

Toward One Competitive and Fair Mortgage Market: Suggested Reforms in *A Tale of Three Markets* Point in the Right Direction

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I. Introduction

Predatory lending, unfortunately, is not a new phenomenon.¹ What is new involves both bad news and good news. The bad news is that predatory lending in both the mortgage and nonmortgage markets has grown exponentially in the last decade, leaving a much deeper and more widespread financial havoc in its wake.² The good news is that, on the mortgage side, Congress, federal agencies, consumer and housing advocates, and the public have focused on this national scandal and made some headway in addressing predatory lending.

Toward this end, Congress passed the Home Ownership and Equity Protection Act (HOEPA), effective in 1995.³ HOEPA creates a special class of regulated closed-end loans. If the annual percentage rate exceeds certain treasury securities by more than 8% for first lien loans, or if certain points

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1. See KATHLEEN KEEST & ELIZABETH RENUART, *THE COST OF CREDIT: REGULATION AND LEGAL CHALLENGES* ch. 2 (2d ed. 2000 & Supp.). Salary lenders (the precursor to the payday lenders of current times) and loansharks appeared on the American scene in the nineteenth century.

2. Regarding small loans, see Lynn Drysdale & Kathleen E. Keest, *The Two-Tiered Consumer Financial Services Marketplace: The Fringe Banking System and its Challenge to Current Thinking About the Role of Usury Laws in Today's Society*, 51 S.C. L. REV. 589 (2000). For a quantification of the cost to homeowners affected by certain mortgage lending abuses, see Eric Stein, *Quantifying the Economic Cost of Predatory Lending: A Report from the Coalition for Responsible Lending*, July 25, 2001, at 2, available at <http://predatorylending.org/prdfs/Quant10-01.pdf> (estimating the annual losses by American borrowers attributed to predatory lending practices to be \$9.1 billion). Foreclosure rates in the subprime mortgage market are significantly higher than in the prime market. See Mortgage Bankers Association of America, *Mortgage Delinquencies Decrease in MBA Survey for First Quarter of 2003* (June 20, 2003), available at <http://www.mortgagebankers.org/news/2003/pr0620a.html> (last visited Nov. 8, 2003) (discussing the first-quarter 2003 Mortgage Bankers Association National Delinquency Survey, which reveals that, in the United States, the percentage of subprime loans in the process of foreclosure is 12 times greater than the percentage of prime loans in foreclosure); see also Patrick Barta, *Delinquent Loans Decline, But Foreclosures Gain*, WALL ST. J., Jan. 8, 2003, at A2 (Mortgage Bankers Association third quarter figures for 2002 reveal an 8.59% foreclosure rate for certain subprime lenders compared with a 1.15% overall rate; LoanPerformance figures showed a 4.33% foreclosure rate for subprime loans in October 2002).

3. 15 U.S.C. §§ 1602(aa), 1639, 1641(d) (2000). HOEPA is an amendment to the Truth in Lending Act, 15 U.S.C. §§ 1601–1667f (2000).

and fees exceed 8% of the total loan amount, the Act is triggered.⁴ These loans are subject to special disclosure requirements and, more critically, to restrictions on substantive terms that are commonly used by abusive lenders, and those who bring them these loans,⁵ to manipulate the cost of these transactions. Significantly, certain types of creditor behavior are also restricted. Unfortunately, the triggers under HOEPA are so high that many abusive loans are not regulated, even though the Federal Reserve Board recently expanded coverage.⁶

Some states have enacted “home loan protection” or “fair lending” statutes or regulations to fill in the gaps left by HOEPA. New Mexico, New Jersey, New York, and North Carolina currently provide the greatest protection for their citizens.⁷ Georgia enacted an even stronger law last year but, by March 2003, the legislature had gutted some of its most significant protections after the governor, a strong proponent, lost his election in November.⁸ Arkansas, California, the District of Columbia, Illinois, Massachusetts, and Texas are other jurisdictions that regulate abusive mortgage loans, though not to the same degree.⁹ In contrast, new laws in Connecticut, Florida, Ohio, and Pennsylvania are likely to have little real effect on predatory practices in those states.¹⁰ Much work remains from the

4. The Federal Reserve Board lowered the APR trigger for first lien loans from 10% to 8% effective October 1, 2002. Truth in Lending Act, 66 Fed. Reg. 65,604, at 65,605 (Dec. 20, 2001). The APR trigger for subordinate lien loans remains at 10%.

