligations and other necessities such as food and clothing.[105]

The remaining question is how CRA should treat banks that fail to comply with the loan eligibility criteria. At a minimum, banks should not receive positive CRA credit for any lending that violates the loan eligibility criteria. The more difficult question is whether CRA should impose demerits. When banks originate and/or broker predatory loans, they actively engage in predatory lending that, in some cases, may be financed by federal subsidies. For these reasons, it is appropriate to impose a powerful disincentive to deter predatory lending by banks. We propose that any bank that fails to satisfy the loan eligibility criteria for its subprime mortgages be precluded from receiving a CRA rating of satisfactory or outstanding, whether or not those mortgages are within the bank's CRA assessment area.

B. Sanctioning Banks for their Indirect Involvement in Predatory Lending

When banks finance subprime lenders through working capital loans, letters of credit, or purchases of subprime loans or securities backed by subprime loans, they may unwittingly or knowingly finance predatory lending. The same is true when they act as underwriters of subprime securitizations. Currently, CRA does not sanction banks when

[104] Id.
[105] If federal regulators do adopt loan eligibility criteria, they should regularly review and amend the guidelines to take into account any new methods that predatory lenders develop to exploit innocent borrowers.

they play these supportive roles. Indeed, the financing of predatory lending may be eligible for CRA credit.

A HUD-Treasury Report underscored the need for secondary market purchasers, including banks, to be part of the solution to predatory lending:

> [w]hile the secondary market could be viewed as part of the problem of abusive practices in the subprime mortgage market, it may also represent a large part of the solution to that problem. If the secondary market refuses to purchase loans that carry abusive terms, or loans originated by lenders engaging in abusive practices, the primary market might react to the resulting loss of liquidity by ceasing to make these loans.[106]

CRA can create incentives for banks to be part of the solution by downgrading banks' CRA ratings if they finance subprime lenders without insisting on appropriate due diligence or adequate internal controls.[107] Reducing banks' CRA ratings for financing

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[106] **HUD-Treasury Report**, supra note 23, at 108.

[107] For example, a bank with an outstanding rating would drop to a satisfactory rating. Federal banking regulators could set standards by developing, by rule or guidance, loan eligibility criteria that subprime lenders would have to observe before they could sell their loans to banks (either individually or through securitization). The Federal Reserve Board's decision in Citigroup Inc., New York, N.Y., 87 Fed. Res. Bull. 600 (Sept. 2001) (EAB), contains a lengthy list of eligibility criteria for loans originated by Citigroup's subprime affiliate, CitiFinancial. Those criteria, among other things, include bans on balloon payments, single premium credit insurance, and negative amortization features; a "referral up" program for prime-eligible borrowers; limits on and waivers of prepayment penalties; institution of testers; caps on points; safeguards against loan flipping; and bans on refinancing of subsidized mortgages within a stated timeframe. Id. at 606-08. In addition, Citigroup agreed to implement a program to provide rate reductions to subprime loan borrowers who make timely payments and a graduation program to refer subprime borrowers with good payment records to Citigroup's prime lender for a prime loan. Id. at 608. For purchased or existing subprime loans held in portfolio, Citigroup committed to give borrowers with balloon payments coming due the option to refinance their loans in lieu of making the balloon payments. Id. at n.48.

Fannie Mae and Freddie Mac have each adopted more limited eligibility criteria designed to disqualify mortgages with certain predatory features from purchase. For example, Fannie Mae will not buy loans where the points and fees exceed five percent of the loan principal. In addition, Fannie Mae restricts prepayment penalties in loans that it purchases. HUD Housing Goal Rules, supra note 37, at 65,068. Similarly, Fannie Mae will not buy loans from lenders who steer prime-eligible borrowers to higher cost subprime lenders without screening for possible predatory lending is one way of providing needed incentives for secondary market monitoring by banks. Similarly, banks

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products. Id. Neither Fannie Mae nor Freddie Mac buy mortgages carrying single premium credit life insurance coverage or high cost mortgages covered by the Home Ownership and Equity Protection Act ("HOEPA"). Id.

