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

Federal Housing Administration (FHA) insurance through HUD creates an additional incentive[88] for lending in LMI neighborhoods by reducing the cost to lenders of default. The

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

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

86 *Id.*

87 *See, e.g.*, HUD-Treasury Report, *supra* note ___, at 106.

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S. Belsky *et al.*, *The Impact of the Community Reinvestment Act on Bank and Thrift Home Purchase Mortgage Lending* (unpublished paper) (March 2001) (finding that the CRA has been effective in increasing home purchase mortgages in LMI neighborhoods); *but see* Drew Dahl *et al.*, *Does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

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

4. *The New Market Structure*

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

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

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

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

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

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

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

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

potential loan purchasers among banks that seek to fulfill their CRA obligations by purchasing loans made to LMI borrowers.[94] Similarly, predatory lenders can make predatory, FHA-insured loans and insulate themselves somewhat from the cost of defaults.[95] Lastly, as we discuss *infra*, AMTPA has enabled predatory lenders to peddle complex and predatory loan products that are difficult for inexperienced and unsophisticated borrowers to understand.

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

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

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

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

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

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

indistinct borrowers in the Stiglitz and Weiss queue are able to obtain credit. There are two reasons for this change. The first is that lenders now have longitudinal data and sophisticated credit scoring and underwriting models that make it possible for them to engage in more accurate risk assessment of people who, in the past, were observationally indistinct.[98] The second factor is securitization itself. Securitization has reduced the marginal cost of procuring additional capital to lend and consequently lenders are less constrained in terms of the amount of money that they can lend.[99]

Borrowers who present elevated risk levels, including people with impaired credit, can now look to the subprime market for credit, where they can take advantage of the influx of mortgage capital and flexible, subprime loan products.[100] Subprime lenders charge these borrowers interest and fees that exceed the rate that traditional prime borrowers pay, commensurate with the higher risk that they present.[101] Most subprime lenders are nonbank

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

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

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

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

101 *See* Canner *et al.*, *Recent Developments*, *supra* note ___, at 244.

entities[102] that emerged as the result of securitization. We refer to the subprime lenders who do not engage in predatory practices as legitimate subprime lenders.

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

C. *Market Failures And Predatory Lending*

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

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

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

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

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

1. *Information Asymmetries: Opportunities For Predatory Lenders And Brokers*

The emergence of new market intermediaries has led to a significant increase in information asymmetries among brokers, lenders, secondary market participants, and borrowers. For example, lenders and secondary market purchasers have different levels of knowledge about borrowers' risk and different levels of commitment to accurate risk assessment.[105] This enables lenders to gain an advantage by withholding information from secondary market purchasers. Our main concern here is with the information asymmetries[106] that exist between inexperienced borrowers who are disconnected from the credit market, and predatory lenders and brokers. An understanding of the nature of these information asymmetries and the ways that lenders can exploit them is critical to our analysis. This is because any proposals to redress predatory lending should be designed to counteract market inefficiencies that make predatory lending possible.

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

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

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

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

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

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

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

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

2. *Taking Advantage Of Information Asymmetries: Locating And Marketing Predatory Loans To Disconnected Borrowers'*

a. *Identifying Communities And People To Target*

In order to exploit these information asymmetries, predatory lenders need to identify people who are disconnected from the credit economy and therefore, are unlikely or unable to engage in comparison shopping. The people most likely to meet these criteria are LMI people[111] of color[112] who, because of credit rationing, discrimination, and other social forces, have not had experience with legitimate lenders.[113] It is relatively easy for predatory lenders to identify these potential borrowers. They can use HMDA data to identify areas of cities in which there is minimal or no lending activity by prime lenders. They can also use census data to find neighborhoods with high percentages of people of color and LMI residents.

Not all LMI borrowers are disconnected from the credit market and thus vulnerable to the wiles of predatory lenders. Just the same, there may be practical reasons why even LMI borrowers with past experience with lenders fall prey to predatory lenders. This may be because they have become infirm or feel that it is not safe to venture far from their homes.[114] They may not have phones needed for comparison shopping and applications or, if they have them, they

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

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

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

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

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

Armed with these various incentives to lend in LMI neighborhoods, predatory lenders procure information that enables them to identify specific individuals[117] with equity in their homes and pressing needs for money.[118] They can search registries of deeds to identify homeowners who do not have mortgages or who are close to paying off their mortgages.[119] From the local tax office, they can learn of homeowners who have outstanding taxes[120] and, therefore,

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

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

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

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

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

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

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

b. *Predatory Lenders' Marketing Tools*

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

The way in which predatory lenders exercise market power is to persuade borrowers to proceed to closing, and to do so before their competitors knock on the door.[122] To accomplish this, predatory lenders have a host of marketing tools at their disposal. Some lenders resort to out-and-out fraud. Other, more sophisticated lenders make truthful disclosures as required by law, but use a variety of hard-sell tactics. Many of these hard-sell tactics capitalize on LMI borrowers' lack of experience with this new breed of lenders and their complex products.

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

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

121 Forrester, *American Dream*, *supra* note ___, at 389.

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

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

c. *Predatory Lenders' Products*

As we have already discussed, the information asymmetries between lenders and brokers, and borrowers are greatest when the borrowers are disconnected from the credit market. These borrowers are least able to understand the terms of their loans[124] and associated risks. In addition, they often do not know how to seek help understanding loan documents and identifying important questions to ask lenders. Predatory lenders take advantage of borrowers' lack of sophistication and lack of access to financial advice and insert loan terms that are not transparent[125] and that would not be acceptable to more experienced borrowers.