5. Examples of those who provide loans to lenders include brokers, home improvement contractors, and mobile home dealers.

6. The three most significant problems with HOEPA are the following: (1) it does not in any way limit what the lender can charge as up-front costs to the borrower or the amount of such fees that can be financed; (2) the interest rate trigger and the points and fees trigger in HOEPA are both too high, allowing many abusive lenders to avoid HOEPA strictures by making high cost loans just under the trigger; and (3) HOEPA does not apply to open-ended loans. However, HOEPA has some good ideas. It is based on the economic rationale that the higher the charges for the loan, the more regulation is necessary and appropriate. By passing HOEPA, Congress has already recognized two essential truths: that there are some loans to which the marketplace does not effectively apply restrictions; and government must step in to provide support to the bargaining position of borrowers who either lack the sophistication to avoid bad loans or do not believe they have a choice if they want the credit.

7. N.M. STAT. ANN. §§ 58-21A-1–58-21A-14 (Michie Supp. 2003); N.J. STAT. ANN. §§ 46:10B-22–46:10B-30 (West Supp. 2003); N.Y. BANKING LAW § 6-L (McKinney 2003); N.C. GEN. STAT. § 24.1-1E (1999).

8. GA. CODE ANN. §§ 7-6A-1–6A-11 (2002). Since its enactment, Georgia’s law has also been under attack from the lending industry and Wall Street. See Standard and Poor’s, Press Release, Standard and Poor’s to Disallow Georgia Fair Lending Act Loans (Jan. 16, 2003), available at <http://www.standardandpoors.com>. S&P refuses to rate any pools of loans for future securitizations if they contain loans covered by the Georgia law.

9. ARK. CODE ANN. §§ 25-53-101–23-53-106 (Michie 2003); CAL. FIN. CODE §§ 4970–4979.7 (West 2003); D.C. CODE ANN. §§ 26-1001–1021, 26-1151.1 (Supp. 2001); 815 ILL. COMP. STAT. §§ 137/1–137/175 (2003); MASS. REGS. CODE tit. 209 §§ 32.32, 40 (2002); TEX. CONST. art. 16, § 50(a).

10. CONN. GEN. STAT. ANN. §§ 36a-746–747, 754 (West 1996); FLA. STAT. ANN. §§ 494.0079–.00797 (West 2002); OHIO REV. CODE ANN. §§ 1349.25–.36 (West Supp. 2003); 63 PA.

consumer's perspective. Any gains may be undermined, at least in Congress, given the political changes wrought by the 2002 elections.¹¹ Despite the federal scene, pressure continues in some states to push forward consumer protection legislation.

The other good news is that researchers and academics have begun to study and report about predatory mortgage lending. High quality research and articles assist in fueling and defining the public policy debate in a positive way. Much of the research to date has involved matching Home Mortgage Disclosure Act (HMDA) data for subprime lenders with census track information in order to draw inferences about the lending patterns to minority borrowers living in low, moderate, and upper income neighborhoods.¹² These studies uniformly reveal that minority borrowers, regardless of income, are much more likely to be sold subprime—ergo, more expensive—loans than their white counterparts.¹³

CONS. STAT. ANN. §§ 456.501–524 (West Supp. 2003). With the exception of Connecticut, these laws simply codify the federal HOEPA without adding additional significant protections. Further, they purport to preempt the ability of local jurisdictions to enact their own consumer protection statutes. Connecticut's law contains even fewer protections than HOEPA, except that it prohibits the charging of prepaid finance charges over 5% of the principal amount of the loan. *Id.*

11. Numerous consumer protection bills were introduced in the 108th Congress. The most comprehensive, Senate Bill S. 2438, was introduced by Senator Sarbanes (D-Md.). On the other side of the fence, Representatives Ney (R-Ohio) and Lucas (D-Ky.) filed an industry endorsed bill in 2003, H.R. 833. The Senate also switched hands as a result of the 2002 elections. Consequently, Senator Sarbanes, formerly the Chair of the Senate Banking Committee, may now be unable to stop harmful industry bills from getting to the Senate floor, a significant change from the power he possessed as Chair. On the state level, the 2002 elections unseated Governor Roy Barnes, who championed the strong Georgia Fair Lending Act. As noted above, within four months of that election, the new governor signed into law significant changes to the Act, gutting the antiflipping provision and essentially eliminating the ability of consumers to raise claims and defenses against the loan holder.

