STILL MORTGAGING THE AMERICAN DREAM: PREDATORY LENDING, PREEMPTION, AND FEDERALLY-SUPPORTED LENDERS

by

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This article discusses the continuing problem of predatory lending abuses in the subprime home mortgage lending market and federal and state attempts to address the problem. Over the protests of consumer advocates, federal agencies have recently issued regulations preempting state predatory lending statutes as applied to national banks and thrifts. In addition, Congress is considering legislation that would preempt state predatory lending laws for all lenders. The article considers the preemption debate, particularly in the context of federally-supported lenders–banks, thrifts, and the government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac. Banks and thrifts receive support through the federal safety net, which includes deposit insurance. Fannie Mae and Freddie Mac are federally chartered, privately-owned corporations that receive other types of federal support. The article concludes that preemption is not warranted for national banks and thrifts or for other lenders, and that banks, thrifts, and the GSEs should be part of the solution to the predatory lending problem by originating, purchasing, and/or securitizing subprime loans in compliance with state and federal law.

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Citigroup is the largest financial services company in the world.[1] Its retail banking group, operating under the name Citibank, includes a number of national banks with federal charters.[2] Citigroup and Citibank are affiliated with a subprime lender[3] who has engaged in predatory mortgage lending practices.

Associates First Capital was notorious for its predatory lending practices in 2000 when Citigroup purchased the company.[4] Associates was at the time under investigation by the Federal Trade Commission (FTC) and the Justice Department "as epitomizing 'predatory' tactics that strip away equity in homes of unsophisticated borrowers by making loans with deceptive terms and fees."[5] Associates' practices included making loans with high interest rates, large upfront fees, balloon payments, and prepayment penalties as well as aggressively selling single-

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[1]*See* HOOVER'S IN-DEPTH COMPANY RECORDS, *Citigroup Inc.* (Sept. 7, 2005), *available at* 2005 WLNR 14057524.

[2]*See* Office of the Comptroller of the Currency, National Banks Active As of 9/30/05, *at* http://www.occ.treas.gov/foia/nblist_Name_St_City_BankNet.pdf.

[3]Subprime lenders are lenders who make subprime loans, which are loans to borrowers with a higher credit risk. See *infra* notes 38-48 and accompanying text for a more extensive discussion of subprime lending.

[4]See Richard A. Oppel & Patrick McGeehan, Along With a Lender, Is Citigroup Buying Trouble?, N.Y. TIMES, Oct. 22, 2000, at 31 [hereinafter Citigroup Buying Trouble]; Richard A. Oppel & Patrick McGeehan, Citigroup Revamps Lending Unit To Avoid Abusive Practices, N.Y. TIMES, Nov. 8, 2000, at C1 [hereinafter Citigroup Revamps]. Martin Eakes, the founder of a nonprofit community lender in North Carolina, is quoted as saying, "It's simply unacceptable to have the largest bank in America take over the icon of predatory lending." Citigroup Buying Trouble, supra, at 31. See also infra Part V.A (discussing the involvement of bank affiliates in predatory lending).

In 1996, Associates had purchased Fleet Finance, another notorious predatory lender. *See* Tony Munroe, *Fleet Unloads Finance Unit,* BOSTON HERALD, July 2, 1996. In 1993 and 1994 Fleet Finance had paid over $100 million in settlement of allegations that it had engaged in predatory lending practices in Georgia. *Id.*

[5]*See Citigroup Revamps, supra* note 4, at C1.

premium credit insurance and “flipping,” or refinancing, loans to generate additional fees without benefit to the borrower.[6] Employees of Associates were under intense pressure to sell credit life insurance, and a subsidiary had collected $900 million in revenue from credit insurance premiums over the five years prior to the Citigroup purchase, selling credit insurance on fifty-seven percent of its real estate loans one year.[7] Consistent with its practice of “flipping” loans, Associates even refinanced zero-interest loans made through Habitat for Humanity.[8] Citigroup promised reforms, but its consumer finance company, Citifinancial, which would eventually take over the Associates branches, planned to continue charging prepayment penalties, selling single premium credit life insurance, and requiring mandatory arbitration clauses in its loans.[9]

In March 2001, the FTC sued Associates, as well as Citigroup and Citifinancial as its successors, alleging that Associates had violated the Federal Trade Commission Act by engaging in deceptive practices to induce consumers to purchase credit insurance and to refinance existing home mortgage loans into new high interest rate loans with high fees.[10] At the time, Citigroup stressed its commitment to resolve problems and implement changes in the former Associates

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[6]*See Citigroup Buying Trouble, supra* note 4, at 31. *See also supra* Part I (describing the practice of predatory lending).

[7]*See id.*

[8]*See id.*

[9]*See Citigroup Revamps, supra* note 4, at C1.

[10]*See* Federal Trade Commission, News Release, Citigroup Settles FTC Charges Against the Associates: Record-Setting $215 Million for Subprime Lending Victims (Sept. 20, 2002), *available at* http://www.ftc.gov/opa/2002/09/associates.htm [hereinafter FTC News Release].

branches.[11] In September 2002, Citigroup reached a settlement with the FTC, agreeing to pay $215 million to customers of Associates who had purchased credit insurance between December 1, 1995, and November 30, 2000,[12] the date on which Citigroup finalized its purchase of Associates.[13] The settlement was made contingent on approval of the settlement of a class action in California providing for payment of an additional $25 million to consumers who refinanced with Associates during the same time period.[14] The settlement was the largest ever reached by the FTC.[15]

Through the pendency of the FTC suit and after the settlement, Citigroup continued to insist that the problems were with the old Associates and that it was instituting reforms.[16] However, in May 2004, the Federal Reserve ordered Citifinancial to pay a $70 million penalty for lending abuses which occurred in 2000 and 2001.[17] The Fed asserted that Citifinancial made home equity loans without adequately determining the ability of borrowers to repay the loans.[18] The penalty was the largest ever assessed by the Federal Reserve for violations of consumer

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[11]*See* Richard A Oppel, *U.S. Suit Cites Citigroup Unit On Loan Deceit,* N.Y. TIMES, Mar. 7, 2001, at A1.

[12]*See* FTC News Release, *supra* note 10.

[13]*See Citigroup Closes Associates Deal,* N.Y. TIMES, Dec. 1, 2000, at C12.

[14]*See* FTC News Release, *supra* note 10.

[15]*See id.*

[16]Citigroup stopped doing business with about 20 percent of the brokers who brought business to Associates, Richard A Oppel, *Citigroup Takes Action Against Brokers at Consumer Loan Unit,* N.Y. TIMES, Apr. 25, 2001, at C1, and agreed to stop selling single-premium credit insurance, opting instead to allow borrowers to pay monthly premiums, Patrick McGeehan, *Citigroup Set to End Tactic on Mortgages,* N.Y. TIMES, June 29, 2001, at C1.

[17]*See* Timothy L. O'Brien, *Fed Assesses Citigroup Unit $70 Million in Loan Abuse,* N.Y. TIMES, May 28, 2004, at C1 [hereinafter *Fed Assesses Citigroup*].

lending laws.[19] More recently, Citigroup disclosed that it had made hundreds of high-cost loans even after adopting a policy of no longer making high-cost loans.[20] The New York attorney general is investigating whether Citigroup made high-cost loans to minority and other vulnerable homeowners who could qualify for lower cost loans.[21]

Citibank is not the only bank affiliated with a subprime lender accused of predatory lending abuses. In 2002, Household International, an affiliate of HSBC Bank USA,[22] agreed to pay $484 million to settle allegations by states that it had engaged in predatory lending practices.[23] In addition, Bank of America, Bank One, Chase, Fleet Bank, and Wells Fargo, or affiliates of these banks, have all been sued based on allegations of predatory lending abuses.[24]

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18 *See Fed Assesses Citigroup, supra* note 17, at C1.

19 *See id.*

20 *See* Eric Dash, *Citigroup Units Kept Making Loans That Violated Policy,* N.Y. TIMES, May 4, 2005, at C9 [hereinafter *Citigroup Violated Policy*]. The high-cost loans covered by Citigroup's policy are defined in the Home Ownership and Equity Protection Act of 1994, 15 U.S.C. §1601 *et seq.* (2000).

21 *See Citigroup Violated Policy, supra* note 20, at C1.

22 *See* HOOVER'S IN-DEPTH COMPANY RECORDS, *HSBC USA Inc.* (Oct. 5, 2005), *available at* 2005 WLNR 16118527.

23 *See* U.S. GENERAL ACCOUNTING OFFICE, REP. NO. GAO-04-280, CONSUMER PROTECTION: FEDERAL AND STATE AGENCIES FACE CHALLENGES IN COMBATING PREDATORY LENDING, REPORT TO THE CHAIRMAN AND RANKING MINORITY MEMBER, SPECIAL COMMITTEE ON AGING, U.S. SENATE 4 (2004) , *available at* http://www.gao.gov/new.items/d04280.pdf [hereinafter GAO REPORT].

24 *See* Comments of the National Consumer Law Center, Consumer Federation of America, National Association of Consumer Advocates, and U.S. Public Interest Research Group to Office of Comptroller of the Currency, OCC Docket No. 03-16 (Oct. 6, 2003), *available at* http://www.nclc.org/initiatives/test_and_comm/10_6_occ.shtml [hereinafter NCLC Comments]; Arthur E. Wilmarth, Jr., *The OCC's Preemption Rules Exceed the Agency's Authority and Present a Serious Threat to the Dual Banking System and Consumer Protection,* 23 ANN REV. BANKING & FIN. L. 225, 315 (2004).

Home ownership is still the American dream,[25] and more Americans than ever are realizing that dream.[26] Predatory lending practices and the foreclosures that result, however, undermine that dream. The federal government has played and continues to play a significant role in promoting home ownership by supporting the home mortgage market, by offering tax incentives to homeowners, by attempting to make home mortgage financing more available and less expensive.[27] Some of the government's efforts to benefit home mortgage lenders and support the mortgage market, however, harm the very homeowners that they are ultimately intended to benefit.[28] Recently, the federal government is thwarting the efforts of state legislators to protect homeowners in their states by preempting state statutes regulating predatory lending abuses. Regulations preempt state predatory lending statutes applicable to national banks and savings associations (also called thrifts), and proposed legislation would preempt the statutes altogether.

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[25] *See* U.S. Department of Housing and Urban Development, Homeownership is a National Priority, *at* http://www.hud.gov/initiatives/homeownership/index.cfm. *See also* Joan Williams, *The Rhetoric of Property,* 83 IOWA L. REV. 277, 326-27 (1998) (discussing the American obsession with homeownership).

[26] *See* U.S. DEPT. OF HOUSING AND URBAN DEVELOPMENT & U.S. DEPT. OF TREASURY, CURBING PREDATORY HOME MORTGAGE LENDING: A JOINT REPORT 13 (June 2000), *available at* http://www.hud.gov/library/bookshelf18/pressrel/treasrpt.pdf [hereinafter HUD/TREASURY JOINT REPORT] (stating that 67.1 percent of American families own a home).

[27] *See* Julia Patterson Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing,* 69 TUL. L. REV. 373, 394 (1994).

[28] Federal law encourages both borrowers and lenders to structure consumer debt as a home equity loan secured by the borrower's home. Furthermore, federal law preempts state usury laws and laws governing alternative mortgage transactions, thus permitting high interest rates and other unfair terms in home equity loans despite state law to the contrary. Finally, federal bankruptcy law, which otherwise could give some relief to debtors, requires a debtor to pay a home equity loan in full on its original terms to avoid foreclosure. *See id.* at 432-35.

In this article I address the preemption debate, particularly in the context of federally-supported lenders–banks, thrifts, and the government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac.[29] I conclude that preemption is not warranted, even for national banks and thrifts, and argue that banks, thrifts, and the GSEs should be part of the solution to the predatory lending problem by operating in the subprime mortgage market in compliance with both state and federal law.

In part I of this Article, I discuss the continuing problem of predatory lending. Minority, elderly, and low-income homeowners are still being victimized by unscrupulous lenders, mortgage brokers, and contractors. They pay too much for credit, obtain loans they cannot afford, and in some cases lose their homes.[30]

Part II explores the efforts of state and federal lawmakers and enforcers to address the predatory lending problem. In 1994, Congress passed the Home Ownership and Equity Protection Act (HOEPA),[31] and many states have since enacted statutes designed to further protect their citizens from predatory lending abuses.[32] Lenders, however, are opposed to state predatory lending statutes and have pressed federal lawmakers to preempt state law.

In Part III, I examine the possible causes of the predatory lending problem. While the issues are complex and the precise causes hard to determine, changes over the last 30 years in the

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[29]Fannie Mae and Freddie Mac are privately-owned government-sponsored entities that support the mortgage market by purchasing and securitizing home mortgage loans. See*infra* Part V.B for a discussion of Fannie Mae and Freddie Mac.

[30]*See infra* Part I.

[31]Pub. L. No. 103-325, tit. 1, subtit. B, 108 Stat. 2190 (codified at 15 U.S.C. §§ 1601-1648 (2000)).