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

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

124 Lax *et al.*, *supra* note ____, at 10.

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

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

In contrast to prime mortgage products, predatory lenders rarely sell plain vanilla, fixed-rate mortgages with easily understood payment terms. Most predatory loans contain terms that require borrowers to make difficult probabilistic computations about the likelihood and magnitude of future market events[126] that are entirely outside their control. For example, predatory loans often feature adjustable rate mortgages (ARMs) whose interest rates and, therefore, monthly payments fluctuate. In order for borrowers to predict their monthly mortgage payments in any rigorous way, they would have to calculate the probability of changes in interest rates for each period in the life of the loan, and determine how the projected changes in the interest rates would affect their monthly payments. Introductory teaser rates, which also are common in predatory loans, exacerbate matters by masking true interest rates and lulling loan applicants into a false sense of security about their ability to repay. Predicting interest rate movements confounds even the brightest financial analysts. Thus, the prevalence of adjustable rate mortgages in predatory loans makes it difficult for borrowers to predict their ability to meet their monthly payments with any confidence.

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

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

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

A smaller subset of subprime loans involves balloon payments, which require probabilistic computations of a different nature. With balloon payments, the date and amount of the balloon payments are certain.[128] What is unknown at the outset, however, is whether market conditions and borrowers' future financial situations will permit them to refinance with affordable terms when the balloon payments come due. While the availability and cost of future credit is a concern for all borrowers with balloon payments, it is a particular concern for borrowers with limited access to credit on affordable terms.[129] Finally, predatory loans often authorize special fees and higher interest rates if borrowers default. When loans are consummated, borrowers cannot know whether they will fall behind on their loan payments and incur these additional fees or higher interest rates.

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127 HUD-Treasury Report, *supra* note ____, at 93.

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

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

Most borrowers, whether they are LMI borrowers or more affluent, are risk-averse and measure the benefits of entering into loans against the downsides, *i.e.*, the increased debt burden and the risk of default and foreclosure. Almost everyone who engages in this calculation, however, "discount[s] risks whose likely occurrence is some time away."[130] Such discounting may be rational because most mortgage borrowers, including LMI borrowers, have never lost their homes to foreclosure before. Just the same, LMI borrowers may be more likely to make unintentional errors in discounting because of their tight finances and the complex, probabilistic terms of their subprime loans. The consequences of such errors are more devastating for LMI borrowers, who have fewer personal and familial resources to draw upon if they misjudge the risks that they can afford.

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

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

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

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130 Langevoort, *supra* note ___, at 640.

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

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

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

Lenders who sell loans on the secondary market often use brokers[132] to market their products.[133] These brokers have little incentive to insure that borrowers are creditworthy because they do not bear the risk of loss in the event of default.[134] Brokers do, however, have an incentive to deceive lenders regarding borrowers' ability to pay. This is because lenders typically compensate brokers only for loans that the lenders approve, based on the interest rate and the size of the loans.[135] For example, predatory brokers may write loans with very high interest rates that borrowers cannot afford and then falsify borrowers' credit histories to indicate

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

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

134 *Id.* at 40.

135 Mansfield, *supra* note ____, at 534; HUD-Treasury Report, *supra* note ___, at 40.

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

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

Lenders who are not predatory may find it difficult to identify and exert control over predatory brokers. They can inadvertently finance predatory loans[140] through brokers and not

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

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

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

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

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

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

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

Secondary market institutions can protect themselves[142] to some extent from deception by lenders. For example, secondary market actors can insert recourse provisions, requiring that

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

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

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

lenders take back loans in the event of borrower default. Recourse provisions will not necessarily deter predatory lending. If defaulting borrowers have sufficient equity in their property, the lenders can take back the loans pursuant to the recourse provisions, flip the loans a few times, each time tacking on huge fees, and eventually foreclose. Alternatively, if the lenders are undercapitalized and secondary market institutions try to invoke recourse provisions following widespread defaults, the lenders can declare bankruptcy or dissolve. Of course, if lenders continuously misinform loan purchasers about risk, the lenders' ability to sell loans on the secondary market will decline.[143] However, lenders, like brokers, can tuck predatory loans in with bundles of good loans, *i.e.*, with low default risks, making it difficult for secondary market participants to detect the lenders' predatory lending activities. For these reasons, of the various measures that legitimate lenders and secondary market participants can implement to protect themselves from predatory brokers and lenders, none has the intended or consequential effect of adequately protecting the borrowers who are victims of predatory lending.

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

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

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

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

[143] *Market for B & C Servicing on the Rise*, NATIONAL MORTGAGE NEWS, Sept. 22, 1997; Brendsel, *supra* note ____, at 26.

lenders should be entering the market[144] and stimulating competition. This has not occurred. We posit that this disequilibrium has arisen because there are disincentives for banks and thrifts to enter the subprime market and because the business models that legitimate subprime lenders employ prevent them from identifying many of the potential borrowers who ultimately become victims of predatory lenders.

a. *Reputational Concerns*

Banks and thrifts are community institutions with valuable reputations. They may perceive that even legitimate subprime lending could damage their reputations. Subprime loans entail a greater risk of default either because of risks associated with the particular borrowers or the risk that the assets securing the loans will depreciate because of unstable prices[145] in LMI neighborhoods. When applicants present higher risks, lenders will either charge higher, risk-adjusted prices or reject the applicants. Either response could evoke community protests that the lenders are being unfair.[146] Furthermore, in some cases, the only way to realize the price of a

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

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

[146] There is evidence that banks feel uncomfortable charging high interest rates because they are concerned that the public will perceive them as "unfair." Hylton & Rougeau, *supra* note ____, at 252 (citing David D. Haddock & Fred S. McChesney, *Why Do Firms Contrive Shortages? The Economics of Intentional Mispricing*, 32 ECON. INQUIRY 562, 566-68 (1994)).