12. See PATRICIA A. MCCOY, BANKING LAW MANUAL § 8.03[2] (2d ed. 2001); DEANNE LOONIN & CHI CHI WU, CREDIT DISCRIMINATION § 4.4.5 (3d ed. 2002). The statute and Regulation C require lenders to keep the following data for each covered loan: the type and purpose of the loan; the amount of the loan; the action taken; the date action was taken; the location of the property; the applicant's race or national origin, sex, and income; and the loan purchaser.

These requirements only apply to federally insured or regulated lenders or where the loan is insured by a federal agency or the lender intends to sell the loan to Fannie Mae or Freddie Mac. Smaller institutions or those that do not do business in a metropolitan area are exempted. As of January 1, 2004, the following additional information must be reported: HOEPA status; interest rate spreads; and lien status.

13. See, e.g., CALVIN BRADFORD, NEIGHBORHOOD REVITALIZATION PROJECT (NRP) OF THE CENTER FOR COMMUNITY CHANGE, RISK OR RACE? RACIAL DISPARITIES AND THE SUBPRIME REFINANCE MARKET: A REPORT OF THE CENTER FOR COMMUNITY CHANGE (2002); DEP'T OF HOUS. & URBAN DEV., UNEQUAL BURDEN: INCOME AND RACIAL DISPARITIES IN SUBPRIME LENDING IN AMERICA (2000); THE REINVESTMENT FUND, PREDATORY LENDING: AN APPROACH TO IDENTIFY AND UNDERSTAND PREDATORY LENDING (2002); KEVIN STEIN & MARGARET LIBBY, CAL. REINVESTMENT COMM., STOLEN WEALTH: INEQUITIES IN CALIFORNIA'S SUBPRIME MORTGAGE MARKET (2001); DANIEL IMMERGLUCK & MARTI WILES, WOODSTOCK INST., TWO STEPS BACK: THE DUAL MORTGAGE MARKET, PREDATORY LENDING, AND THE UNDOING OF COMMUNITY DEVELOPMENT (1999). Subprime loans are loans made at higher interest rates and accompanied by higher fees. Subprime loans are more expensive because many of the borrowers

Drawing upon these studies and other related research, the recently published *A Tale of Three Markets: The Law and Economics of Predatory Lending* is a landmark analysis of the mortgage marketplace, its successes and disturbing failures, and the remedies needed to curb its abusive aspects.¹⁴ The contribution of Professors Engel and McCoy to the body of critical thinking about predatory mortgage lending cannot be overstated.¹⁵ In my view, the important advances of this work number at least three.

First, these authors are the first to thoroughly describe the reality of the mortgage marketplace in today's world—one that is segmented and treats borrowers very differently depending upon whether their mortgage was placed in the prime, subprime, or predatory market.¹⁶ These and other market dynamics are carefully articulated and meticulously documented.

Second, the paper directly challenges the commonly espoused assumption that consumers operate in a rational and fair world. According to this view, consumers are “reasonable,” fully informed, and literate (verbally and arithmetically) people who should be responsible for their choices. Thus, if a mortgage loan contains an abusive term, consumers are stuck with their bargain because they knew or should have known. Disclosure is all the protection that consumers need. The dismantling of these assumptions did not start with Engel and McCoy.¹⁷ However, their paper confronts the reality, known by those working on the front lines with affected homeowners struggling to keep their shelter, that “predatory lending is not about free choice; it is about the suppression of free choice.”¹⁸

Third, *A Tale of Three Markets* reviews and critiques the current legal remedies available to harmed homeowners and suggests the creation of a new legal tool that could produce more effective results. Although adoption of the suitability standard as outlined in the article is problematic in some

provide greater levels of risk due to impaired credit histories. However, prime borrowers who receive subprime loans are getting inappropriately priced loans. Further, whether the actual risk justifies the higher price is disputed. See *infra* subpart II(B).

14. Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEXAS L. REV. 1255 (2002).