In 2000, the Department of Housing and Urban Development concluded that these measures by Fannie Mae and Freddie Mac "lack[ed] important details" and might "not be sufficient" to thwart unwitting purchases of predatory loans. Id. at 65,068. Consequently, HUD promulgated a final rule stipulating that Fannie Mae and Freddie Mac would not receive credit toward HUD's affordable housing goals for purchases of high cost loans, including mortgages, containing one or more of an expanded set of "unacceptable" features and practices. Id. at 65,069. Those unacceptable features and practices include:

1. mortgages that fall within the HOEPA triggers (see Engel & McCoy, supra note 5, Section IV.D.);

2. loans where the total points and fees charged to a borrower exceed five percent of the loan amount (except for small loans or where the five percent cap would make origination unprofitable);

3. prepayment penalties (except where (i) the mortgage provides a rate or fee reduction in exchange for the prepayment penalty; (ii) the borrower is offered a choice of a mortgage that does not contain such a penalty; (iii) the terms of the prepayment penalty are adequately disclosed; and (iv) default does not trigger the prepayment penalty);

4. single premium credit life insurance products;

5. asset-based loans in which the lender did not adequately consider the borrower's ability to repay based upon comparison of his or her income, assets and liabilities to the mortgage payments;

6. declining to report complete borrower information to credit agencies;

7. steering of prime-eligible customers to higher cost products; and

8. failing to comply with fair lending requirements (for example, by discriminating on the basis of prohibited factors such as race, gender or age).

Id. at 65,070-71.

that serve as lead managing underwriters on subprime loan securitizations should receive CRA downgrades if they fail to institute due diligence or other safeguards.[108]

Efforts to monitor subprime loan originators are in their infancy. Nevertheless, Fannie Mae, Freddie Mac, and a number of major banks have adopted rudimentary due diligence procedures when financing subprime lenders.[109] As the secondary market gains more experience monitoring, these tools can be refined. In the meantime, we recommend that the following safeguards apply to all bank purchases of subprime loans, bank loans to subprime lenders, bank loan guarantees to subprime lenders, and bank underwritings of subprime securitizations:

Due Diligence

1. Before the closing, the bank[110] must review the lender's underwriting guidelines, loan processing procedures, loan agreement forms, and

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[108] Banks can serve in other, subsidiary capacities in securitizations, including as registrars, custodians, and paying agents for securitizations of subprime loans. Similarly, banks have served as bond indenture trustees for subprime lenders. Banks that serve in such roles are not in an optimal position to monitor and therefore we would not impose due diligence duties on them.

[109] See, e.g., First Union Corp. Charlotte, N.C.; Wachovia Corp. Winston-Salem, N.C., 87 Fed. Res. Bull. 683, 697 (Oct. 2001) (describing a program that "features reviews of underwriting criteria, second analyses of rejected applications, regression modeling of portfolios, and ongoing training"); Citigroup Inc., New York, N.Y., 87 Fed. Res. Bull. 600 (Sept. 2001) (EAB); Citigroup Inc., New York, N.Y., 87 Fed. Res. Bull. 613 (Sept. 2001) (Banamex); The Chase Manhattan Corporation, New York, N.Y.; J.P. Morgan & Co., Inc., New York, N.Y., 87 Fed. Res. Bull. 76 (Feb. 2001) (describing due diligence actions including on-site review and review of loan documents on any subprime loan purchased); Mizuho Holdings, Inc. (In Formation), Tokyo, Japan, 86 Fed. Res. Bull. 776, 778 (Nov. 2000) (finding no violation of fair lending laws after forwarding loan information to the bank and consulting with HUD, the Department of Justice and the Federal Trade Commission).

[110] Where banks purchase mortgage-backed securities, the lead managing underwriters of the securitizations could discharge this duty. Bank purchasers of such securities should ascertain that the lead underwriters adopt the due diligence and monitoring procedures, and contract terms discussed herein. Cf. Office of Thrift Supervision, Responsible

compliance programs for two purposes: compliance with consumer lending laws and regulations and compliance with the loan eligibility criteria we discussed *supra*.[111]

2. Before closing, the bank should perform on-site sampling of the lender's loans to verify that the lender is complying with the loan eligibility criteria, including the residual income test, and consumer lending laws. Similarly, review should be done with an eye toward red flags suggesting lender or broker fraud, such as unsigned application forms or evidence that borrowers' property was conveyed to the lender.[112]

3. Before closing, the bank should obtain written representations and warranties from the subprime lender ensuring that it complies with, and will continue to comply with, all applicable laws, including consumer protection laws. In addition, each subprime lender should furnish written representations and warranties ensuring that it satisfies the loan eligibility criteria and will continue to do so.[113]

Alternative Mortgage Lending, 65 Fed. Reg. 17,811 (Apr. 5, 2000) ("The institution could, for example, make inquiries to the securitizers concerning their efforts to minimize the inclusion of predatory loans in their securitized pools.").