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

Banks and thrifts also are concerned that if their rejection rates[149] and/or risk-adjusted prices bear any correlation with race, they will be perceived as engaging in mortgage-lending discrimination.[150] This perception could hurt their reputations and give rise to enforcement actions and costly lawsuits.[151]

Predatory lenders are less concerned about their reputations because they are simply conduits, not community institutions.[152] And, to the extent predatory lenders do care when their reputations are tarnished, they can readily dissolve and re-emerge in the same communities under different names. Another feature of predatory lenders that distinguishes them from banks and thrifts is that high interest rates and foreclosure, which may be abhorrent to banks, are not repugnant to predatory lenders. To the contrary, they are defining features of their lending practices. Lastly, the threat of lawsuits alleging fair housing violations may be inconsequential for predatory lenders because these lenders typically are undercapitalized and therefore judgment-proof.

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

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

149 McGarthy & Quercia, *supra* note ____, at 28.

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

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

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

b. *Regulatory Concerns*

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

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

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

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

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

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

c. *Difficulties Assessing Creditworthiness*

Borrower creditworthiness and collateral are core concerns of regulated lenders[156] regardless whether they are engaged in prime, subprime or predatory lending. This is because bank examiners require banks to document the ability of borrowers to repay their loans and the adequacy of the equity in the property securing the loans. These concerns, which unregulated lenders do not have, are made more burdensome by the fact that banks and thrifts are ill-equipped to evaluate the creditworthiness of many LMI borrowers or to assess property values in LMI neighborhoods.

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

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

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

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

LMI borrowers are less likely than more affluent borrowers to have credit histories that fit neatly into banks' underwriting standards.[157] For example, it is not uncommon for LMI borrowers to receive some or all of their income in cash. Because of problems verifying cash income, banks' underwriting standards may exclude income received in cash when calculating an applicant's income. Lenders who want to make loans to LMI borrowers need to develop special tools to assess LMI borrowers' creditworthiness. Banks and thrifts are poorly suited[158] to developing this expertise because their function is to provide diverse services -- from deposit-taking to commercial and personal lending. The cost of developing new risk-assessment methods[159] might well exceed any potential gains they would generate from making loans in LMI communities.[160]

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157 LITAN *et al.*, BASELINE REPORT, *supra* note ___, at 87-83. For example, LMI borrowers are more likely to have weak or non-existent credit histories. Similarly, some LMI borrowers do not have documentation of their finances in a form that is easy for lenders to assess, *e.g.*, people who are self-employed or who function solely in the cash economy. *See* Passmore & Sparks, *supra* note ___, at 3.

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

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

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

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

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

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

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

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

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

brokers, gather information about the relevant economic conditions and residents.[162] They then use this information to determine home values and borrowers' creditworthiness.

d. *Discrimination*

The racial composition of the neighborhoods that predatory lenders target is disproportionately people of color. To the extent that banks have an aversion to lending to people of color that outweighs any market incentives to expand into subprime and/or predatory lending, they will refuse to lend in these areas.[163] Similarly, lenders may use race as a proxy if they find that it is correlated with creditworthiness. If race is easy to determine and creditworthiness is not, then making loans based on race can be more efficient for lenders than investing significant resources into determining applicants' ability to pay.[164] Of course, either type of discrimination, whether based on animus or efficiency, is illegal. In contrast to banks, some of which may discriminate against people of color, predatory lenders target people of color

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

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

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

164 Charles W. Calomiris *et al.*, *Housing Finance Intervention and Private Incentives: Helping Minorities and the Poor*, 26 J. OF MONEY, CREDIT & BANKING 634, 650 (1994).

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

e. *Geographic Constraints*

Banks and thrifts, for the most part, do not have a significant presence in LMI neighborhoods.[165] As a result, they have limited opportunities to develop relationships with LMI borrowers at retail sites[166] or to obtain valuable information on social capital in LMI communities.[167] To compound this problem, LMI borrowers may be reluctant to approach banks and thrifts outside their own neighborhoods.[168] Thus, banks' most effective means of soliciting customers whom they could target for predatory loans would be to establish or, in some cases, re-establish branch banks in LMI neighborhoods, operate out of storefronts[169] or solicit borrowers

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

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

167 Hylton, *supra* note ___, at 218.

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

168 LITAN *et al.*, BASELINE REPORT, *supra* note ___, at 18.

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

door-to-door. Banks may perceive that the cost of establishing new offices would outweigh any profits[170] they could realize from predatory lending. Less expensive options like, storefront operations and door-to-door solicitations, often run counter to bank culture.

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

Although there are compelling reasons why banks and thrifts may be reluctant to enter LMI communities and compete with predatory lenders, banks and thrifts can be involved in and benefit from predatory lending in a veiled capacity. Some banks and thrifts, whose direct lending is legitimate, have subsidiaries and affiliates that employ predatory lending practices.[171] For example, in July 2001, employees of CitiFinancial Mortgage, a subprime mortgage lending unit of Citigroup, Inc., signed affidavits alleging that Citifinancial "had a policy of not giving borrowers legally required disclosures in a timely manner, that employees there regularly forged borrowers' signatures on legal documents, and that loan officers were instructed to avoid telling

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

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

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

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

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

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

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

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

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172 Rob Garver, *Citi Corroborates Two Allegations*, AM. BANKER, July 30, 2001.