15. As one reviewer put it, “[This] paper on predatory lending is groundbreaking for a variety of reasons and should be considered required reading for any policy analyst interested in the subject of predatory lending.” James H. Carr, *Discussion Comments*, in CHANGING FINANCIAL MARKETS AND COMMUNITY DEVELOPMENT 170, 172 (Proceedings of the Federal Reserve System Community Affairs Research Conference, Apr. 5–6, 2001), available at <http://www.chicagofed.org/cedric/2001/Conferencebook.pdf>.

16. Similar analysis preceded Engel and McCoy's work in the nonmortgage lending context. See, e.g., Drysdale & Keest, *supra* note 2, at 591–623 (surveying a variety of high-interest loans targeting those in lower socio-economic classes).

17. In a recent decision, one judge perceptively reviewed the developing literature discussing the fact that market outcomes frequently will be heavily influenced by information asymmetries, control of the format of such information, and the presentation of choices or the lack of choices presented or perceived. *Honorable v. Easy Life Real Estate Sys.*, 100 F. Supp. 2d 885 (N.D. Ill. 2000) (analyzing the market in the context of a reverse redlining claim in the sale of real property).

18. Engel & McCoy, *supra* note 14, at 1358.

respects, the discussion about why a more appropriate remedy may be necessary and how to craft it is essential to any public policy debate.

What follows is a more specific review of the Engel and McCoy article with an eye toward interjecting additional thoughts into the ongoing and dynamic discussion of this important issue.

II. Other Highlights and a Critique of Some Specifics

A. Definition of Predatory Lending

Skeptics of the existence and extent of predatory lending argue against imposing additional controls on the marketplace because predatory lending has not been adequately defined.¹⁹ Engel and McCoy tackle this issue early in their article. The authors do an excellent job of defining predatory lending as “a syndrome of abusive loan terms or practices that involve one or more” of five categories of problems.²⁰ These five categories fairly encompass the range of current abusive practices. However, three types of lender behavior are missing in their overview.

First, Engel and McCoy fail to develop the fact that steering borrowers on the basis of race or ethnicity to loans whose terms are grossly unfavorable when compared to the loans obtained by their white counterparts is strongly suggested by the body of research involving the use of HMDA data.²¹ Theories of “reverse redlining” under the Fair Housing Act (FHA) and the Equal Credit Opportunity Act (ECOA) have survived motions to dismiss, setting the stage for a more global attack against the ugliest underpinning of predatory lending.²² The authors identify steering borrowers into more

19. See, e.g., Michele Heller, *House Panel Calls Reg Reform Priority*, AM. BANKER, Apr. 5, 2001, at 4 (noting the opposition of House Financial Services Chairman Michael B. Oxley to legislation designed to combat predatory lending that lacks an adequate definition of the term).

20. Engel & McCoy, *supra* note 14, at 1260. These five categories are: “(1) loans structured to result in seriously disproportionate net harm to borrowers, (2) harmful rent seeking, (3) loans involving fraud or deceptive practices, (4) other forms of lack of transparency in loans that are not actionable as fraud, and (5) loans that require borrowers to waive meaningful legal redress.” *Id.*

21. See *supra* note 12–13 and accompanying text.

22. See, e.g., *Matthews v. New Century Mortgage Corp.*, 185 F. Supp. 2d 874 (S.D. Ohio 2002) (denying motion to dismiss reverse redlining claim under section 3605 of the FHA and the Ohio state law equivalent and denying similar motion as to ECOA claims because the consumer only needed to allege that she was discriminated against in the terms of her credit for a prohibited reason); *Hargraves v. Capital City Mortgage Corp.*, 140 F. Supp. 2d 7 (D.D.C. 2000) (holding that reverse redlining practices by mortgage lenders are actionable under the FHA and the ECOA), *motion for reconsideration aff'd in part and denied in part*, 147 F. Supp. 2d 1 (D.D.C. 2001) (granting summary judgment on ECOA and FHA claims raised by two plaintiffs who never applied for credit on their own behalf but did so on behalf of the church plaintiff); *Honorable*, 100 F. Supp. 2d at 886–87 (denying a motion to dismiss exploitation theory under the FHA in which the plaintiffs alleged that the real estate company targeted African Americans and lured them into buying homes that were not as represented); see also *Assocs. Home Equity Servs., Inc. v. Troup*, 778 A.2d 529 (N.J. Super. Ct. App. Div. 2001) (denying summary judgment in a foreclosure action when a reverse redlining claim under the FHA and state law was raised as a defense).