[111] See supra notes 101-105 and accompanying text.

[112] See, e.g., First Union Corp. Charlotte, N.C.; Wachovia Corp. Winston-Salem, N.C., 87 Fed. Res. Bull. 683 (Oct. 2001); Citigroup Inc., New York, N.Y., 87 Fed. Res. Bull. 600 (Sept. 2001) (EAB); Citigroup Inc., New York, N.Y., 87 Fed. Res. Bull. 613 (Sept. 2001) (Banamex); The Chase Manhattan Corporation, New York, N.Y.; J.P. Morgan & Co., Inc., New York, N.Y., 87 Fed. Res. Bull. 76 (Feb. 2001); Mizuho Holdings, Inc. (In Formation), Tokyo, Japan, 86 Fed. Res. Bull. 776 (Nov. 2000). See also Office of Thrift Supervision, Responsible Alternative Mortgage Lending, 65 Fed. Reg. 17,811 (Apr. 5, 2000) ("[A]n institution might sample loan files to ensure that the originating lender has appropriately priced the product, looking for evidence of excessive fees.").

[113] See, e.g., Citigroup Inc., New York, N.Y., 87 Fed. Res. Bull. 600 (Sept. 2001) (EAB); Citigroup Inc., New York, N.Y., 87 Fed. Res. Bull. 613 (Sept. 2001) (Banamex); The

4. Before closing, the bank should review copies of all complaints regarding the originator's lending practices in agency and court proceedings over the past five years and ascertain the outcome of those complaints. It should also inquire into any agency investigations or proceedings or criminal prosecutions concerning alleged discrimination or lending abuses over the same time period. The subprime lender should also furnish written representations and warranties that it is in full compliance with any court orders, agency directives, consent decrees and/or settlement terms regarding its lending terms and/or practices.

<u>Contract Terms</u>

1. In the contract, the subprime lender must agree to maintain loan documentation that is sufficient to verify compliance with loan eligibility criteria and consumer lending laws and regulations.
2. For securitizations or loan purchases, the contract should contain a recourse provision requiring the subprime lender to take back all loans that become delinquent or go into default. The recourse provisions should go into effect if the bank, in its sole discretion, determines that the lender fails to comply with the loan eligibility criteria or consumer lending laws, or that the lender's documentation is so inadequate that the bank cannot adequately monitor the lender's practices.
3. The contract should require the subprime lender to provide regular reports to the bank on the status of pending or recently resolved litigation, prosecution

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Chase Manhattan Corp., New York, N.Y.; J.P. Morgan & Co., Inc., New York, N.Y., 87 or other formal complaints alleging abusive lending practices or lending discrimination.[114]

4. The contract should require the subprime lender to provide credit reporting agencies with monthly full-file credit reports on borrowers for every loan purchased.[115]

Monitoring Post-Closing[116]

1. Following closing, the bank should do periodic random spot checks of the subprime lender to ensure compliance with the representations and warranties.
2. Following closing, the bank should conduct special audits of the lender's subprime terms and practices whenever red flags appear indicating possible predatory lending (such as press reports of new investigations or lawsuits, a surprisingly high delinquency or default rate on purchased loans, or complaints by borrowers or their counsel).

C. Deterring Steering of Prime Borrowers to Subprime and Predatory Loans

To the extent that banks or their non-bank subsidiaries and affiliates are steering prime eligible borrowers to subprime loans, they are running afoul of the principles that

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Fed. Res. Bull. 76 (Feb. 2001).

[114] Cf. Citigroup Inc., New York, N.Y., 87 Fed. Res. Bull. 600 (Sept. 2001) (EAB) (requiring Citigroup to submit quarterly reports for two years to the Federal Reserve Board on the status of all major litigation involving any of its subprime affiliates and compliance with any resulting court orders or court-approved settlements).