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

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

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

6. *Lack Of Price Competition Among Predatory Lenders*

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

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

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

Frequently, they are not actively looking for loans even though they have pressing financial needs. These borrowers have little or no experience with lenders and loan terms,[177] and do not know how to shop for credit. The arrival of a lender on their doorstep just when they are facing a daunting financial obligation is a "dream come true." They leap at the chance to obtain the money and look no further, fearful that the opportunity to borrow is fleeting.[178] As a result, they do not look beyond the lenders whom approach them first. Although the predatory lenders who reach borrowers first do run the risk that other lenders will be on their heels and will offer less expensive loans, the lenders minimize this risk by creating a false sense of urgency[179] so that borrowers will move quickly to commitment and closing. The combination of market power[180]

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

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

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

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

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

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

IV. REMEDIES

Generally, neither the states nor the federal government have comprehensive laws designed to redress predatory lending. Rather, victims of predatory lending currently must rely on a loose assortment of statutes and common law that were not designed to address the devastating harm inflicted by predatory lenders. These remedies are rooted in traditional liberal notions of informed consent and free will.[182] Consistent with that liberal ideology, under current remedies, predatory lending contracts are generally enforceable except where fraud or nondisclosure has operated in some way that is inimical to free will. Barring culpable misrepresentation, however, the law normally does not question the substance of predatory loan terms.

A. *Market Discipline*

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

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

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

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

B. *Remedies Under Contract Law And The Uniform Commercial Code*

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

Three doctrines in the law of contracts and the U.C.C. permit challenges to the underlying substance of contract provisions: unconscionability, impracticability and frustration. Of these, the latter two generally do not apply to predatory lending cases.[185] The doctrine of unconscionability holds out some promise for victims of predatory lending, although its utility in practice has been limited.

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183 *See* Section ____ *supra.*

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

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

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

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

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

Unconscionability has been defined to include "an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party."[187] For a number of reasons, many courts have been reluctant to condemn excessive prices as unconscionable, "without more."[188] As E. Allan Farnsworth has explained, "the price

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

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

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

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

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

The ability to raise unconscionability as a defense, like many other contract defenses, is subject to further restrictions when parties who purchased loans on the secondary market sue delinquent borrowers. In those cases, the borrowers' ability to raise defenses is severely limited by the holder in due course doctrine. Under that doctrine, a secondary market purchaser can defeat "personal" defenses if it meets the following requirements as a holder in due course: (1) the purchaser is the holder; (2) of a negotiable note; (3) who took the note for value; (4) in good faith; and (5) without notice of the defenses.[191] Once a purchaser qualifies as a holder in due course, it can cut off the defense of unconscionability, as well as all other personal defenses to the loan agreement.[192]

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

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

191 *See generally* White & Summers, *supra* note ___, §§ 14-1 through 14-7.

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

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

Finally, unconscionability claims and defenses are extremely expensive to litigate, dampening incentives to bring those claims.[193] Proof that the price is dictated by commercial reality may be sufficient to defeat the claim or defense and such proof may be easy to come by, depending on the nature of the price term in question. In the case of a predatory loan, for example, a lender may be able to prove that the high price of the loan is justified by risk-based pricing, *i.e.*, in which prices rise in response to the added risk presented by the borrower.

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

C. *Antifraud Laws*

Fraud laws are some of the oldest measures designed to redress information asymmetries in the formation of contracts. Common-law fraud requires proof of affirmative misrepresentation, but does not encompass misleading omissions or manipulation. In addition, common-law fraud requires proof of detrimental reliance by the borrower.[194] Perpetrators can be subject to criminal sanctions and/or compensatory damages in civil actions brought by victims.

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

193 *See, e.g.*, Creola Johnson, *Welfare Reform and Asset Accumulation: First We Need a Bed and a Car*, 2000 WIS. L. REV. 1221, 1256 (2000); WALTER K. OLSON, THE LITIGATION EXPLOSION 211 (1991); Arthur A. Leff, *Unconscionability and the Crowd--Consumers and the Common Law Tradition*, 31 U. PITT. L. REV. 349, 354-57 (1969) (criticizing case-by-case litigation of unconscionability claims as inefficient in consumer transactions); SINAI DEUTCH, UNFAIR CONTRACTS 243 (1977) (unconscionability challenges are rare due to the cost and risk of litigation).

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

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

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

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[195] *See* Joan Potter, *Fighting Home Equity Fraud and Predatory Lending: One Community's Solution*, COMMUNITY REINVESTMENT REPORT (Federal Reserve Bank of Cleveland Summer 2000). *See also* Mike Tobin & Bob Paynter, *Feds raid real estate, mortgage operations*, PLAIN DEALER, Aug. 22, 2001, at A1.

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

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

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[196] *See generally* NATIONAL CONSUMER LAW CENTER, UNFAIR AND DECEPTIVE ACTS AND PRACTICES § 1.1 (4th ed. 1997 & Supp.) (hereinafter cited as "Unfair and Deceptive Acts and Practices").

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

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

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

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

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

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

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

199 *See id.* ch. 8.

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

because financial institutions are exempted or because credit and insurance are deemed not to be "goods and services."[201] In states where state UDAP statutes do cover credit, enforcement heavily depends on the priorities of individual state attorneys general and available resources. Only a few attorneys general, such as in North Carolina and New York, have actively pursued enforcement of any sort under state UDAP statutes.[202] Similarly, weak attorneys' fee provisions in some state UDAP statutes discourage the private bar from bringing state UDAP claims.[203]

D. *Disclosure*

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

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

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201 *See* UNFAIR AND DECEPTIVE ACTS AND PRACTICES, *supra* note ___, §§ 2.2.1-2.2.1.4, 2.3.1.

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

203 *See* UNFAIR AND DECEPTIVE ACTS AND PRACTICES, *supra* note ___, §§ 8.8.2.1-8.8.6.2.

204 *See* notes ___-___ *supra* and accompanying text.

205 *See* notes ___-___ *supra* and accompanying text.