[32]*See infra* Part II.B.

operation of the mortgage market for both prime and subprime loans have been a major contributing factor. While these changes have served the prime market well, they have increased the likelihood that subprime borrowers will be victimized. Investors in home mortgages can purchase predatory loans, turning a blind eye to dishonest originators, and can hide under the holder in due course doctrine and the securitization process to avoid loss and liability. A major increase in the availability of subprime credit has opened the door to predatory lenders, and market failures have kept honest subprime lenders from driving the dishonest ones out of the market. Finally, federal preemption of state consumer protection measures has prevented states from responding to the full extent possible.

Part IV discusses recent developments in the federal preemption of state predatory lending laws as well as the validity of regulatory attempts at preemption. In January 2004 the Office of the Comptroller of the Currency (OCC) announced that federal banking law preempts state predatory lending statutes as applied to national banks and their operating subsidiaries.[33] The Office of Thrift Supervision (OTS) had previously issued a similar determination earlier with respect to federal savings associations.[34] In addition, a bill currently before Congress would preempt state predatory lending statutes altogether.[35]

In Part V, I discuss the involvement of federally-supported lenders–banks, thrifts, and government sponsored enterprises--in the subprime and predatory lending markets. Banks and thrifts and the GSEs have taken vastly different approaches to the subprime mortgage market and

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[33] *See infra* notes 249-57 and accompanying text.

[34] *See infra* notes 258-73 and accompanying text.

[35] *See infra* Part IV.B.

the predatory lending problem. Federal banks and thrifts are involved in the subprime mortgage market and in some cases make or profit indirectly from predatory loans. Banks and thrifts have sought and obtained protection from state predatory lending initiatives through federal preemption. Fannie Mae and Freddie Mac, on the other hand, have become increasingly involved in the purchase and securitization of subprime loans while adhering to guidelines designed to prevent their purchase of predatory loans. Both have successfully operated under the patchwork of state mortgage law for many years and the more recent patchwork of predatory lending laws emerging in an increasing majority of the states.

In Part VI, I argue that the federal government should not preempt state predatory lending law. Both real estate finance and consumer protection have traditionally been areas governed by state rather than federal law. In recent years when the federal government has intervened in these areas, federal statutes and regulations have typically created a minimum standard for consumer protection rather than preempting the field of regulation. When state governments regulate, they can be more responsive to the needs of their citizens and can be innovative in trying new solutions. State enforcers are more likely to prosecute small actors in predatory lending that federal enforcers may ignore.

I assert that varying state laws are not as onerous on lenders as they may claim. Since subprime loans tend to be originated by local mortgage bankers and mortgage brokers, the originators can comply with local law, and investors can police their originators and purchase only from those that do comply with local law. The states already have varying laws governing real estate finance, so adding additional requirements is only a matter of revising forms and standards that already differ from state to state. Furthermore, Fannie Mae and Freddie Mac can further their regulatory goals of leading the market in loans to low and moderate-income families and in low and moderate-income neighborhoods by participating in the subprime market to a greater extent and by setting standards for compliance with each state's law.

Federal attempts to curb the predatory lending problem have thus far been unsuccessful. As a result, state legislatures have reacted to the problem by enacting statutes aimed at protecting consumers in their states. This article argues that the federal government should not tie the hands of state legislatures and state attorneys general who are trying to combat mortgage lending abuses because predatory lending is still a problem.

II. THE PROBLEM OF PREDATORY LENDING

Predatory lending is alive and well,[36] as the lawyers in the trenches is legal aid offices across the country can attest. Despite federal and state statutory measures aimed directly at curbing the problem, homeowners are still victimized. In fact, the incidence of predatory lending has increased since 1994 when Congress enacted HOEPA.[37]

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[36]*See* GAO Report, *supra* note 23, at 23-25; HUD/ TREASURY JOINT REPORT, *supra* note 26, at 22. In March of 2000, Secretary of Housing and Urban Development, Andrew Cuomo, formed the National Task Force on Predatory Lending. *Id.* at 13-14. Task force members included "representatives of consumer advocacy groups; industry trade associations representing mortgage lenders, brokers, and appraisers; local officials; and academics." *Id.* at 14. Recommendations in the HUD/Treasury Joint Report are based in significant part on information gathered by the task force. *Id.* at 13.

[37]*See Legislative Solutions to Abusive Mortgage Lending Practices: Hearing Before the Subcomms. on Financial Institutions and Consumer Credit and Housing and Community Opportunity of the House Comm. on Financial Services,* 109th Cong. 1 (2005), *available at* http://financialservices.house.gov/hearings.asp?formmode=detail&hearing=389&comm=3 [hereinafter *Hearing on Legislative Solutions*] (statement of Martin Eakes, CEO, Self-Help and the Center for Responsible Lending) ("As the subprime mortgage market has boomed, climbing from $35 billion to $530 billion in the decade through last year, so to have abusive loans, which

Predatory lending must be distinguished from subprime lending. Subprime loans are loans with a higher risk of default because of the credit characteristics of the borrowers.[38] Borrowers may be a higher credit risk because of previous delinquencies, foreclosures, or bankruptcies, their debt-to-income ratios, or other factors.[39] Because of the greater risk of default by these borrowers, subprime loans carry higher interest rates than prime loans.[40] Even within the subprime market, interest rates vary according to risk.[41] Subprime loans are classified according to risk as A- (lowest risk), B, C, or D (highest risk),[42] with interest rates varying from about half a point to as much as four points above prime rates.[43]

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are concentrated in this market."); *Predatory Mortgage Lending: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. 398 (2001) [hereinafter *Hearings on Predatory Mortgage Lending*] (statement of Mike Shea, Executive Director, ACORN Housing Corp.); 66 Fed. Reg. 65,604 (Dec. 20, 2001) ("With this increase in subprime lending there has also been an increase in reports of "predatory lending.").

[38] *See* Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, & Office of Thrift Supervision, Expanded Guidance for Subprime Lending Programs 2 (2001) [hereinafter Expanded Guidance]; *Hearings on Predatory Mortgage Lending*, *supra* note 37, at 311 (statement of John A. Courson, Mortgage Bankers Ass'n), 345-46 (statement of David Berenbaum, National Community Reinvestment Coalition).

[39] Expanded Guidance, *supra* note 38, at 2-3.

[40] *See* HUD/TREASURY JOINT REPORT, *supra* note 26, at 27.

[41] *See id.* at 28.

[42] *Id.* at 33.

> These grades are not well defined across the industry, but an "A-minus" borrower may have good credit generally but has had some minor payment delinquencies in the past year. A "C" or "D" borrower may have a marginal or poor credit history , including multiple payment delinquencies in the past year or past bankruptcies.

Id. at 33-34. Prime loans are classified as A loans. *Id.* at 33.

[43] *Id.* at 28. Underwriting standards are not uniform among subprime lenders. JOHN C. WEICHER, THE HOME EQUITY LENDING INDUSTRY: REFINANCING MORTGAGES FOR BORROWERS WITH IMPAIRED CREDIT 13, 34 (Hudson Institute 1997). Weicher's report states:

Most subprime lenders provide a valuable service by giving borrowers access to credit to buy homes, make home improvements, or borrow against the equity in their homes for other purposes.[44] In the past, almost all subprime loans were either home equity loans or home improvement loans, but in recent years, subprime lenders have also entered the purchase money loan market.[45] Most subprime loans, however, are still made for the purposes of refinancing, debt consolidation, or general consumer credit.[46] Subprime loans used to be primarily second lien loans, but today they are predominantly first lien loans.[47] While most subprime loans are not predatory, predatory loans are almost always subprime.[48]

> In sharp contrast to the prime mortgage market, there are no generally accepted underwriting guidelines for the subprime home equity lenders. Individual firms set their own guidelines. They typically take the same factors into consideration but set different criteria to qualify for a given credit grade. Hence, one firm's B loans may look like another's C loans. Underwriting appears to be an art rather than a science. . . .

Id. at 13.

[44]HUD/TREASURY JOINT REPORT, *supra* note 26, at 2-3.

[45]*See id.* at 30.

[46]*Id.*; WEICHER, *supra* note 43, at 31.

[47]*See* HUD/TREASURY JOINT REPORT, *supra* note 26, at 30, 47. Most home mortgage loans are not subject to state usury limitations because federal law preempts state usury limitations for "federally-related" loans secured by a first lien on residential real property in most states. *See infra* notes 222-32 and accompanying text.

[48]*See* GAO REPORT, *supra* note 23, at 4; HUD/TREASURY JOINT REPORT, *supra* note 26, at 2; *Hearings on Predatory Mortgage Lending*, *supra* note 37, at 311-12 (statement of John A. Courson, Mortgage Bankers Ass'n), 346 (statement of David Berenbaum, National Community Reinvestment Coalition), 398 (statement of Mike Shea, Executive Director, ACORN Housing Corp.).

Predatory loans are characterized by high interest rates and points that exceed the amount necessary to cover the lender's risk,[49] excessive fees and closing costs that are usually financed as part of the loan,[50] frequent refinancing or "loan flipping" with additional points and fees,[51] lending based on home equity without regard to the borrower's ability to repay,[52] and outright fraud.[53] Borrowers are often required to refinance low interest rate purchase money loans as part

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[49]*See* GAO REPORT, *supra* note 23, at 3; *Hearing on Legislative Solutions, supra* note 37, at 3 (statement of Stella Adams, Board Member, National Community Reinvestment); *Hearings on Predatory Mortgage Lending, supra* note 37, at 346 (statement of David Berrenbaum, National Community Reinvestment Coalition), 296 (statement of Esther Canja, President, AARP). Homeowners may pay interest rates as high as 29 percent per annum. *See, e.g., Hearing on Legislative Solutions, supra* note 37, at 5-6 (statement of Martina Guilfoil, Executive Director, Inglewood Neighborhood Housing). They may pay points totaling as much as 33 percent of the amount financed. *See Problems in Community Development Banking, Mortgage Lending Discrimination, Reverse Redlining, and Home Equity Lending: Hearings Before the Senate Comm. on Banking Housing and Urban Affairs,* 103d Cong., 1st Sess. 447 (letter from Elizabeth Renuart, Managing Att'y, St. Ambrose Legal Servs., to Sen. Donald W. Riegle Jr. (Feb. 17, 1993)) [hereinafter *1993 Hearings on Problems in Lending*].

[50]*See* GAO REPORT, *supra* note 23, at 3; HUD/TREASURY JOINT REPORT, *supra* note 26, at 2, 21; *Hearings on Predatory Mortgage Lending*, *supra* note 37, at 318 (statement of Irv Ackelsberg, Community Legal Services), 312 (statement of John A. Courson, Mortgage Bankers Ass'n); *Mortgage Lending Practices: Hearing Before the House Banking and Financial Services Comm.,* 106th Cong. 12 (2000) [hereinafter called *Hearing on Mortgage Lending Practices*] (statement of Gary Gensler, Undersecretary for Domestic Finance, Dept. of Treasury).

[51]*See* GAO REPORT, *supra* note 23, at 3; HUD/TREASURY JOINT REPORT, *supra* note 26, at 2, 21; *Hearings on Predatory Mortgage Lending*, *supra* note 37, 323-24 (statement of Irv Ackelsberg, Community Legal Services), 312 (statement of John A. Courson, Mortgage Bankers Ass'n), 295 (statement of Judith A. Kennedy, Nat'l Ass'n of Affordable Housing Lenders); *Hearing on Mortgage Lending Practices, supra* note 50, at 12 (statement of Gary Gensler, Undersecretary for Domestic Finance, Dept. of Treasury).

[52]*See* GAO REPORT, *supra* note 23, at 3; HUD/TREASURY JOINT REPORT, *supra* note 26, at 2, 22; *Hearing on Legislative Solutions, supra* note 37, at 3 (statement of Stella Adams, Board Member, National Community Reinvestment Coalition).

[53]*See* GAO REPORT, *supra* note 23, at 3; HUD/TREASURY JOINT REPORT, *supra* note 26, at 2, 22; *Hearings on Predatory Mortgage Lending*, *supra* note 37, 233 (statement of Jeffrey Zeltzer, National Home Equity Mortgage Association), 296 (statement of Esther Canja, President, AARP), 312 (statement of John A. Courson, Mortgage Bankers Ass'n); *Hearing on*

of the new higher interest rate home equity loan.[54] When a borrower has difficulty making payments on the predatory loan, the lender may encourage refinancing of the debt with a larger loan carrying a higher interest rate and requiring higher monthly payments and payment of additional points and closing costs.[55] Borrowers rarely obtain any benefit from a loan flip other than postponing a foreclosure, and they end up owing more after having paid additional points and fees to the same or another predatory lender. Predatory loans may also have other unfair terms such as high prepayment fees, balloon payments, exorbitant late charges, and single premium credit insurance.[56] Fraudulent practices include falsifying loan applications, forging borrowers signatures, changing loan terms at closing, misrepresenting loan terms, physically obscuring key terms, and having borrowers sign documents with key terms left blank.[57] In some cases, lenders make the loans without regard to the borrowers' ability to repay, relying instead on

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Mortgage Lending Practices, supra note 50, at 12 (statement of Gary Gensler, Undersecretary for Domestic Finance, Dept. of Treasury).