[115] Fannie Mae and Freddie Mac require monthly full-file credit reports of all subprime lenders from whom they purchase loans. See **HUD Housing Goal Rules**, supra note 37, at 65,068.

[116] Monitoring requirements should only apply if banks are engaged in ongoing or repeated purchases, loans, guarantees or underwritings.

motivated CRA. This is even more egregious if banks receive CRA credit for these loans.

One antidote would be to include an anti-steering provision in the loan eligibility criteria discussed earlier.[117] Under such an anti-steering provision, banks that originate or broker subprime loans would have to determine whether subprime applicants qualify for prime loans under the same underwriting criteria that they use for prime applicants. Alternatively, the provision could require that banks use Fannie Mae's Desktop Underwriting or Freddie Mac's Loan Prospector to determine whether subprime borrowers are eligible for prime loans.[118] Violations of the anti-steering provision would have the same consequence as failing to abide by the loan eligibility criteria. Similarly, banks should insist on anti-steering provisions when underwriting or purchasing subprime loans, or securities backed by subprime loans. They should insist on the same provisions when extending loans or issuing letters of credit to subprime lenders.[119]

D. Encouraging Legitimate Subprime Lending by Banks

The paucity of legitimate subprime lending to LMI borrowers by banks suggests that CRA incentives to make subprime loans do not overcome the disincentives to banks of engaging in such lending.[120] The inaction by banks has, in turn, enabled predatory

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[117] See supra notes 101-105 and accompanying text.
[118] See, e.g., Fannie Mae, Announcement 00-03, Attachment 1, available at www.efanniemae.com (last visited Feb. 21, 2002); **Freddie Mac, Automated Underwriting**, supra note 37, 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, **Nat'l Mortgage News**, June 12, 2000, at 22; Brian Angell, A Score to Settle; Consumer Demand Is High For Credit Scores. What Is The Holdup?, **U.S. Banker**, Aug. 2000, at 34.
[119] Fannie Mae will not buy loans from lenders who steer prime-eligible borrowers to higher cost products. See HUD Housing Goal Rules, supra note 37, at 65,068.
[120] See supra text accompanying note 56.

lending to take hold in LMI neighborhoods. One way to correct this problem would be to award additional CRA credit to banks that directly or indirectly support legitimate subprime lending.[121] We recommend that under the lending or the investment test, banks receive credit for brokering or originating legitimate subprime loans, or financing legitimate subprime lending through one of the mechanisms we have discussed.

We also recommend awarding additional CRA credit to banks that refinance predatory loans with legitimate subprime loans.[122] Refinancing predatory loans can be problematic for banks because the loan-to-value ("LTV") ratios often exceed one hundred percent.[123] Furthermore, victims of predatory loans often have poor credit histories, sometimes solely due to the predatory loans. Banks will be reluctant to refinance loans to borrowers with poor credit histories or who do not have sufficient equity in their property.

Nevertheless, the impediments to refinancing predatory loans are not insurmountable. Predatory lenders often violate disclosure requirements or engage in fraud. As a result, they may be amenable to reducing the outstanding balance of

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[121] By legitimate, we mean in compliance with our proposed loan eligibility criteria and anti-steering provisions.

New York lenders, with assistance from Fannie Mae, community groups, and legal services attorneys, have refinanced one million dollars of predatory loans. Comment of Fannie Mae regarding the joint advance notice of proposed rulemaking; Community Reinvestment Act (CRA) Regulations, Oct. 17, 2001, available at www.ots.treas.gov/docs/95312.pdf (last visited Feb. 21, 2002).

[122] See, e.g., Neighborhood Housing Services of Chicago, Rebuilding Chicago's Neighborhoods 11 (2001), available at www.nhschicago.org/news/pdf/annual00.pdf (last visited Mar. 26, 2002) (describing the NORMAL program in Chicago that assists borrowers refinance predatory loans with more affordable fixed-rate loans). In cases where the lenders engaged in steering or where borrowers improved their credit, it might even be appropriate for banks to refinance predatory loans with prime loans.

borrowers’ loans in response to legal action. In turn, that would reduce the borrowers’ LTV and increase the equity in their property. Banks could employ their legal departments or work with legal services attorneys or pro bono outside counsel to put pressure on predatory lenders to reduce borrowers' principal. Similarly, in deciding whether to refinance predatory loans, banks could rely on the borrowers’ credit histories prior to their obtaining predatory loans. The prior credit history would help banks distinguish borrowers whose blemished credit histories reflect long-term credit problems from those with credit problems due to predatory loans. Banks could accordingly limit their refinancing to the latter group.