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

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

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

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

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

[208] 15 U.S.C. § 1607. The Federal Reserve Board of Governors has exclusive authority for promulgating regulations implementing TILA and HOEPA. 15 U.S.C. § 1604(a). Responsibility for enforcing TILA and HOEPA, however, is divided among nine federal agencies. 15 U.S.C. §§ 1607(a), (c). *See* Rohner & Miller, *supra* note ___, ¶¶ 6.09[5], 13.02 (2000). State attorneys general are also empowered to enforce HOEPA. 15 U.S.C. § 1640(e). *See* TRUTH IN LENDING, *supra* note ___, §10.6.3.

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

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

[210] *See generally* TRUTH IN LENDING, *supra* note ___, ch. 8.

closing.[211] HOEPA's private remedies include all of the remedies available under TILA, plus special enhanced damages consisting of all finance charges and fees paid by the borrower[212] and expanded rights of rescission.[213]

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

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

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

212 15 U.S.C. § 1640(a)(4). *See generally* TRUTH IN LENDING, *supra* note ___, § 10.6.

213 15 U.S.C. § 1635; 12 C.F.R. § 226.23(a)(3). *See generally* TRUTH IN LENDING, *supra* note __, §§ 10.3.3, 10.6.2.

214 15 U.S.C. § 2605(f) (authorizing actual damages, statutory damages, costs and attorneys' fees).

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

216 15 U.S.C. § 2608. The defendant is liable for up to three times the amount that was charged for the title insurance. *Id.* § 2608(b).

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

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

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

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

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

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

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

219 *See* notes ___-___ *supra* and accompanying text.

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

221 15 U.S.C. §§ 1602(aa)(1)-(aa)(4); 12 C.F.R. §§ 226.32(a)(1), (b)(1). In addition, there is a complex system of exclusions from "total points and fees." The exclusions encompass certain application fees, late charges, premiums for credit insurance, closing costs, security interest charges and filing and recording fees. *See* TRUTH IN LENDING, *supra* note ___, § 3.9.

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

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

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

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

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

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

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

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

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

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

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

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

E. *Consumer Education And Counseling*

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

Under federal law, credit counseling is mandatory only for reverse mortgages for older homeowners under the Home Equity Conversion Mortgage program administered by HUD.[228] Two states have provisions on subprime credit counseling. New York requires high-cost lenders to advise applicants that credit counseling is available and to provide them with a list of counselors. Counseling is not mandatory.[229] North Carolina goes further and requires counseling by state-approved counselors for all high-cost loans.[230] Otherwise, counseling proposals have been rejected in the past, due to industry opposition and also due to concerns about cost.

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

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

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

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

230 N.C.G.S. § 24-1.E(c)(1).

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

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

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

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

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

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

Wholly apart from these issues, there is a more basic problem with relying on education and/or counseling. Without more, a solution founded on education or counseling puts the onus on potential victims to avoid predatory loan terms, rather than on the perpetrators.[234] Such reliance is nothing more than *caveat emptor* served up with an informational brochure or loan counseling. Likewise, education and counseling do little to redress the basic inequities in bargaining power that underlie many predatory loans.

F. *Price Regulation*

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

The recent history of usury limits for residential mortgages in the United States has been one of deregulation, accompanied by the re-imposition of limits on non-interest price terms in high-cost loans. Following high inflation in the 1960s and 1970s, usury limits for home mortgages were largely abolished in the United States. As we discussed *supra,* deregulation in residential mortgages resulted from two federal statutes, DIDMCA[235] and AMTPA,[236] that were enacted in the early 1980s. DIDMCA pre-empted state usury limits on first mortgages and

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

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

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

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

In 1994, early concerns about predatory lending led Congress to amend TILA to add HOEPA, which imposed price controls on the non-interest terms of high-cost, closed-end home mortgages other than purchase money mortgages. HOEPA does not limit nominal interest rates *per se*. However, for the small group of subprime loans that activate its triggers,[238] HOEPA prohibits certain other price terms,[239] including balloon payments in loans other than bridge loans, maturing in less than five years, negative amortization, advance payments,[240] higher interest rates on default and numerous prepayment penalties.[241]

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

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237 *See supra* notes ___ and accompanying text.

238 *See supra* note ___ and accompanying text.

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

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

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

242 *See* notes ___ *supra* and accompanying text.

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

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

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

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243 Tex. Const. Art. 16, § 50(a).

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

245 N.C.G.S. § 24-1.E(b).

246 N.C.G.S. § 24-1.1E(b).

247 N.C.G.S. §§ 24-10.2(b), (c).

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

249 *See* text accompanying note ___ *supra*.

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

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

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250 General Regulations of the New York Banking Board § 41.2.

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

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

252 *See* notes ___ *supra* and accompanying text.

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

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

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253 *See, e.g.*, Norman N. Bowsher, *Usury Laws: Harmful When Effective*, 56 REV. – FED. RES. BANK OF ST. LOUIS 16, 17-23 (1974); Jaffee & Russell, *supra* note ___; James McNulty, *A Reexamination of the Problem of State Usury Ceilings: The Impact in the Mortgage Market* 21-24 (Fed. Home Loan Bank Bd. 1979); Harold C. Nathan, *Economic Analysis of Usury Laws*, 10 J. BANK RESEARCH 200, 202-10 (1980); Ostas, *supra* note ___; Michael M. Tansey & Patricia H. Tansey, *An Analysis of the Impact of Usury Ceilings on Conventional Mortgage Loans*, 9 J. AM. REAL ESTATE & URBAN ECON. ASS'N 265 (1981); Bruce Yandle & Jim Proctor, *Effect of State Usury Laws on Housing Starts*, 13 J. FINANCIAL & QUANTITATIVE ANALYSIS 549, 554-55 (1978).