[54] *See Hearings on Predatory Mortgage Lending*, *supra* note 37, 318 (statement of Irv Ackelsberg, Community Legal Services); *1993 Hearings on Problems in Lending, supra* note 49, at 447 (letter from Elizabeth Renuart, Managing Att'y, St. Ambrose Legal Servs., to Sen. Donald W. Riegle Jr. (Feb. 17, 1993)). For example, John Thomas, a disabled African American man, was required to refinance his 10.5 percent first mortgage at an interest rate of 11.99 percent in order to get a second lien loan at an interest rate of 23.9 percent. *See Hearing on Legislative Solutions, supra* note 37, 2-3 (statement of Martina Guilfoil, Executive Director, Inglewood Neighborhood Housing).

[55] *See* HUD/TREASURY JOINT REPORT, *supra* note 26, at 21.

[56] *See Hearings on Predatory Mortgage Lending*, *supra* note 37, at 398 (statement of Mike Shea, Executive Director, ACORN Housing Corp.), 347 (statement of David Berenbaum, National Community Reinvestment Coalition).

[57] *See Hearings on Predatory Mortgage Lending*, *supra* note 37, at 347 (statement of David Berenbaum, National Community Reinvestment Coalition); *1993 Hearings on Problems in Lending*, *supra* note 49, at 309 (statement of Scott Harshbarger, Att'y General, Commonwealth of Mass.).

the borrower's equity in the home to secure the loan,[58] which is an underwriting practice that is not appropriate for home mortgage lending.

The targets of predatory lenders are most often minorities, the elderly, and the inner-city and rural poor.[59] Borrowers from predatory lenders usually have substantial equity in their homes due to rising real estate values or to reduction of purchase money debt, but are short on cash because of their low or fixed incomes.[60] They may need money to make home repairs or improvements, to pay for necessities such as medical care, or to consolidate household debts.[61]

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[58] *See Hearings on Predatory Mortgage Lending*, *supra* note 37, at 318 (statement of Irv Ackelsberg, Community Legal Services), 346 (statement of David Berenbaum, National Community Reinvestment Coalition). In fact, cases have been documented in which monthly payments on a home equity loan exceeded the borrower's monthly income. *See*, *e.g.*, *1993 Hearings on Problems in Lending*, *supra* note 49, at 260 (statement of Terry Drent, Ann Arbor Community Dev. Dep't) (discussing monthly payments of $250 required of a borrower with a monthly income of $220), 292 (statement of Eva Davis, Resident, San Francisco) (discussing approximate monthly payments of $2,000 required of a borrower with a monthly income of under $1,100); Gary Chafetz & Peter S. Canellos, *Elderly Poor Losing Homes in Loan Scam: Unregulated Lenders Offer High Rates, Risks*, BOSTON GLOBE, May 6, 1991, at 1, 6 (discussing monthly payments of $2,062 required of a borrower with a monthly income of about $800).

[59] *See Hearing on Mortgage Lending Practices, supra* note 37, at 12 (statement of Gary Gensler, Undersecretary for Domestic Finance, Dept. of Treasury), 20 (statement of Donna Tanoue, Chairwoman, FDIC); *1993 Hearings on Problems in Lending*, *supra* note 49, at 254 (statement of Scott Harshbarger, Att'y General, Commonwealth of Mass.), 257 (statement of Kathleen Keest, Nat'l Consumer Law Ctr.).

[60] *See* SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, THE COMMUNITY DEVELOPMENT, CREDIT ENHANCEMENT, AND REGULATORY IMPROVEMENT ACT OF 1993, S. Rep. No. 169, 103d Cong. 1st Sess. 22 (1993).

[61] *See id.*; *1993 Hearings on Problems in Lending*, *supra* note 49, at 449 (letter from William E. Morris, Director of Litig., S. Ariz. Legal Aid, to Sen. Donald W. Riegle Jr. (Feb. 18, 1993)).

The elderly are particularly vulnerable because they typically have a great deal of equity in homes that they have owned for many years and because they are likely to be on fixed incomes.[62]

Perpetrators of predatory lending abuses include lenders, mortgage brokers, and home improvement contractors.[63] These parties seek out particularly vulnerable homeowners on whom to prey.[64] Upon finding a likely prospect, a lender, broker, or contractor may use high pressure tactics or fraud to induce the homeowner to enter into an abusive loan transaction.[65]

Predatory lending can be tremendously profitable for perpetrators of abuses. Mortgage brokers and lenders who originate loans collect large up-front fees when the loan is made. When the homeowner makes payments, the lender reaps an enormous profit based on the high interest rates. If the homeowner cannot pay, the lender forecloses and takes any equity in the house.[66]

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[62] *See Hearings on Predatory Mortgage Lending*, *supra* note 37, at 296-97 (statement of Esther Canja, President, AARP); HUD/TREASURY JOINT REPORT, *supra* note 26, at 72; ROBERT J. HOBBS ET AL., NATIONAL CONSUMER LAW CENTER, CONSUMER PROBLEMS WITH HOME EQUITY SCAMS, SECOND MORGAGES, AND HOME EQUITY LINES OF CREDIT 9 (Am. Ass'n of Retired Persons 1989).

[63] *See Hearings on Predatory Mortgage Lending*, *supra* note 37, at 444 (statement of Consumer Bankers Ass'n); *Hearing on Mortgage Lending Practices, supra* note 50, at 12 (statement of Gary Gensler, Undersecretary for Domestic Finance, Dept. of Treasury).

[64] *See Hearings on Predatory Mortgage Lending*, *supra* note 37, at 17-18 (statement of Leroy Williams, private citizen). They may check foreclosure notices to find financially troubled homeowners or may cruise certain neighborhoods looking for homes in need of repair. *See* Mike Hudson, *Stealing Home: How the Government and Big Banks Help Second-Mortgage Companies Prey on the Poor*, 26 CLEARINGHOUSE REV. 1476, 1479 (1993).

[65] *See* 1993 *Hearings on Problems in Lending*, *supra* note 49, at 309 (statement of Scott Harshbarger, Att'y General, Commonwealth of Mass.).

[66] *See Hearings on Predatory Mortgage Lending*, *supra* note 37, at 318 (statement of Irv Ackelsberg, Community Legal Services).

Even if the borrower prepays the loan by refinancing, the lender profits if the loan has a prepayment penalty.[67]

The effects of predatory lending are devastating for the individuals who are victims and for their neighborhoods. At best, the victims of predatory lenders end up paying too much in fees and interest for their loans. The worst case scenario is that they lose their homes to foreclosure. A dramatic increase in foreclosures in inner-city neighbors has followed the increase in subprime lending in recent years.[68] For individuals and families, the loss of a home to foreclosure is devastating, both financially and psychologically.[69] Foreclosures caused by predatory lending have a negative impact on neighborhoods as well since the impact of foreclosures may be concentrated in low-income areas.[70] Vacant homes caused by foreclosures can cause a decrease property values and an increase in crime that can destabilize at-risk

[67]*See id.* Prepayment penalties are much more common in subprime loans than in prime loans.

[68]HUD/TREASURY JOINT REPORT, *supra* note 26, at 24. For example, foreclosures of homes in Baltimore grew from 1,900 in 1995 to more than 5,000 in 1999. *Id.*

[69]*Id;* Forrester, *supra* note 27, at 385-86. Financial issues include loss of equity in the home and in some states the possibility of a deficiency judgment. *See* Alex M. Johnson, Jr., *Critiquing the Foreclosure Process: An Economic Approach Based on the Paradigmatic Norms of Bankruptcy,* 79 VA. L. REV. 959, 966-67 (1993). Psychological issues include mental illness, suicide, crime, family problems, sadness, depression, sleep loss, and anger. *See Mortgage Foreclosures: Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 98th Cong., 1st Sess. 276 (1983) (statement of John J. Sheehan, Director of Legis., United Steelworkers of Am.); Marc Fried, *Grieving for a Lost Home: Psychological Costs of Relocation, in* URBAN RENEWAL: THE RECORD AND THE CONTROVERSY 359, 359-61 (James Q. Wilson ed., 1966).

[70]HUD/TREASURY JOINT REPORT, *supra* note 26, at 25.

neighborhoods.[71] Therefore, predatory lending has an impact beyond the homeowners who obtain predatory loans.

Problems caused by predatory lenders first caught the attention of lawmakers over a decade ago.[72] However, predatory lending has difficult to regulate in part because it is difficult to define.[73] Some practices, such as fraud, are clearly illegal. Other predatory lending practices have been perfectly legal, and some individual practices are legitimate under certain circumstances.[74] As the incidence of predatory lending has continued to increase, lawmakers have continued to grapple with the problem.

II. GOVERNMENTAL RESPONSE TO PREDATORY LENDING

A. Federal Response to Predatory Lending

1. Home Ownership and Equity Protection Act and Regulation Z

In 1994 in response to problems stemming from predatory lending, Congress enacted the Home Ownership and Equity Protection Act.[75] HOEPA defines certain home mortgage loans as "high-cost" loans and, with respect to high-cost loans, requires particular disclosures and

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[71] *Id. See also 1993 Hearings on Problems in Lending, supra* note 49, at 254 (statement of Scott Harshbarger, Att'y General, Commonwealth of Mass.) (Predatory lending practices targeting low-income neighborhoods may result in "the social fabric of many inner-city urban neighborhoods [being] torn apart and communities destablized.")

[72] *See generally 1993 Hearings on Problems in Lending, supra* note 49.

[73] *See* HUD/TREASURY JOINT REPORT, *supra* note 26, at 17.

[74] For example, a prepayment penalty could be appropriate in a prime mortgage loan if a borrower makes an informed decision to include this provision in order to obtain a lower interest rate.

[75] Pub. L. No. 103-325, tit. 1, subtit. B, 108 Stat. 2190 (codified at 15 U.S.C. §§ 1601-1648 (2000)).

prohibits designated unfair terms.[76] The Act specifically excludes from its application purchase money mortgages, reverse mortgages, and home equity lines of credit,[77] so it applies to refinance loans and to second lien loans that are not lines of credit. HOEPA initially defined high-cost home mortgage loans as those with an APR more than ten points above Treasury bill rates or with points and fees exceeding the greater of eight percent of the loan amount or $400, but the Act provided for adjustment by the Federal Reserve Board after two years.[78] HOEPA requires that lenders make the required disclosures to a homeowner three days before the consummation of the loan and prohibits the lender from changing the terms of the loan without giving new disclosures.[79] The Act prohibits prepayment penalties under certain circumstances,[80] an increased interest rate on default,[81] balloon payments to be made less than five years after the closing of the loan,[82] and negative amortization[83] in high-cost loans. In addition, HOEPA prohibits lenders from engaging "in a pattern or practice" of making high-cost loans without regard to the borrower's ability to repay.[84] HOEPA provides for civil liability for non-compliance[85] and for enforcement by state attorney generals.[86]

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[76] 15 U.S.C. §§ 1601 *et seq.*

[77] 15 U.S.C. § 1603(i), (w), (aa), (bb).

[78] 15 U.S.C. § 1603(aa). The Federal Reserve Board adjusted the trigger rate in 2002. *See infra* notes 95-98.

[79] *See* 15 U.S.C. § 1639(a), (b).

[80] *Id.* § 1639(c).

[81] *Id.* § 1639(d).

[82] *Id.* § 1639(e).

[83] *Id.* § 1639(f).

[84] *Id.* § 1639(h).

[85] *See id.* § 1640.

HOEPA eliminates holder-in-due-course status for purchasers of HOEPA covered loans.[87] As a result, assignees of HOEPA loans are subject to all claims and defenses that the homeowner could have asserted against the originator.[88] HOEPA does, however, limit the liability of assignees to the total amount of the debt paid and remaining unpaid.[89] In addition, HOEPA provides a safe harbor for assignees who can demonstrate that "a reasonable person exercising ordinary due diligence, could not determine . . . that the mortgage was [a HOEPA covered loan]."[90]

Consumer advocates have criticized HOEPA as being ineffective in part because it is not inclusive enough.[91] First, very few subprime loans exceed the interest rate threshold.[92] In fact, lenders may keep interest rates just below the HOEPA trigger in order to avoid the requirements of the Act. Secondly, the fee trigger excludes reasonable fees paid to third parties[93] as well as fees paid by someone other than the borrower.[94] As a result, the trigger does not include potentially abusive fees such as single premium credit insurance and yield spread premiums paid

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[86]*See id.* § 1640(e).

[87]*See* 15 U.S.C. § 1641(d)(1); Bryant v. Mortgage Capital Resource Corp., 197 F.Supp.2d 1357 (2002). See *infra* Part III.D for a discussion of the holder in due course doctrine.

[88]15 U.S.C. § 1641(d)(1).

[89]*Id.* at 1641(d)(2).

[90]*Id.* at 1641(d)(1).

[91]*See* HUD/TREASURY JOINT REPORT, *supra* note 26, at 85; *Hearing on Legislative Solutions, supra* note 37, at 3 (statement of Stella Adams, Board Member, National Community Reinvestment Coalition).

[92]*See* HUD/TREASURY JOINT REPORT, *supra* note 26, at 85.

[93]15 U.S.C. § 1602(aa)(4).

[94]*See* HUD/TREASURY JOINT REPORT, *supra* note 26, at 85.

to a mortgage broker. Finally, HOEPA does not apply to high cost purchase money loans, reverse mortgages or home equity lines of credit.