In sum, in light of the lack of legitimate subprime lending in LMI neighborhoods, the prevalence of predatory lending in these neighborhoods, and the disincentives to banks of offering legitimate subprime loans, we recommend that banks that engage in legitimate subprime lending, especially those that restructure predatory loans, receive additional CRA credit.

E. Rewarding Banks that Develop Programs that Reach Potential Victims of Predatory Lending

CRA incentives to increase legitimate subprime lending in LMI communities and thereby stimulate competition will be ineffective unless banks reach LMI borrowers. Banks’ failure in this regard is part and parcel of their failure to serve their communities.

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[123] See, e.g., Consumers Union, The Hard Sell: Combating Home Equity Lending Fraud in California, Part II, available at www.consumersunion.org/finance/hspart2wc989.htm (last visited Mar. 26, 2002).

For this reason, banks should receive CRA credits under the service test[124] for adopting practices that effectively reach LMI customers.[125]

The easiest, although arguably least effective, method[126] to address predatory lending is through consumer education programs that inform consumers of the risks of predatory lending and identify alternative sources of loans.[127] The success of education programs hinges on whether the information makes its way to the people who most need it. Thus, CRA should encourage banks to move beyond hanging educational posters at bank branches, and to instead establish educational programs at grocery stores, libraries, day care centers, senior citizens' centers, churches and other public places. In addition, CRA should provide incentives to banks to form partnerships with established community organizations and entities that residents trust. These partnerships can play critical roles in informing consumers.

CRA should also reward banks that evaluate ways in which their lending and marketing practices might inhibit profitable lending to LMI borrowers and then implement strategies to remove these inhibitions. For example, a bank might discover

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[124] Woodstock Institute, Comments on 2002 ANPR on CRA, October 4, 2000, available at www.ots.treas.gov/docs/95136.pdf (last visited Feb. 21, 2002).

[125] For a discussion of ways that banks can attract LMI customers and customers of color, see John P. Caskey, Bringing Unbanked Households into the Banking System, available at http://www.brook.edu/dybdocroot/es/urban/capitalxchange/article10.htm (last visited April 10, 2002).

[126] See Engel & McCoy, supra note 5, Section IV.E.

[127] To date, some of the most aggressive efforts by banks to market to LMI borrowers have been a consequence of fair lending suits. The Department of Justice has brought numerous actions against banks alleging that they engaged in racially discriminatory lending practices. In consent decrees, banks have agreed to target marketing efforts on African-American communities, work with African-American community groups to determine the banking needs in their communities, and work with local real estate agents in African-American communities. See Christina M. Gattuso, Fair Lending: Compliance After Chevy Chase, 10 **Rev. of Banking & Fin. Servs**. 141 (1994).

that the main reason it is not originating loans in LMI neighborhoods is because it is not familiar with the neighborhoods or the people who live there.[128] The bank could then undertake a study of the neighborhoods to learn about the housing stock and the credit profile of the residents. If the investigation revealed promising markets for the bank, it could stimulate an infusion of loan capital to the communities and generate the competition that is essential to drive out predatory lenders.

Similarly, CRA should reward banks that evaluate and revise their lending criteria to insure that they are not rejecting qualified LMI borrowers. Banks use an array of different underwriting guidelines to determine borrowers' eligibility for loans. These criteria can lead to vastly divergent assessments of the credit risk that borrowers present.[129] For LMI borrowers, who are more likely to be at the margin of eligibility, algorithms that falsely inflate their risk level even slightly can preclude them from obtaining loans from banks. When limitations in underwriting criteria lead banks to reject creditworthy LMI borrowers, these borrowers may well turn to predatory lenders.