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

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

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

G. *Anti-discrimination Remedies*

The evidence suggests that predatory lenders target members of protected groups and that their practices often have a disparate impact on protected groups. Thus, some victims of predatory lending may have disparate treatment,[257] disparate impact[258] or "pattern and practice"[259] claims under the Equal Credit Opportunity Act of 1974 (ECOA) or the Fair Housing Act (FHA).[260] ECOA prohibits lenders from discriminating in credit transactions, including mortgages, according to race, color, religion, national origin, sex, marital status, age or receipt of

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

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

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

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

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

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

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

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261 15 U.S.C. §§ 1601 *et seq.*

262 15 U.S.C. § 1691e.

263 42 U.S.C. §§ 3601-3619 (Title VIII of the Civil Rights Act of 1968); *see generally* Frank Lopez, Note, *Using the Fair Housing Act to Combat Predatory Lending*, 6 GEO. J. POVERTY LAW & POL'Y 73 (1999).

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

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

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

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

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

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

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

269 Dane, *supra* note ____, at 544.

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

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

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

Punitive damages awards, which should provide incentives for victims of discrimination, fail to perform their intended function. This is, in part, because the FHA limits punitive awards to $11,000.[274] In addition, the reference points that courts use to determine the reasonableness of punitive awards serve to limit punitive damages in fair lending cases. For example, one guidepost is that punitive awards should bear a reasonable relationship to civil penalties. Under ECOA and the FHA, however, civil penalties are capped, placing a further limitation on punitive damages awards. The relationship between compensatory awards and punitive damages is another criterion that courts consider in determining the amount of punitive awards. To the extent that fair lending plaintiffs recover only small damages awards or non-monetary damages such as rescission, their punitive awards will be limited correspondingly.[275] A final factor that reduces the incentive power of punitive awards is the reluctance of courts to impose punitive

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

272 *See* Dane, *supra* note ___, at 549.

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

274 42 U.S.C. § 3612(g)(3).

275 Engel, *supra* note ____, at 1195-97.

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

In 1992, the Department of Justice (DOJ) took action to fill the breach by bringing its first "pattern or practice" lawsuit under ECOA alleging racial discrimination by a lender. The suit, against Decatur Federal Savings and Loan in the Atlanta metropolitan area, culminated in a consent decree in which Decatur agreed to extend one million dollars in loans to previously rejected black applicants.[277] Since then, the Justice Department has prosecuted a series of cases alleging lending discrimination, most of which have been in response to press exposés of lending discrimination and all of which have settled.[278] DOJ's ability to mount cases, however, is, "hampered by staff shortages, the costly, time-consuming nature of compiling proof of discrimination and inevitable shifts in political winds."[279]

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

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

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

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

279 Schwemm, *supra* note ___, at 322-23; *see generally* Rice, *supra* note ___, at 638-39.

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

V. SUITABILITY

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

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

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

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

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

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281 *See* notes ___-___ *infra* and accompanying text.

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

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

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

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

emerging in the insurance field, partly in response to legislation enacted by Congress in 1999.[286] Furthermore, in insurance as well as in securities, regulators and the courts have been particularly rigorous when the allegations of violations of suitability relate to lending abuses in the financing of securities and insurance purchases.

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

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

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286 *See* Section ___ *infra*.

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

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

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

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

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

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

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

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

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

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

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

A. *A Brief Overview Of Suitability In Securities And Insurance*

1. *Suitability In The Securities Industry*

a. *The Duty And Its Source*

The suitability doctrine originated in the securities industry and dates back to the late1930s. Far from being monolithic in nature, suitability has numerous strands, consisting of different rules adopted by different bodies for different purposes. In the securities industry, where the doctrine is most developed, suitability requirements appear in the disciplinary rules of industry self-regulatory organizations (SROs), *i.e.*, the stock exchanges and the NASD. They also appear in the regulations and holdings of the SEC, as well as in court decisions in private securities fraud claims under Section 10(b) of the Securities Exchange Act of 1934 (the Exchange Act)[292] and Rule 10b-5.[293]

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[292] 15 U.S.C. § 78j(b).

[293] 17 C.F.R. § 240.10b-5. Suitability is not restricted to corporate securities. Suitability duties in one form or another also exist in the area of municipal securities. MSRB Rule g-19, MSRB MANUAL, Exchange Act Rel. No. 33,869, 56 SEC Docket (CCH) 1062, 1064 (Apr. 7, 1994).

i. *The NASD And The Stock Exchanges*

The first suitability rules appeared in the disciplinary rules of the NASD and the securities exchanges, which are subject by law to review, revision and approval by the SEC.[294] The best-known suitability rule, the NASD's suitability requirement, was adopted in response to the Maloney Act of 1938.[295] In the Maloney Act, Congress authorized the SEC to register national securities associations, subject to the condition that such associations adopt rules designed, among other things, "to prevent fraudulent and manipulative acts and practices [and] to promote just and equitable principles of trade."[296]

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

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

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

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

296 15 U.S.C. § 78*o*-3(b)(6).