In response to criticism, the Federal Reserve Board revised regulations under HOEPA effective October 2002.[95] The new Reg Z lowers the trigger for first lien loans to eight points above Treasury bill rates and includes premiums for credit insurance paid at closing in the fee trigger.[96] In addition, the rule prohibits a creditor from refinancing a high cost mortgage within twelve months of closing unless the refinancing is in the "borrower's best interest."[97] This provision was intended to address the problem of loan flipping.[98] Despite the new regulations, consumer advocates claim that HOEPA is still not effective.[99]

2. FTC Enforcement Actions

The Federal Trade Commission has filed enforcement actions against lenders engaged in predatory lending activities under HOEPA and other federal statutes.[100] Between 1998 and

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[95] 66 Fed. Reg. 65604 (2001).

[96] 12 C.F.R. § 226.32(a)(1)(i).

[97] 12 C.F.R. § 226.32(b)(1)(iv).

[98] 66 Fed. Reg. 65604-1, at 65617.

[99] *See Hearing on Legislative Solutions, supra* note 37, at 3 (statement of Stella Adams, Board Member, National Community Reinvestment Coalition); *Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit: Hearing Before the Subcomms. on Financial Institutions and Consumer Credit and Housing and Community Opportunity of the House Comm. on Financial Services,* 108th Cong. 11 (2003), *available at* http://financialservices.house.gov/media/pdf/110503ms.pdf [hereinafter *Hearing on Protecting Homeowners*] (testimony of Margot Saunders, Managing Attorney, National Consumer Law Center) ("Unfortunately it is clear that HOEPA has not stopped predatory lending. Indeed, the problem has only grown worse in the eight years since it has become effective.")

[100] Other federal statutes the FTC has used in enforcement actions include the Federal Trade Commission Act (FTC Act), 15 U.S.C. §§ 41-58 (2000), the Truth in Lending Act (TILA),

2003, the FTC filed 19 complaints and reached settlements in most of those cases.[101] Most of the settlements required compensation to consumers and an agreement by the lender to stop certain practices. Some of the most notable settlements include the settlement reached with Citigroup[102] and a $60 million settlement with First Alliance Mortgage Company.[103] The FTC and other federal agencies focus their efforts on "cases that will have the most impact, such as those that may result in large settlements to consumers or that will have some deterrent value by gaining national exposure."[104] Therefore, the FTC's enforcement actions have been against some of the largest and worst offenders.

B. States' Response to Predatory Lending

More than thirty states have adopted statutory or regulatory schemes designed to address the predatory lending problem.[105] Many of the state statutes are similar to HOEPA in that

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15 U.S.C. §§ 1601-1665 (2000), the Real Estate Settlement and Procedures Act (RESPA), 12 U.S.C. § 2603 (2000), and the Fair Debt Collection Practices Act (FDCPA), § 1692 (2000).

[101] *See* Federal Trade Commission, FTC Subprime Lending cases (since 1998), *available at* http://www.ftc.gov/opa/2002/07/subprimelendingcases.htm; GAO REPORT, *supra* note 23, at 37, Appendix I. The Department of Justice and the Department of Housing and Urban Development were involved in some of the cases. *Id.* These cases involved violations of the Equal Credit Opportunity Act (ECOA), 15 U.S.C. §1691 (2000), and the Fair Housing Act (FHA), 42 U.S.C. §§ 3601-3631 (2000).

[102] *See supra* notes 12-15 and accompanying text.

[103] *See* GAO REPORT, *supra* note 23, at 37.

[104] *Id.* at 40.

[105] *See, e.g.,* FLA. STAT. ANN. §§ 494.0079, 494.00791 (West Supp. 2005); GA. CODE ANN. § 7-6A-1 to 7-6A-13 (2004); N.C. GEN. STAT. § 24-1.1E (2003); N.J. STAT. ANN. §§ 46:10B-24 to 46:10B-35 (West Supp. 2005); N.Y. BANKING § 6-l (McKinney Supp. 2005); OHIO REV. CODE ANN. §§ 1349.25 - 1349.37 (LexisNexis 2002); 63 PA. CONS. STAT. ANN. §§ 456.501 - 456.524 (West Supp. 2005). *See also* Butera & Andrews, *2005 Detailed Status*

statutory restrictions are triggered by loans with interest rates or fees in excess of set levels.[106] Some have statutes with triggers that are lower than HOEPA's,[107] while others are the same.[108] Some of the statutes have multiple triggers with more stringent requirements for loans with higher levels of interest rates and/or fees.[109] Most of the statutes have additional restrictions or requirements beyond HOEPA's for loans that are covered.[110] Statutes in some states have increased the regulation and licensing requirements of originators and brokers.[111]

Summary Chart of State and Local Predatory Lending Legislation, *at* http://www.butera-andrews.com/state-local/index.html (last updated Aug. 5, 2005).

In addition, some local governments have adopted ordinances prohibiting predatory lending practices. *See, e.g.,* OAKLAND, CAL., MUNI. CODE § 5.33 (2001); LOS ANGELES, CAL., MUNI. CODE ch. 16 (2003); Cleveland, Ohio, Ordinance 372-02 (Mar. 4, 2002); Dayton, Ohio, Ordinance 29990-01 (July 11, 2001); NEW YORK CITY, NEW YORK, LOCAL LAW 36 § 6-128 (2002); Summit County, Ohio, Ordinance 2004-386, 2004-618 (Aug. 16, 2004). However, some of these ordinances have been held to be preempted by state law. *See* Am. Fin. Servs. Ass'n. v. City of Oakland, 34 Cal.4th 1239, 23 Cal.Rptr.3d 453 (2005) (holding that the Oakland ordinance is preempted by California's predatory lending statute); Dayton v. State, 157 Ohio App.3d 736, 813 N.E.2d 707 (2004) (holding that the Dayton ordinance by Ohio's predatory lending statute); Stephen F.J. Ornstein, et al., *Local Anti-Predatory Lending Litigation Update*, 59 CONS. FIN. L.Q. REP. 153 (2005). Other ordinances are subject to ongoing litigation to determine whether they are preempted by state law. *Id.* at 156.

[106]*See, e.g.,* FLA. STAT. ANN. §§ 494.0079, 494.00791; GA. CODE ANN. § 7-6A-2(17); N.C. GEN. STAT. § 24-1.1E; N.J. STAT. ANN. § 46:10B-24; OHIO REV. CODE ANN. § 1349.25(D); 63 PA. CONS. STAT. ANN. § 456.503. *See also* GAO REPORT, *supra* note 23, at 58.

[107]*See, e.g.,* GA. CODE ANN. § 7-6A-2(17); N.C. GEN. STAT. § 24-1.1E(6)(b); N.J. STAT. ANN. § 46:10B-24.

[108]*See, e.g.,* OHIO REV. CODE ANN. § 1349.25(D); TEX. FIN. CODE ANN. § 343.201 (Vernon 2001).

[109]*See, e.g.,* N.J. STAT. ANN. § 46:10B-24. *See also* Baher Azmy & David Reiss, *Modeling a Response to Predatory Lending: The New Jersey Home Ownership Security Act of 2002,* 35 RUTGERS L.J.645, 674 -76 (2004) (discussing the New Jersey Statute).

[110]*See, e.g.,* GA. CODE ANN. § 7-6A-2(17); N.C. GEN. STAT. § 24-1.1E(6)(b); N.J. STAT. ANN. § 46:10B-26.

[111]*See* GAO REPORT, *supra* note 23, at 62.

North Carolina was the first state to enact a comprehensive predatory lending statute in 1999.[112] Like HOEPA, the North Carolina statute defines "high-cost" loans, but the trigger is set lower than HOEPA for points and fees.[113] For these high-cost loans, the statute prohibits call provisions giving a lender discretion to accelerate,[114] balloon payments,[115] negative amortization,[116] increased interest rate upon default,[117] financing of any points or fees or charges payable to a third party (which includes yield spread premiums),[118] and making a loan without regard to the borrower's ability to repay.[119] In addition, the statute prohibits the financing of insurance premiums and "flipping" for all consumer home loans.[120] Therefore, the statute goes beyond HOEPA in offering protection to North Carolina homeowners because it covers more loans and imposes more stringent restrictions.

Consumer advocates cite the North Carolina statute as a success,[121] and a number of states have followed the lead of North Carolina in adopting statutes with lower triggers and more

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[112]Act to Prohibit Predatory Lending, 1999 N.C. Sess. Laws 332 (codified at N.C. GEN. STAT. § 24-1.1A - 10.2 (2003)).

[113]The trigger for points and fees is 5% of the loan amount, N.C. GEN. STAT. § 24-1.1E(a)(6)(b), rather than 8% of the loan amount set by HOEPA, 15 U.S.C. § 1602(aa)(1)(B)(i). The trigger for APR is the same as HOEPA's at 8% above Treasury bill rates. N.C. GEN. STAT. § 24-1.1E(a)(2).

[114]N.C. GEN. STAT. § 24-1.1E(b)(1).

[115]*Id.* § 24-1.1E(b)(2).

[116]*Id.* § 24-1.1E(b)(3).

[117]*Id.* § 24-1.1E(b)(4).

[118]*Id.* § 24-1.1E(c)(3).

[119]*Id.* § 24-1.1E(c)(2).

[120]*Id.* § 24-1.1E(c)(4).

[121]*See Hearing on Legislative Solutions, supra* note 37, at 2 (statement of Martin Eakes, CEO, Self-Help and the Center for Responsible Lending).

prohibitions than HOEPA.[122] Despite the additional protection that North Carolina law gives to subprime borrowers, the subprime market has grown in North Carolina at a rate similar to states without a similar statute.[123] Every significant subprime lender that made loans in 1999 before the statute became effective continued to do business in North Carolina in 2000 after the statute was effective.[124] North Carolina had 15% more than the national average of subprime loans per capita in 2000.[125]

Georgia's statute, the Georgia Fair Lending Act (GFLA),[126] on the other hand, initially caused concern until it was quickly amended by the Georgia legislature.[127] The statute, in its original form, was the strongest in the nation. It created three categories of loans: "home loans," "covered home loans," and "high-cost home loans."[128] While the "home loan" category included most home mortgage loans,[129] the other two categories were defined based on a loan's annual percentage rate or on points and fees charged.[130] The statute created a different set of restrictions for each of the three categories. Some restrictions, including limits on late fees and a prohibition

[122] *See, e.g.,* IND. CODE §§ 24-9-4-1 to 24-9-4-12 (West Supp. 2004); N.J. STAT. ANN. §§ 46:10B-24, 26 (West Supp. 2005); N.Y. BANKING § 6-l (McKinney Supp. 2005).

[123] *See Hearing on Legislative Solutions, supra* note 37, at 2 (statement of Martin Eakes, CEO, Self-Help and the Center for Responsible Lending).

[124] *See* Center for Responsible Lending, Support H.R. 1182, CRL Policy Brief No. 10 (Mar. 10, 2005) *available at*
http://www.responsiblelending.org/pkfs/pb010-MillerWattFrank-0305.pdf.

[125] *Id.* at 2.

[126] GA. CODE ANN. § 7-6A (2004).

[127] S.B. 53, 147th Gen. Assme., Reg. Sess. (Ga. 2003).

[128] GA. CODE ANN. § 7-6A-2(6), (8), (9), (19) (Supp. 2002) (amended 2003).

[129] *Id.* §7-6A-2(9).

[130] *Id.* §7-6A-2(6), (8), (19).

on financing of credit life insurance, applied to all home loans.[131] A restriction on flipping applied to covered home loans.[132] Most of the restrictions, including limits on prepayment fees, a prohibition on negative amortization, and credit counseling requirements, applied only to high-cost home loans.[133] Finally, purchasers of high-cost home loans were made "subject to all affirmative claims and any defenses with respect to the loan that the borrower could assert against the original creditor . . . ."[134]

After the Georgia legislature enacted the GFLA, rating agencies responded by refusing to rate mortgage backed securities secured by pools of residential loans containing any loans originated in Georgia after the effective date of the statute.[135] One of the primary concerns of the rating agencies and lenders was that assignees would have unlimited liability for affirmative claims that the borrower could assert against the originator. In response, the Georgia legislature amended the assignee liability provision of the GFLA to add a safe harbor for lenders who exercise reasonable due diligence to avoid purchasing high-cost home loans and to limit the

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[131] *See id.* § 7-6A-3.

[132] *See id.* § 7-6A-4.

[133] *See id.* § 7-6A-5.

[134] *Id.* § 7-6A-6.

[135] *See* Press Release, Fitch Ratings, Fitch Ratings Declines to Rate Georgia Loans in RMBS Pools, Considers Impact to Other Predatory Lending Legislation (Feb. 5, 2003), *available at* http://www.mortgagebankers.org/srchindex.html; Press Release, Moody's Investors Service, Inc. Moody's Expands Consideration of Assignee Liability for Residential Mortgages in Securitizations (Jan. 30, 2003), *available at* http://www.mortgagebankers.org/srchindex.html; Press Release, Standard and Poor's, Standard and Poor's to Disallow Georgia Fair Lending Act Loans (Jan. 16, 2003), *available at* http://www.mortgagebankers.org/srchindex.html.

liability of those lenders who do not fit within the safe harbor.[136] The rating agencies subsequently announced that they would again rate pools with Georgia loans.[137]

Likewise, other states have enacted statutes with assignee liability provisions similar to the one in the amended Georgia statute.[138] These states also include a safe harbor for lenders who exercise reasonable due diligence to avoid purchasing high-cost home loans.[139]

Not surprisingly, lender and mortgage broker advocates have been critical of state predatory lending laws.[140] They claim that state regulations are too burdensome on honest subprime lenders,[141] that compliance with the patchwork of state laws is too costly,[142] and that state laws will have a negative affect on the availability of subprime credit.[143] Lender groups have fought state laws at the state level and have at the federal level proposed that federal law

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[136]*See* GA. CODE ANN. § 7-6A-6 (2003). The legislature also amended the GFLA to eliminate the "covered home loan" category altogether. *See id.* § 7-6A-2.