It is possible and desirable for banks to test the predictability of their underwriting criteria and, if necessary, to make adjustments that would insure greater access of loan capital to LMI borrowers without sacrificing profitability.[130] This could include devising

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[128] Robert B. Avery et al., CRA Special Lending Programs, 87 Fed. Res. Bull. 712, 722 (2000) (noting that the better the banks know their local markets and borrowers, the less risky their portfolios).

[129] See M. Cary Collins, et al., The Influence of Bureau Scores, Customized Scores, and Judgmental Review on the Bank Underwriting Decision-Making Process, in **Federal Reserve System, Changing Financial Markets and Community Development** 103 (2001) (demonstrating that underwriting standards can generate divergent estimates of default risk).

[130] For example, North Dallas Bank & Trust works with a real estate developer to offer home-purchase loans to Hispanic borrowers who would not qualify under traditional underwriting guidelines. The developer provides prospective buyers with a home buying

methods for evaluating the credit risks presented by borrowers who have not participated in the credit economy or develop programs to help borrowers build credit records over time. For these reasons, we recommend that CRA reward banks under the service test if they undertake serious evaluations of their underwriting standards to detect any standards that lead them to reject creditworthy LMI borrowers and, if warranted, amend their underwriting standards or business practices to eliminate unnecessary hurdles to lending to these borrowers.

F. Predatory Lending by Non-bank Subsidiaries and Affiliates of Banks and Independent Lenders

In an earlier section, we discussed the appropriate CRA response to banks that finance subprime lending by other entities. In this section, we consider whether the subprime activities of non-bank mortgage affiliates of banks and/or independent mortgage companies should be regulated directly under CRA.

Subprime activities by non-bank affiliates of banks do not undergo CRA examinations unless their parent holding companies so request. However, the Fed will review CRA protests about the subprime operations of a non-bank affiliate in connection with a bank holding company's application for a deposit facility.[131] Until quite recently,

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guide written in Spanish and offers free seminars on the home buying process. The lender markets its loans through home buying fairs, churches and community groups. Thus far, all of the loans have been good quality and none have gone to foreclosure. Federal Reserve Bank of Dallas, Tapping an Untapped Market, **Banking and Community Perspectives** (Jan. 2, 2002), available at www.dallasfed.org/htm/pubs/perspect/00_q_3.html.

[131] We urge the Fed to continue those reviews with the level of detail seen in Citigroup's application to acquire EAB. See Citigroup Inc., New York, N.Y., 87 Fed. Res. Bull. 600 (Sept. 2001) (EAB); see also Citigroup Inc., New York, N.Y., 87 Fed. Res. Bull. 613 (Sept. 2001) (Banamex).

that review has been cursory. Independent mortgage lenders are not subject to CRA in any form.

Extending CRA to subprime non-bank affiliates of banks would mean mandatory CRA examinations and CRA ratings for all such affiliates and possibly more probing investigations of those affiliates by the Fed in connection with applications for deposit facilities. Extending CRA to independent subprime lenders would be limited to mandatory CRA examinations and CRA ratings.[132]

Extending CRA to non-bank subprime lenders has a certain surface appeal. Doing so would penalize subprime lenders who cross over the line into predatory practices. Furthermore, it would do so across-the-board, and place all lenders on equal competitive footing with banks in terms of their CRA obligations.[133] Nevertheless, we advise against extension of CRA to non-bank subprime lenders of any sort. Our foremost concern is the political capital that would be needed to expand the range of entities covered by CRA.

In the area of predatory lending, direct relief for victims is the most pressing need, not CRA examinations or ratings. Aggrieved borrowers need an effective cause of action for damages or rescission.[134] CRA does not afford that relief, however, because it does not authorize private rights of action.[135] Similarly, victims of predatory lending need help

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[132] The Fed does not review merger applications by independent lenders that do not involve bank holding companies.
[133] See **Pinsky & Threlfall**, supra note 32, at 9.
[134] Elsewhere, we have critiqued current remedies and proposed a federal cause of action for breach of suitability that is designed to redress predatory loans. See generally Engel & McCoy, supra note 5.
[135] See **Banking Law Manual**, supra note 7, § 8.03[1][b]; Kaimowitz v. Board of Governors, 940 F.2d 610, 611-14 (11th Cir. 1991); Washington v. OCC, 856 F.2d 1507, 1509-12 (11th Cir. 1988).

in restructuring or refinancing their loans. CRA does not provide that assistance. We believe that the time and political capital needed for predatory lending reforms would best be used in enacting direct relief for victims, not in extending CRA, especially because sentiment in Congress runs deep against any further expansion of CRA.[136]

Our second rationale harkens back to our earlier discussion of the federal subsidy.[137] The traditional justifications for imposing CRA obligations on regulated lenders, to the extent that they are valid, are significantly weaker in the context of lending by non-bank subsidiaries and affiliates, and independent mortgage companies that do not receive any direct federal subsidies.