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

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

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

(1) the customer's financial status;

(2) the customer's tax status;

(3) the customer's investment objectives; and

(4) such other information used or considered to be reasonable by such [broker-dealer] in making recommendations to the customer.[299]

The New York Stock Exchange has a Know-Your-Customer rule, Rule 405[300] that courts routinely have interpreted[301] to impose a suitability requirement.[302] The American Stock Exchange and the regional stock exchanges have similar Know-Your-Customer rules.[303]

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

300 Rule 405 provides:

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

2 NY Stock Exch. Guide (CCH) ¶ 2405.

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

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

2 NY Stock Exch. Guide (CCH) ¶ 2401.

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

303 *See* Roach, *supra* note ___, at 1086-87.

ii. *The Securities And Exchange Commission*

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

A. *Adjudicatory Decisions*

In its adjudicated suitability cases, the SEC's initial task has been to articulate how the duty of suitability arises from the antifraud provisions of the federal securities laws. Under established SEC precedents, securities fraud extends beyond common-law fraud to include "acts that violate the obligation of fair dealing" by "professional broker-dealers and their salesmen."[306] Based on that principle, the SEC has held that recommending unsuitable securities to customers "violate[s] the obligation of fair dealing."[307]

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

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

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

306 Cohen & Rabin, *supra* note ___, at 702. *See also, e.g.*, Louis Loss, *The SEC and the Broker-Dealer*, 1 VANDERBILT L. REV. 510, 517 (1948).

307 *See* Mundheim, *supra* note __, at 470-71.

making their services available to the public, broker-dealers implicitly represent that they "will deal fairly with . . . customers in accordance with the standards of the profession,"[308] and that violations of the implied representation of fair dealing constitute fraud.[309] Under the SEC's alternative theory, the "trust and confidence" theory, broker-dealers who cultivate the trust and confidence of their customers thereby become fiduciaries and owe a duty to act in the customers' best interests.[310] Under both theories, securities fraud is actionable both for affirmative misrepresentations and where broker-dealers who enlist trust violate that trust by not revealing that securities they recommend are unsuitable.[311]

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

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

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

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

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

Loss, *supra* note ___, at 529.

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

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

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

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

One issue that has arisen in securities suitability cases is the role of customer consent to unsuitable stock purchases. The SEC has found brokers liable under the suitability doctrine for buying speculative securities for customers whom the broker knew could not afford the risks presented or that were counter to the customer's stated needs[317] even when the customer consented to the purchase.[318] In the controversial case of *Philips & Co.*,[319] for example, the SEC held that a "broker is obliged to observe [the suitability requirement] regardless of a customer's wishes."[320] In *Philips*, the agency affirmed a NASD finding that a broker violated the NASD's suitability rule by advising people of limited means to buy oil stock that he knew was too

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314 *Id.*

315 *See* Mundheim, *supra* note ___, at 449

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

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

318 37 S.E.C. 66 (1956).

319 *Id.*

320 Roach, *supra* note ___, at 1126.

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

Similarly, over time, the SEC rejected the view that disclosure can cure suitability violations. For example, in *Powell & McGowan, Inc.*,[322] the SEC found violations of suitability where a salesperson sold speculative securities to a senile customer through a "persistent and aggressive sales campaign."[323] The Commission went further to hold that disclosures would not have exempted the broker from liability because no amount of disclosure would have enabled the customer to evaluate the merits of the securities on a reasoned basis.[324] Subsequently, the Commission suggested that even when customers are fully competent, disclosures might not be sufficient to cure suitability violations.[325] Thus, the Commission's stance has evolved to embrace a suitability requirement that cannot be waived by disclosures or customer consent.

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

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

322 41 S.E.C. 933 (1964).

323 *Id.* at 934-935.

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

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

room cases such as *Mac Robbins & Co.*,[326] the Commission has repeatedly held that it is fraud for a broker-dealer "to induce a hasty decision by the customer" where "no effort [was] made by the salesman . . . to determine whether the security recommended [was] suitable for the customer."[327]

As one commentator has noted, "[b]oiler rooms are special precisely because, unless the high-pressure salesperson assumes an affirmative duty to inquire and assure suitability, unsuitable transactions are inevitable, and this truth should be obvious to the salesperson."[328] The same can be said of subprime mortgage lending. By definition, subprime mortgages impose higher financial burdens and are targeted at individuals of modest means who are least able to afford them and least able to understand the terms. As with boiler room sales of securities, it should be incumbent on subprime lenders and brokers to determine that borrowers who assume those obligations have the capacity to repay them.

B. *SEC Suitability Regulations*

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

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

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

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

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

Similarly, in Exchange Act Rule 15c2-5, adopted in 1962, the SEC adopted a suitability requirement for "equity funding programs" involving lending abuses. In the equity funding programs at issue, broker-dealers convinced "persons of modest means and little financial experience" to purchase mutual fund shares and to pledge those shares to secure personal loans, the proceeds of which were used to pay for insurance policy premiums.[330] In essence, equity funding programs were schemes to sell insurance policies on financing terms that many customers could not afford. The SEC "discovered that in many cases [the programs] were being offered to persons for whom they were wholly inappropriate."[331] In response, in Rule 15c2-5, the Commission announced that henceforth it would be a "fraudulent, deceptive, or manipulative act or practice" under Section 15(c)(2) of the Exchange Act[332] for a broker or a dealer to assist in arranging credit to a purchaser of securities (other than routine margin borrowing) without first ascertaining suitability.[333] Specifically, the Rule requires broker-dealers who wish to arrange such loans to:

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

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329 17 C.F.R. § 15g-9(b)(2). The NASD's parallel penny stock suitability rule appears at NASD Rules of Fair Practice, NASD MANUAL (CCH) ¶ 2310-1, IM 2310-1.

330 Mundheim, *supra* note ___, at 454.

331 *Id.*

332 15 U.S.C. § 78*o*(c)(2).