[137]*See* Azmy & Reiss, *supra* note 109, at 68.

[138]*See, e.g..,* ARK. CODE ANN. § 23-53-105(a) (Supp. 2005); N.J. STAT. ANN. § 46:10B-24 (West Supp. 2005).

[139]*See* ARK. CODE ANN. § 23-53-105(a); N.J. STAT. ANN. § 46:10B-24.

[140]*See Hearing on Legislative Solutions, supra* note 37, at 3-4 (statement of Steve Nadon, Chairman, Coalition for Fair & Affordable Lending), 3 (statement of Micah S. Green, President, The Bond Market Ass'n), 4 (statement of Jim Nabors, President-Elect, Nat'l Ass'n of Mortgage Brokers).

[141]*See id.* at 3-4 (statement of Steve Nadon, Chairman, Coalition for Fair & Affordable Lending), 3 (statement of Micah S. Green, President, The Bond Market Ass'n), 4 (statement of Jim Nabors, President-Elect, Nat'l Ass'n of Mortgage Brokers).

[142]*See id.* at 4 (statement of Steve Nadon, Chairman, Coalition for Fair & Affordable Lending), 3 (statement of Micah S. Green, President, The Bond Market Ass'n), 4 (statement of Jim Nabors, President-Elect, Nat'l Ass'n of Mortgage Brokers).

[143]*See id.* at 3-4 (statement of Steve Nadon, Chairman, Coalition for Fair & Affordable Lending), 3 (statement of Micah S. Green, President, The Bond Market Ass'n), 4 (statement of Jim Nabors, President-Elect, Nat'l Ass'n of Mortgage Brokers).

should preempt state laws. Consumer groups on the other hand applaud the efforts of state legislatures to combat predatory lending abuses.

III. CAUSES OF PREDATORY LENDING

To solve the problem of predatory lending, it is necessary to ascertain is causes, and a number of commentators have suggested possible causes.[144] Certainly there are multiple factors that contribute to the problem. Some of the factors that have led to the proliferation of mortgage lending abuses are a result of changes in the mortgage market that have occurred over the past twenty to thirty years.

A. Changes in the Mortgage Market

Before the mid-1970's most prime mortgage loans were made by depository institutions using deposits to fund the loans.[145] Home mortgage loans were made primarily by thrifts to local borrowers using savings deposits of local depositors.[146] The thrift would handle all aspects of

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[144]*See, e.g.,* Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine,* 35 CREIGHTON L. REV 503, 507 (2002); Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending,* 80 TEX. L. REV. 1255, 1257 (2002); Forrester, *supra* note 27, at 419; Cathy Lesser Mansfield, *The Road to Subprime "HEL" Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market,* 51 S. CAR. L. REV. 473.

[145]In the late 1970s savings and loans made half to as much as 60% of home mortgage loans. *See* Mansfield, *supra* note 144, at 498 n.155 (citing 125 CONG. REC. 29,930 (1979) (statement of Sen. Morgan) (stating that savings and loans made about 60% of all home mortgage loans up to 1979) and David F. Seiders, *Recent Developments in Mortgage and Housing Markets,* 65 FED. RES. BULL. 173, 180 (1979) (finding that in 1978 savings and loans made half of all home mortgage loans)).

[146]*See, e.g.,* IT'S A WONDERFUL LIFE (1946). When depositors threaten a "run on the bank," Jimmy Stewart, as George Bailey, says:

the transaction including the origination of the loan,[147] the funding of the loan from it own capital in the form of deposits, and the servicing of the loan throughout its life.[148] The loan would be held by the local savings and loan until it was paid off or until a default resulted in foreclosure. Thus, the savings and loan had a long-term relationship with the borrower.

The subprime mortgage market was dominated by finance companies that originated loans using funds obtained through commercial paper, bonds, bank lines of credit, and both long-term and short-term debt.[149] The finance companies held the loans they originated in portfolio[150] or used the loans to secure their own debt. The finance company that made a loan thus performed the origination, servicing, and ownership functions associated with the loans they made.[151] In the past, subprime loans made up a very small portion of the home mortgage market,[152] and most subprime loans were second lien loans.[153]

> You're thinkin' of this place all wrong as if I had the money back in a safe. The money's not here. Why, your money's in Joe's house, that's right next to yours, and in the Kennedy house and Mrs. Maplin's house and a hundred others. You're lending them the money to build, and then they're going to pay it back to you as best they can.

Id.

[147]Origination includes taking a loan application, checking the credit and employment of the borrower, obtaining an appraisal of the property, and seeing that loan documents are prepared and executed. GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE TRANSFER, FINANCE AND DEVELOPMENT 892 (6th ed. 2003).

[148]Servicing includes the collection of payments, holding tax and insurance escrow accounts, paying taxes and insurance premiums from escrow accounts, and handling defaults. *Id.* at 479.

[149]HUD/TREASURY JOINT REPORT, *supra* note 26, at 40.

[150]*Id.*

[151]Home improvement contractors were often involved in the origination of home improvement loans made by finance companies. Sometimes the contractor originated loans and sold them to a finance company, and sometimes the contractor referred loans to the finance

Today both the prime and subprime mortgage markets operate differently with the functions of origination, servicing and ownership generally being performed by different parties. Capital markets are the source of most mortgage loan funds. Fewer loans are originated by depository institutions, and more are originated by mortgage and finance companies or through mortgage brokers.[154] Mortgage companies are in the business of originating mortgage loans for sale to investors or to be securitized. Mortgage companies do not require a large amount of capital available for investment, since they typically hold mortgages only until a sufficient number of mortgages can be pooled and sold to an investor or securitized.[155] The mortgage company often borrows money to fund the loans through a warehouse line of credit, which the company draws down as loans are made and repays when a package of loans is sold.[156] Sometimes the mortgage company or other originator retains the servicing function, but more often than not a company other than the originating lender will be servicing the loan.[157]

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company. Abuses in home improvement loans led to the adoption of the FTC's Holder in Due Course Rule in 1976. *See* Julia P. Forrester, *Constructing a New Theoretical Framework for Home Improvement Financing,* 75 OR. L. REV. 1095, 1105-06 (1996).

[152]*See* HUD/TREASURY JOINT REPORT, *supra* note 26, at 29. In 1983, subprime loans made up only 1.4% of the home mortgage market. *See* Fred Faust, *Minorities Likely to Pay More for Loans, Report Says,* ST. LOUIS POST-DISPATCH, Oct. 22, 1999, at C8. Even in 1994, subprime originations accounted for less than 5% of all mortgage originations. HUD/TREASURY JOINT REPORT, *supra* note 26, at 29.

[153]HUD/TREASURY JOINT REPORT, *supra* note 26, at 30.

[154]*See* Mansfield, *supra* note 144, at 526; HUD/TREASURY JOINT REPORT, *supra* note 26, at 39.

[155]*See infra* note 173 and accompanying text.

[156]See *infra* notes 336-37 and accompanying text for a discussion of warehouse lines of credit.

[157]*See* Michael G. Jacobides, *Mortgage Banking Unbundling: Structure, Automation and Profit,* 61 MORTGAGE BANKING 28 (Jan. 1, 2001), *available at* 2001 WLNR 4301659.

Often the initial contact with a borrower is not even made by the originator of the loan but by a mortgage broker. Mortgage brokers may be involved in more than half of all home mortgage loan originations according to the National Association of Mortgage Brokers.[158] Brokers are paid a fee by the borrower or the lender and in some cases perform many of the origination functions other than underwriting and the initial funding. Brokers also may be paid a yield spread premium if the broker can induce the borrower to borrow at a rate above the rate offered by the lender for a particular loan.[159]

Some investors in loan pools purchase and hold them directly, but more frequently today the loans are securitized with investors buying securities backed by the pool of loans. Securitization of home mortgage loans began in the prime mortgage market in the 1970s with Ginnie Mae guaranteeing securities backed by mortgage loans[160] and Freddie Mac issuing mortgage backed securities.[161] The private sector first became significantly involved in securitization in the late 1970s after rating agencies began rating mortgage backed securities not expressly or impliedly backed by the federal government.[162] By the 1980s a significant portion

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[158]*See Hearing on Mortgage Lending Practices, supra* note 37, at 683 (statement of the National Home Equity Mortgage Association); HUD/TREASURY JOINT REPORT, *supra* note 26, at 39. *See also* WEICHER, *supra* note 43, at 32 (stating that brokers originated 36 percent of subprime mortgage loans in 1996).

[159]HUD/TREASURY JOINT REPORT, *supra* note 26, at 40.

[160]*See* STEVEN L. SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION § 1:2 (3rd ed. 2002). Ginnie Mae is a government agency in the U.S. Department of Housing and Urban Development. *See infra* note 366 and accompanying text.

[161]*See infra* note 367 and accompanying text.

[162]Eggert, *supra* note 144, at 537; Comm. On Bankr. & Corporate Reorganization of the Ass'n of the Bar of the City of New York, *Structured Financing Techniques,* 50 BUS. LAW. 527, 537 (1995).

of mortgage loans were securitized. Securitization did not take hold in the subprime mortgage market until the 1990s, but is now a major factor in the subprime mortgage market.[163]

A private lender that wants to securitize a pool of mortgage loans will typically create a special purpose corporation, trust or other entity, called a special purpose vehicle or SPV.[164] The SPV is created to be "bankruptcy remote" so that creditors of the lender will not have claims against the SPV.[165] The SPV issues the securities to raise cash to purchase the loan pool from the lender.[166] Investors in the securities need only be concerned with the cash flow coming from the mortgage loans and not with the originating lender's financial condition.[167] Because a security represents a small interest in a large pool of mortgage loans, the risk of default on any one mortgage loan is shared among the holders of the securities. The securities are typically rated by one of the rating agencies,[168] and may have a third party credit enhancement such as a guaranty, surety bond, or bank letter of credit.[169] Another type of credit enhancement involves the issuance of subordinated securities to investors willing to accept additional repayment

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[163]In 1994, 32% of subprime loans were securitized. By 1998, the rate was 55% before it dropped back to 37% in 1999. HUD/TREASURY JOINT REPORT, *supra* note 26, at 41. *See also* Glenn B. Canner, et al., *Recent Developments in Home Equity Lending,* 84 FED. RES. BULL. 241, 249 (1998) ("Most subprime lenders place heavy reliance on securitization of their loans to fund their operations.").

[164]*See* Steven L. Schwarcz, The Alchemy of Asset Securitization, 1 STAN. J. L., BUS. & FIN. 133, 134 (1994).

[165]*See id.* at 135-36; SCHWARCZ, *supra* note 160, § 1:1.

[166]SCHWARCZ, *supra* note 160, § 1:1.

[167]Schwarcz, *supra* note 164, at 136.

[168]*Id.* The most well-known rating agencies are Standard & Poor's Rating Group ("S&P"), Moody's Investors Service, Inc. ("Moody's") and Fitch, Inc. ("Fitch"). *See* SCHWARCZ, *supra* note 160, § 1:2 n.13.

[169]*See id.* § 2:3.

risks.[170] With credit enhancements, securities backed by subprime loans can achieve investment grade status.[171] As a result, securitization has funneled additional funds into the subprime mortgage market.

B. Parties Involved in Origination

Changes in the operation of the mortgage market have contributed to the proliferation of abusive mortgage lending practices. One of the changes exacerbating the problem is the type of parties involved in the mortgage origination process. Today loans are originated by mortgage companies and mortgage brokers whose sole purpose is the origination function.[172] Mortgage companies may fund a mortgage loan initially with borrowed funds, but will sell the loan as soon as the company has enough loans for a pool. Therefore, a mortgage company does not have to be highly capitalized.[173] Mortgage brokers require even less capital since they typically do not

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[170] *Id.* §2:4; HUD/TREASURY JOINT REPORT, *supra* note 26, at 42. Senior securities have less risk and a lower interest rate, while subordinate securities have greater risk and a higher interest rate. *See* Schwarcz, *supra* note 164, at 143.

[171] *See* HUD/TREASURY JOINT REPORT, *supra* note 26, at 42.