It is true that non-bank affiliates and subsidiaries may receive indirect benefits from the federal subsidy to banks. Thus, one might argue that CRA should be extended to bank affiliates and subsidiaries, but not to independent subprime lenders. Unfortunately, such a piecemeal extension might well have the undesirable effect of encouraging non-bank affiliates to exit subprime lending, thereby relegating the field to unregulated mortgage lenders. Such an outcome would be highly unfortunate. To be sure, subprime lending by non-bank affiliates has not been free from abusive practices. Nevertheless, bank holding companies are subject to reputational and regulatory constraints that independent subprime lenders do not face. For example, the fear of negative publicity may be an incentive for bank holding companies to curb exploitative

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[136] In the negotiations leading up to passage of the Gramm-Leach-Bliley Act of 1999, the Senate voted to exempt smaller depository institutions from CRA altogether and to excuse institutions that qualified for safe harbor protection from routine CRA examinations. Although these cuts were later restored in conference, they reflect the depth of opposition on the Hill toward CRA. See **Banking Law Manual**, supra note 7, § 8.03[1], introduction.

[137] See supra text accompanying notes 70-79.

lending practices by subprime affiliates. Similarly, the Citigroup/EAB case put bank holding companies on notice that approval of their deposit facility applications will hinge on some level of Fed scrutiny of subprime lending practices.

Finally, our proposal to sanction banks that directly or indirectly support predatory lending will help deter institutions that are not covered by CRA from originating predatory loans. The due diligence and other requirements that we recommend imposing on banks will make it difficult for non-CRA covered institutions to obtain bank financing to support predatory lending. In sum, our proposal accomplishes the same objective—deterring predatory lending by non-bank affiliates and subsidiaries, and independent mortgage companies—without extending CRA.

V. Conclusion

In this article, we sought to answer the question: given the surge in predatory lending, what is the proper response of CRA? CRA and federal subsidizes to regulated lenders can inadvertently facilitate predatory lending and, therefore, it is appropriate to harness CRA to curtail predatory lending. Similarly, CRA, as it currently is administered, fails to penalize banks that engage in predatory lending, directly or indirectly.

We recommend that federal bank regulators use CRA to sanction behavior that could further predatory lending. For example, regulators should deny both satisfactory and outstanding CRA ratings to banks that fail to satisfy specific loan eligibility criteria designed to counteract predatory lending when originating or brokering subprime mortgages. Similarly, CRA ratings should drop where banks finance subprime lenders—either through letters of credit or working capital loans or purchases of subprime mortgages or interests in subprime securitizations—without instituting adequate due diligence and monitoring safeguards against predatory lending.

Conversely, we recommend that CRA be used to reward beneficial conduct by banks designed to reduce predatory lending. For example, increased CRA credit for legitimate subprime lending by banks could inject badly needed healthy competition into the subprime market. CRA credit should also be used to reward banks for refinancing predatory loans with legitimate loans. Special marketing programs designed to offer legitimate credit to groups targeted by predatory lenders likewise deserve CRA credit, as do innovative underwriting guidelines for LMI borrowers.

Finally, we advise against extending CRA examinations and ratings to non-bank subprime lenders, whether or not they are affiliated with banks. The traditional justification for applying CRA to banks—as a quid pro quo for the federal safety net that banks enjoy—is too attenuated outside of the bank context to apply to non-bank lenders. Where subsidized funds at banks are financing predatory lending by non-banks, our proposals to change the way that CRA is administered at banks would cut off those subsidies at their source. In addition, a campaign to extend CRA to non-bank lenders would further waste political capital better used to enact direct relief to victims of predatory lending.