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

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

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

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

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

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

Finally, the SEC's "accredited investor" rules form a variation on the suitability doctrine. Under Regulation D, limited offerings and other securities offerings that qualify for an exemption from Securities Act registration are exempt from full disclosure so long as broker-dealers only market exempt offerings to sophisticated investors (or, in SEC jargon, "accredited

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

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

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

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

b. *Enforcement*

In the securities industry, there are several avenues for enforcing suitability. SROs can initiate disciplinary proceedings against their members or associates for violating SRO suitability rules or those of the SEC. In SRO proceedings, the SROs can either expel respondents who are found in violation or impose lesser sections, such as suspensions or fines. In addition, the SEC can adjudicate suitability through two separate avenues. The first is through appeals of SRO disciplinary proceedings to the SEC. The second is in direct SEC disciplinary proceedings against broker-dealers[339] for alleged Exchange Act antifraud violations.[340] Similarly, injured investors can bring suit for suitability violations. Violations involving fraud are actionable under the implied private right of action for securities fraud in Section 10(b) (either in court or in arbitration proceedings).[341] In addition, securities arbitration proceedings initiated by

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

338 *See* 17 C.F.R. § 230.501(a).

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

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

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

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

c. *Industry Implementation*

Suitability determinations are now routine in the securities industry. Legitimate broker-dealers insure compliance with industry and SEC suitability requirements by surveying their customers to insure that they have an accurate assessment of customers' risk thresholds and by implementing internal controls. Typically, customers opening new accounts fill out a new account form. As part of these forms, customers must complete a "suitability" questionnaire that requires them to disclose their: (1) financial status; (2) investment objectives; (3) risk tolerance; and (4) prior investment experience.[342] Upper-level management then reviews the customers' answers before any trades are executed. In addition, many firms use computers to compare customers' answers to the suitability questions with the securities that they are considering. The computer can generate "red flags" if comparisons suggest that there are suitability concerns. If a client is warned that an investment is unsuitable and nevertheless insists on going forward with the transaction, the transaction will require upper-level management review, explicit warnings and special client releases at a minimum.[343] In many cases, due to liability concerns, legitimate firms will refuse to execute unsuitable transactions because of unsettled case law on the role of

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

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

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

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

2. *Suitability In The Insurance Industry*

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

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

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

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344 *See* note ___ *supra* and accompanying text.

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

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

The seminal decision that expanded the securities suitability doctrine to insurance products was *SEC v. VALIC*,[348] where Supreme Court ruled that variable annuities were subject to federal securities regulation. In *VALIC*, the Court noted that while variable annuities are "issued by insurance companies [that] are subject to state insurance regulation," they "also contain investment risks."[349] Since *VALIC*, the SEC has regulated variable insurance products as securities[350] and the NASD has imposed a duty of suitability in the sale of these products.[351] In a series of recent enforcement actions and Notices to Members, the NASD has specifically emphasized that NASD Rule 2310 on suitability applies to the sale of variable life insurance and annuities.[352]

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

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

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

348 359 U.S. 65 (1959).

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

350 *Id.*

351 *See id.* at 22.

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

suitability requirement in insurance. Under contract and/or tort law, insurers have to act in good faith and deal fairly when they respond to settlement offers.[353] Beginning in the early 1970s, this duty of good faith and fair dealing was expanded from third-party claims[354] to first-party claims as well,[355] including claims by owners of variable annuities and life insurance policies with investment features.

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

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

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

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

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

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

358 *Id.* at 707-11.

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

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

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

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359 *Id.* at 711-20.

360 *Id.* at 714.

361 *Id.* at 715.

362 *Id.*

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

the suitability of a particular product for an individual customer. Some provisions provide no guidance whatsoever[364] or require only a general duty of inquiry.[365] Others mandate that insurers consider customers' insurance objectives, financial situations, needs and age when recommending products.[366] At least three other states have statutes, rules or rulings that impose suitability obligations of a more limited nature on some segment of insurance sales.[367] Other state insurance commissioners have called for suitability standards in insurance, especially with respect to seniors.[368] In the meantime, one industry trade association, the Insurance Marketplace

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

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

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

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

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

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

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

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

The passage of the Gramm-Leach-Bliley Act in November 1999 provided added federal impetus for an industry-wide suitability rule in insurance. In Gramm-Leach-Bliley, Congress specified that unless twenty-nine states agree on reciprocity in insurance agent licensing or adopt uniform licensing laws and regulations by November 11, 2002, insurance sales by banks will face a national registration system for insurance agents and brokers under the auspices of the National Association of Registered Agents and Brokers (NARAB).[370] If states opt for uniform licensing laws in lieu of reciprocity, Gramm-Leach-Bliley requires states to adopt suitability standards for insurance sales in order to "ensure that an insurance product, including any annuity contract, sold to a consumer is suitable and appropriate for the consumer based on financial information disclosed by the consumer."[371] With this provision, Congress expressly required any uniform national licensing scheme in insurance to include a suitability standard.

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

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

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

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

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

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

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

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

B. *Theoretical Bases For Suitability In The Subprime Market*

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

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373 *Id.* at 23.

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

The current draft model language would provide:

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

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

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

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

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

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

376 37 S.E.C. 66 (1956).

377 *Id.* at 68.

378 *See, e.g.*, Kerr, *supra* note ___, at 831.

379 *See* Hu, *supra* note ___, at 2325.

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

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

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

The same economic rationales for suitability apply to the subprime mortgage market. Disclosure has proven useless, and financial literacy is hopelessly costly and highly unlikely to succeed. In addition, just as with boiler room securities operations, the extreme sales tactics of

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381 Mundheim, *supra* note ___, at 450.

382 *See* Kerr, *supra* note ___, at 830.

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

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

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

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

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

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

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

C. *Adapting Suitability To Subprime Mortgage Lending*

1. *Structure And Enforcement Channels*

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

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

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

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

388 *See* Sections ___-___ *infra* for our proposal recommending such a cause of action.

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

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

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

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

2. *An SRO Requirement*

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

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

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

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

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

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

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

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