[172] *See supra* notes 154-59 and accompanying text. Subprime lenders rely more on brokers and "correspondents"–lenders who make loans using funds borrowed through a warehouse line of credit–than do prime lenders. *See* WEICHER, *supra* note 43, at 32-33. In 1996, 47 percent of suprime loans were originated by correspondents and 36 percent by brokers. *Id.* at 32. In the prime market in the same year, correspondents accounted for 35 percent of originations and brokers for 22 percent. *Id.*

[173] *See* Leland C. Brendsel, *Securitization's Role in Housing Finance,* in A PRIMER ON SECURITIZATION 24 (Leon T. Kendall & Michael J. Fishman eds., 1996) ("Although it is a stretch to suggest that anyone with a modem and a fax machine can be a lender today, relatively little capital is required to start a mortgage banking operation in the 1990s, and even less to become a mortgage broker."), *quoted in* Eggert, *supra* note 144, at 556. Yesterday's lenders had to be more highly capitalized because they generally retained ownership of the loans they originated for the life of the loans.

fund loans, but just make a fee for putting borrower and lender together, for taking the borrower's loan application, for checking the borrower's credit, and for otherwise participating in the origination process.[174] As a result, when a borrower has a claim against a mortgage company or broker for predatory lending practices, the culpable party may be judgment-proof.

Also contributing to the predatory lending problem is the lack of regulation of parties involved in the origination process. The HUD-Treasury National Predatory Lending Task Force identified mortgage brokers and home improvement contractors, both intermediaries in the origination of mortgage loans, as being significantly involved in predatory lending practices.[175] Both are significantly less regulated than the depository institutions that originated many mortgage loans in the past. Home improvement contractors are subject to regulation under the law of some states, but not under federal law.[176] Regulation of mortgage brokers is primarily state law and is modest compared to regulation of the other types of institutions involved in home mortgage lending.[177] The lack of regulation makes it easier to get into the mortgage brokering business, easier to perpetrate abusive practices, and easier to close up shop before victims of abuse can be compensated.

The low capitalization necessary for mortgage bankers and mortgage brokers as well as their lack of regulation has led to the proliferation of mortgage lending abuses by fly-by-night

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[174]*Id;* HUD/Treasury Joint Report, *supra* note 26, at 39.

[175]HUD/TREASURY JOINT REPORT, *supra* note 26, at 39.

[176]*Id.*

[177]*Id.* at 40. In response to the predatory lending problem, some states have recently adopted more stringent regulation and licensing requirements for mortgage bankers and mortgage brokers, including new bonding and educational requirements. *See* GAO REPORT, *supra* note 23, at 62.

operators. Mortgage bankers and brokers can originate loans using predatory practices, then shut down and move to another state. When originators quickly sell loans on the secondary market after origination, the new lender is left to deal with any defenses to payment or may be immune under the holder in due course doctrine.[178] When intermediaries like home improvement contractors and mortgage brokers are involved in originating a loan, they may be more concerned with generating fees than with the loan's ultimate repayment.[179] But when the homeowner seeks a remedy, the intermediary may be judgment proof, may have moved to another state, or may be out of business. The homeowner may thus be left without a remedy.

C. Separation of Investors from the Problems

The new horizontal segmentation of the mortgage lending market is also a factor in the increase in predatory lending. Because of the separation in the functions of mortgage lending, the party who deals directly with the borrower in brokering or originating the loan may not have any dealings with the borrower after origination. Although originating lenders sometimes retain the servicing function, where a broker is involved, the originating lender may not even have an office in the same community or the same state as the borrower. The parties who broker, originate, and service loans rarely own the loans they broker, originate or service.

Thus, investors in mortgage loans can separate themselves from any abusive practices. They do not suffer harm to their reputations that might come about by being involved in abusive practices. In addition, as discussed below, purchasers of abusive loans are often protected by the

[178] *See infra* subpart D.

[179] HUD/TREASURY JOINT REPORT, *supra* note 26, at 40.

holder in due course doctrine against many of a borrower's claims or defenses that might arise from the abusive practices.[180] Purchasers of securities backed by predatory loans are further separated from involvement in the origination or terms of individual loans and are further insulated from loss.[181] Therefore, investors may provide the funding for predatory loans while turning a blind eye to the abusive practices involved in their origination.

D. Holder in Due Course Doctrine

One factor that insulates investors in predatory loans from liability is the holder in due course doctrine. The holder[182] of a negotiable promissory note[183] becomes a holder in due course if the note is not obviously forged, altered, irregular or incomplete and the holder takes it for value, in good faith, and without notice of certain problems.[184] A holder in due course holds a

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[180]*See* Eggert, *supra* note 144, at 613; Forrester, *supra* note 27, at 422. *See infra* subpart D.

[181]*See infra* subpart E.

[182]A holder is a person who obtains an instrument by negotiation. *See* U.C.C. § 3-201(a) (2000). Negotiation requires transfer of possession and indorsement for an instrument payable to the order of a particular party. *Id.* § 3-201(b).

[183]A negotiable instrument is "an unconditional promise or order to pay a fixed amount of money, with or without interest or other charges described in the promise or order, if it:

> (1) is payable to bearer or to order at the time it is issued or first comes into possession of a holder;
>
> (2) is payable on demand or at a definite time; and
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> (3) does not state any other undertaking or instruction by the person promising or ordering payment to do any act in addition to the payment of money . . . ."

U.C.C. § 3-104(a) (2000).

[184]A holder in due course is "the holder of an instrument if:

note free from personal defenses of the maker and claims in recoupment of the maker against the original payee.[185] Personal defenses include fraud in the inducement, misrepresentation, mistake, lack or failure of consideration, and breach of warranty.[186]

The problems that give rise to personal defenses are exactly the types of problems that often exist in predatory mortgage loans. Therefore, an assignee who is a holder in due course can avoid these defenses to payment and require the borrower to pay the note despite valid

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> (1) the instrument when issued or negotiated to the holder does not bear such apparent evidence of forgery or alteration or is not otherwise so irregular or incomplete as to call into question its authenticity; and
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> (2) the holder took the instrument:
>
> (A) for value;
>
> (B) in good faith;
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> (C)without notice that the instrument is overdue or has been dishonored or that there is an uncured default with respect to payment of another instrument issued as part of the same series;
>
> (D) without notice that the instrument contains an unauthorized signature or has been altered;
>
> (E) without notice of any claim to the instrument described in Section 3-306; and
>
> (F) without notice that any party has a defense or claim in recoupment described in Section 3-305(a).

U.C.C. § 3-302(a).

Good faith requires both "honesty in fact" and " the observance of reasonable commercial standards of fair dealing." U.C.C. § 3-103(a)(4). In determining if a holder has observed reasonable commercial standards of fair dealing, the test is not whether the holder exercised care in the purchase of a note but considers rather the fairness of the holder's conduct. U.C.C. § 3-103 cmt. 4.

[185]U.C.C. § 3-305.

[186]U.C.C. § 3-305 cmt. 2.

defenses to payment.[187] The borrower's only recourse then is to sue the originator or broker who committed the fraud or engaged in other conduct giving rise to a defense. These parties may no longer be in business or may be judgment proof.[188] Thus,the borrower may have to continue paying on the note to avoid foreclosure and yet lack any meaningful recourse against the culpable parties.

The holder in due course doctrine has a history of creating problems for consumers. Prior to 1976, sellers of goods and services to consumers could separate the consumer's obligation to pay from the seller's obligation to perform by selling the consumer's note to a holder in due course.[189] The transferee of the note, as a holder in due course free of personal defenses, could insist on payment even if the goods or services were not delivered, were not performed, or were defective. The FTC found that sellers used this ability to transfer a note free from contract defenses as a means to effectuate unethical sales practices in consumer transactions.[190]

In response to these abuses in consumer sales, the FTC promulgated a trade regulation rule, the Holder in Due Course Rule, which eliminates the holder in due course doctrine for

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[187]*See, e.g.,* Wilson v. Toussie, 260 F.Supp.2d 530 (E.D. N.Y. 2003) (holding that current lenders who acquired mortgage loans at closing or on the secondary market were holders in due course and thus claims based on predatory lending practices of original lenders were dismissed against current lenders); Stuckey v. Provident Bank, 2005 WL 613535 (Miss. 2005) (holding that the assignee of home mortgage loan, as a holder in due course, was immune from claims that the original lender had engaged in predatory lending practices).

[188]*See supra* notes 172-74 and accompanying text.

[189]Guidelines on Trade Regulation Rule Concerning Preservation of consumers' Claims and Defenses, 41 Fed. Reg. 20,022-23 (1976); Forrester, *supra* note 151, at 1105.

[190]Preservation of Consumers' Claims and Defenses: Promulgation of Trade Regulation Rule and Statement of Basis and Purpose, 40 Fed. Reg. 53,506, 53,509 (1975).

certain transactions.[191] The Rule operates by requiring a notice in consumer credit contracts that makes the holder of the contract subject to claims and defenses that the debtor could assert against the seller.[192] Affirmative recovery by a consumer against the holder of a consumer credit contract is limited to the amount that the consumer has already paid,[193] so the holder's loss is limited to the amount to be paid under the consumer credit contract. The FTC Holder in Due Course Rule applies only to sales of goods or services for personal, family or household use and for $25,000 or less.[194] Therefore, it applies to some home improvement loans, but not to other home mortgage loans.

At the time the FTC rule was adopted, lenders predicted dire consequences which did not materialize.[195] The FTC Holder in Due Course Rule caused only a small reduction in the availability of consumer credit.[196] In 1988, the FTC reviewed the Rule to determine the economic impact on small businesses and, in particular, on the availability of credit, but it

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[191]Preservation of Consumers' Claims and Defenses, 16 C.F.R. §§ 433.1-.3 (2005).

[192]*See id.* § 433.2.

[193]*See id.* § 433.2 (a), (b).

[194]16 C.F.R. § 4.33.1(b), (d), (e).

[195]Kurt Eggert, *Held Up In Due Course: Codification and the Victory of Form Over Intent in Negotiable Instrument Law*, 35 CREIGHTON L. REV. 363, 429-30 (2002); William H. Lawrence & John H. Minan, *The Effect of Abrogating the Holder-in-Due-Course Doctrine on the Commercialization of Innovative Consumer Products,* 64 B.U. L. REV. 325, 338-39 & n.51 (1984).

[196]*See* JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE 503 (4th ed. 1995); Eggert, *supra* note 195, at 429; Lawrence & Minan, *supra* note 195, at 338-39 & n.51; Edward L. Rubin, *Learning From Lord Mansfield: Toward a Transferability Law for Modern commercial Practice,* 31 IDAHO L. REV. 775, 789 (1995).

received few comments in response to its review.[197] Honest merchants and lenders were able to adapt to the FTC Rule, so only the dishonest ones were greatly affected.[198]

HOEPA has a provision that operates in a manner similar to the FTC Holder in Due Course Rule for home mortgage loans covered by HOEPA.[199] Like the FTC Rule, HOEPA limits the liability of the assignee of a loan to the amount to be paid under the loan.[200] In addition, many state predatory lending statutes also provide for assignee liability to varying degrees.[201]

E. Further Insulation by Securitization

Independent of the holder in due course doctrine, investors in mortgaged-backed securities are protected against loss beyond the loss of their investment. Investors hold securities representing an interest in a pool of loans and are not holders of any individual loans. Therefore, the risk of loss to the investor is determined by the performance of the entire pool of loans rather than by any individual loan. In a securitization, an SPV is typically the holder of the loans.[202] In most securitization transactions, the SPV is created for the particular transaction and its only

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[197] *See* FTC Ends Review of "Holder" Rule, *at* http://www.ftc.gov/opa/predawn/F93/holderrul2.htm. The FTC concluded that the Rule had "not had a significant economic impact on small businesses" and retained the rule as written. *Id.*

[198] *See* Homer Kripke, *Consumer Credit Regulation: A Credit-Oriented Viewpoint,* 68 COLUM. L. REV. 445, 473 (1968).

[199] *See supra* notes 87-90 and accompanying text.

[200] *See supra* note 89 and accompanying text.

[201] *See supra* notes 134, 136, and 138-39 and accompanying text.

[202] *See supra* notes 164-66 and accompanying text.

assets are the loans making up the pool that is the subject of the securitization.[203] If a borrower has a defense to payment of a particular loan that the borrower may assert against the SPV,[204] then the loss is spread among the holders of the securities. Even if an SPV as holder of a predatory loan has affirmative liability to a borrower, its only assets from which to pay that liability are the other loans in the pool and, once again, the risk is spread among the holders of the securities. If the SPV becomes insolvent, then the investors lose their investment, but cannot have further liability to injured borrowers. The borrowers, not the investors, are the ones who can end up holding the bag.

The risk to investors in mortgage backed securities is further reduced where there are credit enhancements such as third-party insurance, guarantees, surety bonds, or letters of credit whereby "a creditworthy party ensures payment of all or a portion of the securities issued by the SPV."[205] In this case, the third party bears all or some of the risk of loss. Another type of "credit enhancement" involves the purchase by a third party of subordinated securities.[206] The owner of the subordinated securities bears more of the risk of loss than the holders of the senior securities who are thus protected against loss. Therefore, investors in mortgaged backed securities are protected against loss caused by predatory lending practices of the originator even beyond protection provided by the holder in due course doctrine and even where the doctrine does not apply.

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[203] *See* Schwarcz, *supra* note 164, at 138.

[204] The borrower may be able to assert a defense because it is a real rather than a personal defense or because the SPV is subject to defenses under HOEPA or a state predatory lending statute.

[205] SCHWARCZ, *supra* note 160, § 2:3 at 15-16.

F. Increased Availability of Subprime Credit Due to Securitization

Securitization of mortgage loans also contributes to the predatory lending problem because of the greatly increased amount of capital now available for investment in mortgage loans. When most home mortgage loans were made by depository institutions, the limited available credit went to prime borrowers.[207] The tremendous increase in the size of the market for subprime loans is a result of securitization. Since the 1990s when securitization of subprime loans proliferated, the volume of subprime lending has increased drastically from $35 billion in 1994 to $160 billion in 1999[208] and to $529 billion in 2004.[209] In addition, as securitization of subprime loans has become more common, prime lenders, Wall Street investment firms, and the GSEs have become involved as additional players in the subprime market.[210]

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[206] *Id.* §2:4.

[207] Engel & McCoy, *supra* note 144, at 1272-73; Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information,* 71 AM. ECON. REV. 393, 406-07 (1981); John V. Duca & Stuart S. Rosenthal, *Do Mortgage Rates Vary Based on Household Default Characteristics? Evidence on Rate Sorting and Credit Rationing,* 8 J. REAL EST. FIN. & ECON. 99, 101-02 (1994). Finance companies making subprime loans mostly made second lien loans for home improvement or debt consolidation. *See supra* notes 44-47 and accompanying text.

[208] HUD/TREASURY JOINT REPORT, *supra* note 26, at 2, 42. *See also Hearings on Predatory Mortgage Lending*, *supra* note 37, at 398 (statement of Mike Shea, Executive Director, ACORN Housing Corp.) (increasing 900% between 1993 and 1999), 345 (statement of David Berenbaum, National Community Reinvestment Coalition) ("increased almost 1000 percent from 1993-1998").

[209] *Top 25 B&C Lenders in 2004*, 2005 Mortgage Market Statistical Annual, Vol. 1 (March 2005).

[210] HUD/TREASURY JOINT REPORT, *supra* note 26, at 45-46. GSE involvement has been primarily with subprime borrowers with A- credit ratings. *Id.* at 46.

With the increase in the size of the subprime market has come an increase in predatory lending abuses.[211] Notably, the increase in subprime lending and the related increase in predatory lending occurred after the enactment of HOEPA. The availability of legitimate subprime loans to borrowers who do not qualify for prime loans should theoretically reduce the amount of predatory lending because borrowers should have more options. However, most victims of predatory lenders do not shop around for the best deal. In fact, many homeowners with predatory loans did not seek out credit but were approached by the lender, a home improvement contractor, or a mortgage broker. These homeowners may not understand the terms of their loans, may not realize they could get credit on better terms, or may have been fraudulently induced into the loan with promises of better terms than they ultimately receive.[212] As a result, predatory lending continues despite the availability of reputable subprime lending options. The increased availability of funds created by securitization of subprime loans has made more funds available to predatory lenders as well.

G. Market Failure

Professors Engel and McCoy make a compelling argument that market failures have been a key factor in the proliferation of predatory loans.[213] They classify the mortgage market into

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[211] *See* 66 F.R. 65604 ("With this increase in subprime lending there has also been an increase in reports of "predatory lending."). A consumer advocacy group estimated in 2001 that predatory lending cost affected borrowers to the extent of $9.1 billion annually. *See* Eric Stein, Coalition for Responsible Lending, *Quantifying the Economic Cost of Predatory Lending* 3, *available at* http://responsiblelending.org.

[212] *See* Forrester, *supra* note 27, at 389-90.

[213] Engel & McCoy, *supra* note 144, at 1277-97. *See also* Forrester, *supra* note 27, at 419-21 (discussing market failure in home equity loan market).

three segments: the prime market, the legitimate subprime market, and the predatory loan market.[214] Borrowers in the predatory loan market are disconnected from the credit market "because of historical credit rationing, discrimination, and other social and economic forces."[215] Some of the borrowers in the predatory market could qualify for prime loans but for some reason do not have access to the prime market.[216] Others are properly classified as subprime borrowers, but do not have access to the legitimate subprime market. Finally, some simply cannot afford credit and should not have access to any type of loan.[217]

People who are disconnected from the credit market are those who for some reason cannot or do not shop for the best credit deal.[218] They tend to be borrowers who do not shop for credit at all because they may not realize that credit is available. They are targeted by contractors, brokers, and predatory lenders who take advantage of information asymmetries to induce the borrowers to take out a loan on disadvantageous terms because they are not aware that better terms are available.[219] Predatory lenders have very different marketing strategies from legitimate lenders who advertise then wait for borrowers to approach them. Predatory lenders shop for and approach the borrowers and thus reach borrowers who would not otherwise apply

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[214]Engel & McCoy, *supra* note 144, at 1278.

[215]*Id.* at 1279.

[216]*Id.*; Freddie Mac, Automated Underwriting: Making Mortgage Lending Simpler and Fairer for America's Families Ch. 5 n.5-6 (Sept. 1996) *available at* http://www.freddiemac.com/corporate/reports/. One Freddie Mac study determined that between ten and fifty percent of subprime borrowers qualified for a prime loan, *id.* Ch. 5 n.5, and a poll of subprime lenders found that half of subprime borrowers qualified for a prime loan, *id.* Ch. 5 n.6.

[217]*See* Engel & McCoy, *supra* note 144, at 1279.

[218]*Id.* at 1281.

[219]*See* Forrester, *supra* note 27, at 389, 420.

for a loan on their own.[220] Therefore, the existence of legitimate subprime lenders does not drive predatory lenders out of the market. Since the market cannot eliminate predatory lending, government intervention is necessary.

H. Federal Preemption of State Consumer Protection Legislation

Another factor in the growth of predatory lending has been the federal preemption of state consumer protection measures.[221] In 1980 Congress enacted the Depository Institutions Deregulation and Monetary Control Act (DIDMCA),[222] which preempts state usury ceilings on any "federally related mortgage loan" secured by a first lien on residential real estate.[223] Because of DIDMCA's broad definition of "federally related mortgage loan," the preemption applies to

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[220]*See supra* notes 64-65 and accompanying text.

[221]*See* Forrester, *supra* note 27, at 388, 419; Mansfield, *supra* note 144, at 476.

[222]Pub. L. No. 96-221, 94 Stat. at 132 (codified as amended in scattered sections of 12 U.S.C.).

[223]12 U.S.C. § 1735f-7a(a)(1) (2000). The reasons for Congress' preemption of state usury laws were:

> (i) to promote the stability and viability of financial institutions by allowing them to charge and collect realistic market interest on mortgage loans, and (ii) to promote the national housing policy and the American dream of homeownership by legislatively opening a spigot which would insure an increased and evenly-spread flow of available mortgage money.

Smith v. Fidelity Consumer Discount Co., 898 F.2d 907, 911 (3rd Cir. 1990) (quoting Bank of New York v. Hoyt, 617 F.Supp. 1304, 1311 (D.R.I. 1985). Preemption of usury laws was necessary to the viability and stability of the nation's financial institutions because DIDMCA also eliminated ceilings on interest rates paid on savings and loan deposits. S. REP. NO. 368, 96th Cong., 2d Sess. 19 (1980), *reprinted in* 1980 U.S.C.C.A.N. 236, 255. Preemption of usury laws promoted homeownership because interest rates had risen above usury ceilings in some states making mortgage funds unavailable in those states since lenders could not make loans at market rates. *Id.* at 254-55.

virtually any first lien home mortgage made by an institutional lender.[224] DIDMCA provides that states could opt out of the usury preemption during a specified time period, but only sixteen jurisdictions did so.[225] Although DIDMCA is limited in its application to first lien loans, lenders can require a borrower to refinance existing liens in order to fit within the preemption.[226] Most courts that have addressed the issue have held that the DIDMCA preemption applies to non-purchase money loans so long as the lender has a first lien.[227] The issue now appears to be settled.[228]

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[224]*See* Forrester, *supra* note 27, at 399. A federally related mortgage loan is any loan that is (1) made by a lender whose deposits or accounts are federally insured, (2) made by a federally regulated lender, (3) made, insured, guaranteed, or otherwise assisted by HUD or any other federal agency, (4) eligible for purchase by FNMA, GNMA, or FHLMC, or from any financial institution from which it could be purchased by FHLMC, or (5) made by any creditor subject to the Truth in Lending Act who makes or invests in residential real estate loans totaling more than $1 million per year. 12 U.S.C. § 1735f-5(b)(2). For purposes of the usury law preemption, the term is expanded to include loans made by any lender approved by HUD for participation in a federal mortgage insurance program and loans made by an individual providing financing for the sale of the individual's residence. *See id.* § 1735f-7a(a)(1)(C)(vi).

[225]*See* Frank S. Alexander, *Federal Intervention in Real Estate Finance: Preemption and Federal Common Law,* 71 N.C. L. REV. 293, 315 (1993).

[226]*See* Forrester, *supra* note 27, at 417-18.

[227]*See* Brown v. Investor Mortgage Co., 121 F.3d 472, 475 (9th Cir. 1997); Smith v. Fidelity Consumer Discount Co., 898 F.2d 907, 912 (3rd Cir. 1990); Gora v. Banc One Fin. Servs., Inc., No. 95 C 2542, 1995 WL 613131 (N.D. Ill. Oct. 17, 1995); L.G.H. Enters., Inc. v. Kadilac Mortgage Bankers, Ltd. (*In re* L.G.H. Enters.), 146 B.R. 612, 616 (E.D.N.Y. 1992). *See also* Bank of New York v. Hoyt, 617 F. Supp. 1304, 1310 (D.R.I. 1985) (finding that DIDMCA applies to construction loans made to residential developers so long as other statutory requirements are met); FirstSouth F.A. v. Lawson Square, Inc. (*In re* Lawson Square, Inc.), 61 B.R. 145, 150 (Bankr. W.D. Ark. 1986) (finding that DIDMCA applies to loans made for the purpose of developing residential real estate so long as the lender takes a first lien on the property). *But see* Fidelity Fin. Servs. Inc. V. Hicks, 214 Ill.App.3d 398, 406 (Ill. App. Ct. 1991) (holding that DIDMCA applies only to purchase money loans).

[228]*See* Mansfield, *supra* note 144, at 520.

Because of DIDMCA, subprime lenders can legally charge whatever rate of interest a particular borrower will pay by requiring a first lien on the borrower's home. Because of the market failures discussed above,[229] some borrowers will pay interest at a rate higher than the rate that would reflect the lender's risk of making the loan.[230] One of the characteristics of a predatory loan is an interest rate that exceeds the amount necessary to compensate the lender for the risk of making the loan.[231] Some borrowers that could obtain prime loans are steered to the subprime market. Other borrowers are subprime borrowers but pay more interest in the predatory loan market than they would pay in the legitimate prime market.[232] DIDMCA is one of the causes of the predatory lending problem because states could regulate the rates that lenders charge on first lien home mortgage loans absent DIDMCA.

Another federal statute, the Alternative Mortgage Transaction Parity Act (Parity Act) preempts state laws that restrict alternative mortgage transactions,[233] which include variable interest rate loans, loans with balloon payments, and shared appreciation mortgages.[234] The Parity Act applies to any "loan or credit sale secured by an interest in residential real

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[229]*See supra* subpart G.

[230]*See* Engels & McCoy, *supra* note 144, at 1279 (discussing subprime borrowers who would qualify for a prime loan); *see also* Mansfield, *supra* note 144, at 542 ("[I]t does not appear that pricing is closely tied to actual risk or any other objective factors."). As evidence, Professor Mansfield cites, *inter alia,* the profitability of subprime lenders and their lack of uniformity in underwriting and pricing. *Id.* at 540-41.

[231]*See supra* note 49 and accompanying text.

[232]*See supra* notes 214-17 and accompanying text.

[233]12 U.S.C. § 3803 (2000).

[234]*Id.* § 3802(1).

property,"[235] so it is not limited to purchase money loans or to loans secured by a first lien.[236] Various federal agencies had adopted regulations that permitted federally chartered financial institutions to provide alternative mortgage financing,[237] and the Parity Act extended the preemption of state law in this area to apply to other residential mortgage lenders.[238] Under the Parity Act, these other lenders may make alternative mortgage loans that comply with the federal regulations rather than with state law.[239] As with the federal preemption of state usury law under DIDMCA, states were permitted to opt out of the preemption,[240] and several states did.[241]

Under the Parity Act, predatory lenders have been able to require certain onerous terms in home mortgage loans because state regulation of those terms has been preempted by the Act. For example, states may not prohibit balloon payments in home mortgage loans because of Parity Act.[242] Therefore, a predatory loan may be amortized over 30 years, but with a large balloon payment due after only three years. When a balloon payment becomes due, the borrower

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[235]*Id.* Congress enacted the statute because "alternative mortgage transactions are essential to the provision of an adequate supply of credit secured by residential property." *Id.* § 3801(a)(2).

[236]*See* Forrester, *supra* note 27, at 419.

[237]12 U.S.C. § 3801(a)(3).

[238]*Id.* § 3803(c).

[239]*Id.* § 3801(b), 3803(a). Congress gave authority to the Office of the Comptroller of the Currency (for banks), the National Credit Union Administration (for credit unions), and the Office of Thrift Supervision (for other housing creditors) to "identify, describe, and publish those portions or provisions of their respective regulations that are inappropriate for (and thus inapplicable to), or that need to be conformed for the use of, nonfederally chartered housing creditors. . . ." Pub. L. No. 97-320, § 807(b), *reprinted in* 12 U.S.C. § 3801 note.

[240]12 U.S.C. § 3804.

[241]*See, e.g.*, ME. REV. STAT. ANN. tit. 9-A, § 1-110 (West Supp. 1993); N.Y. BANKING LAW § 6-g (McKinney 1990).

[242]*See* 12 U.S.C. §§ 3802(1)(B), 3803.

must find the funds to pay off the loan or refinance, which means additional fees and closing costs. Until recently, predatory lenders could also charge large prepayment penalties and onerous late charges without regard to state regulation because of the Parity Act.[243] Balloon payments, large prepayment penalties, and onerous late charges are all common features of a predatory loan.[244]

In 2003 the OTS removed both prepayment rules and late fee rules from the list of its regulations that preempt state law under the Parity Act.[245] The OTS had determined that "the application of its late fee and prepayment penalty regulations to housing creditors might be contributing to predatory lending practices in the subprime mortgage market."[246] The change was backed by state attorneys general as a means to combat predatory lending.[247] In response to a challenge by the National Home Equity Mortgage Association, the Court of Appeals for the District of Columbia upheld the right of the OTS to determine the types of loan terms that are covered by the Parity Act.[248] Therefore, states may now regulate prepayment premiums and late fees for nonfederally chartered lenders. For federal banks and thrifts, however, state consumer protection measures aimed at combating the predatory lending problem are preempted.

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[243] 12 C.F.R. §§ 560.33, 560.34 (amended). Prepayment penalties are much more common in subprime loans than in prime loans.

[244] *See supra* note 56 and accompanying text.

DIDMCA and the Parity Act allow high interest rates and unfair loan terms that might otherwise be prohibited by state law. Bankruptcy law prevents the loan terms from being changed. *See* Forrester, *supra* note 27, at 427-35.

[245] 67 Fed. Reg. 60,542 (2002).

[246] National Home Equity Mortgage Ass'n v. OTS, 373 F.3d 1355, 1357 (2004) (citing 65 Fed. Reg. 17,811, 17,813 (Apr. 5, 2000)).

[247] 373 F.3d at 1361-62.

IV. FEDERAL PREEMPTION OF STATE PREDATORY LENDING LAWS

A. Recent Regulatory Developments

In 1996 pursuant to Home Owners' Loan Act (HOLA),[249] the Office of Thrift Supervision (OTS) issued regulations that preempt state laws "affecting the operations of federal savings associations . . . to enable federal savings associations to conduct their operations in accordance with the best practices of thrift institutions."[250] The regulation specifically provides that it "occupies the entire field for regulation of federal savings associations."[251] More specifically, the regulation preempts state laws that impose requirements regarding licensing, credit terms, loan fees, disclosure requirements, origination, and interest rate ceilings.[252] Recently, the OTS has issued letters announcing preemption of predatory lending statutes in Georgia,[253] New York,[254] New Jersey,[255] and New Mexico.[256] In addition, the OTS has

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[248]*Id.* at 1356.

[249]12 U.S.C. §§ 1461-68c (2000).

[250]12 C.F.R. § 560.2(a) (2005).

[251]*Id.*

[252]12 C.F.R. § 560.2(b). The regulation provides that it does not preempt state laws that "only incidentally affect the lending operations of Federal savings associations" such as contract and commercial law, real property law, tort law and criminal law. *Id.* § 560.2(c).

[253]Preemption of Georgia Fair Lending Act, OTS Op. Chief Counsel P-2003-1 (Jan. 21, 2003) *at* http://www.ots.treas.gov/docs/r.cfm?56301.pdf.

[254]Preemption of Georgia Fair Lending Act, OTS Op. Chief Counsel P-2003-2 (Jan. 30, 2003) *at* http://www.ots.treas.gov/docs/r.cfm?56301.pdf.

[255]Preemption of Georgia Fair Lending Act, OTS Op. Chief Counsel P-2003-5 (July 22, 2003) *at* http://www.ots.treas.gov/docs/r.cfm?56301.pdf.

[256]Preemption of Georgia Fair Lending Act, OTS Op. Chief Counsel P-2003-6 (Sept. 2, 2003) *at* http://www.ots.treas.gov/docs/r.cfm?56301.pdf.

concluded that operating subsidiaries of federal savings associations enjoy the same preemption as the associations themselves.[257]

In January of 2004, the Office of the Comptroller of the Currency (OCC) issued a regulation preempting state laws governing mortgage lending as applied to national banks and their operating subsidiaries.[258] The regulation preempts "state laws that obstruct, impair, or condition a national bank's ability to fully exercise its Federally authorized real estate lending powers."[259] Specifically, the regulation preempts state law limitations on licensing and registration, insurance requirements, loan-to-value ratios, amortization, payments, term, escrow accounts, disclosures, due on sale clauses, and other matters.[260] Therefore, the regulation would preempt state predatory lending statutes.[261]

In another rule finalized on the same day, the OCC amended its regulation on visitorial powers.[262] The amended regulation provides that "the OCC has exclusive visitorial authority with respect to the content and the conduct of activities authorized for national banks under

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[257] *Id.* at 2 n.4.

[258] Bank Activities and Operations; Real Estate Lending and Appraisals, 69 Fed. Reg. 1904, 1917 (Jan. 13, 2004) (codified at 12 C.F.R. § 34.4(a) (2005)). On the same day the OCC issued regulations preempting state laws in the areas of deposit-taking, 12 C.F.R. § 7.4007, non-mortgage lending, *id.* § 7.4008, and the business of banking generally *id.* § 7.4009.

[259] 12 C.F.R. § 34.4 (a) (2005).

[260] *Id.*

[261] In August of 2003 the OCC made a preemption determination about the Georgia act only, Preemption Determination and Order, 68 Fed. Reg. 46,264 (Aug. 5, 2003), and at that time issued the proposed regulation preempting all state predatory lending laws, 68 Fed. Reg. 46,119 (Aug. 5, 2003).

[262] Bank Activities and Operations, 69 Fed. Reg. 1895 (Jan. 13, 2004) (codified at 12 C.F.R. § 7.4000 (2005)).

Federal law."[263] The OCC claims pursuant to its regulations that state authorities do not have any visitorial powers over national banks or over their operating subsidiaries.[264] The rule provides that the OCC has exclusive authority to initiate either administrative or judicial proceedings to enforce state law against national banks as well as against their operating subsidiaries.[265] This amendment goes hand-in-hand with the preemption regulation by making clear the OCC's position that states do not have visitorial powers to enforce state laws.

The OCC preemption regulation is similar in its scope to the OTS regulation preempting state lending requirements as related to federal savings associations. Although the OCC has not formally adopted a rule of field preemption as did the OTS, the OCC has described its regulations as having the same preemptive effect as the OTS regulations.[266] Thus, virtually all provisions of every state predatory lending statute would be preempted according to the regulation.

In an attempt to militate against the effects of preempting state laws aimed at curbing mortgage lending abuses, the regulation adds certain limits. The regulation prohibits national banks from making loans "based predominantly on the bank's realization of the foreclosure or liquidation value of the borrower's collateral, without regard to the borrower's ability to repay the loan."[267] In addition, the regulation prohibits practices that would be unfair or deceptive

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[263] 12 C.F.R. § 7.4000(a)(3).

[264] *See* 69 Fed. Reg. 1900-01, 1913.

[265] *See* 69 Fed. Reg. 1897-1900.

[266] *See* 68 Fed. Reg. 46,119, 46,129 n.91 (Aug. 5, 2003); OCC, News Release 2004-3, *OCC Issues Final Rules on National Bank Preemption and Visitorial Powers* at 1, 4 (Jan. 7, 2004), *available at* http://www.occ.treas.gov; Wilmarth, *supra* note 24, at 234-35.

[267] 12 C.F.R. § 34.3(b).

under the Federal Trade Commission Act.[268] Since, however, banks were already subject to FTC trade regulations, the OCC regulation adds very little.

The OCC regulation explicitly applies to the operating subsidiaries of national banks as well as to national banks themselves. A national bank may apply to the OCC to acquire or establish an operating subsidiary,[269] and may conduct in an operating subsidiary the same activities that are permissible for a national bank.[270] The permitted activities of an operating subsidiary include "[m]aking loans" and "[p]urchasing, selling servicing, or warehousing loans or other extensions of credit, or interests therein."[271] Therefore, the activities of a subprime mortgage lender could be conducted in an operating subsidiary of a national bank.

In promulgating the new regulations, the OCC stated that operating subsidiaries of national banks had not been involved in predatory lending.[272] However, banks can now transfer mortgage operations to operating subsidiaries in order to avoid the operation of state predatory lending statutes and to engage in predatory lending practices. Further, one concern expressed about the new regulation is the lack of oversight that the OCC will be able to provide.[273] So even with the OCC's prohibitions against predatory lending practices, the question arises as to the OCC's ability to police operating subsidiaries of national banks as well as the banks themselves.

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[268] *Id.* § 34.3(c).

[269] 12 C.F.R. § 5.34(e)(5)(i)(A) (2005).

[270] *Id.* § 5.34(e)(1).

[271] *Id.* § 5.34(e)(5)(v)(C), (D).

[272] *See* 69 Fed. Reg. 1904, 1914.

[273] *See infra* notes 447-52 and accompanying text.

B. Recent Developments in Congress

In March of 2005, Representatives Bob Ney and Paul Kanjorski[274] introduced a bill in Congress that would amend HOEPA to preempt state predatory lending laws and would otherwise weaken some of HOEPA's provisions.[275] In addition to providing for the preemption of state predatory lending statutes, the bill would remove fees currently included in calculating the trigger for a high cost loan including fees for single premium credit insurance, would not prevent lenders from "flipping" subprime loans, and would weaken HOEPA provisions for assignee liability.[276] Lending groups support the bill, particularly the preemption of state predatory lending laws.[277] Consumer advocates do not.[278]

C. The Law of Preemption

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[274]Ney is a Republican representing the 18th Congressional District of Ohio, and Kanjorski is a Democrat representing the 11th Congressional District of Pennsylvania. *See* Office of the Clerk, U.S. House of Representatives, Member Information, http://clerk.house.gov/members/index.html.

[275]Responsible Lending Act, H.R. 1295, 105th Cong. (2005). Earlier in the same month, Representatives Brad Miller (D-NC), Mel Watt (D-NC), and Barney Frank (D-MA) introduced a bill that would strengthen HOEPA along the same lines as North Carolina's statute. *See* Prohibit Predatory Lending Act, H.R. 1182, 105th Cong. (2005).

[276]H.R. 1295, 105th Cong. (2005). *See also* Center for Responsible Lending, *H.R. 1295 – Responsible Lending Act; Center for Responsible Lending Section-by-Section Analysis*, 22-23 (April 6, 2005), *at* http://www.responsiblelending.org/pdfs/pa-NK_Sections.pdf.

[277]*See Hearing on Legislative Solutions, supra* note 37, at 3-4 (statement of Steve Nadon, Chairman, Coalition for Fair & Affordable Lending), 3 (statement of Micah S. Green, President, The Bond Market Ass'n), 4 (statement of Jim Nabors, President-Elect, Nat'l Ass'n of Mortgage Brokers).

[278]*See id.* at 3 (statement of Stella Adams, Board Member, National Community Reinvestment), 4 (statement of Martin Eakes, CEO, Self-Help and the Center for Responsible Lending).

Under the Supremacy Clause of the United States Constitution,[279] Congress has the power to preempt state law[280] so long as it is acting within the scope of its Constitutionally delegated powers.[281] Determining whether Congress has preempted state law is a matter of determining Congressional intent.[282] Courts may find express or implied Congressional intent to preempt state law.[283] The Supreme Court, however, has created a presumption that areas of the law traditionally left to the states are not preempted by federal law "unless that was the clear and manifest purpose of Congress."[284]

Express preemption occurs when Congress includes a preemption clause in a federal statute stating explicitly its intent to preempt state law.[285] An example is DIDMCA which expressly preempts state usury statutes unless a state has opted out.[286] Another example is the

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[279]U.S. CONST. art. VI, cl. 2. The Supremacy Clause provides that "the Laws of the United States . . . shall be the supreme Law of the Land; . . . any Thing in the Constitution of Laws of any state to the Contrary notwithstanding." *Id.*

[280]*See id.;* Barnett Bank v. Nelson, 517 U.S. 25, 30 (1996); California Fed. Sav. & Loan Ass'n v. Guerra, 479 U.S. 272 (1987).

[281]*See* Gregory v. Ashcroft, 501 U.S. 452, 460 (1991).

[282]Barnett, 517 U.S. at 30; Retail Clerks v. Schermerhorn, 375 U.S. 96, 103 (1963).

[283]*See* Barnett, 517 U.S. at 31; Cipollone v. Liggett Group, 505 U.S. 504, 516 (1992) ("Congress' intent may be 'explicitly stated in the statute's language or implicitly contained in its structure and purpose.'") (quoting Jones v. Rath Packing Co., 430 U.S. 519, 525 (1977)).

[284]Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947) (quoted in Medtronic . . .); *see also* Nina M. Mendelson, *Chevron and Preemption,* 102 MICH. L. REV. 737, 738-39 (2004); Paul E. McGreal, *Some Rice with Your Chevron?: Presumption and Deference in Regulatory Preemption,* 45 CASE W. RES. L. REV. 823, 824 (1995).

[285]Barnett, 517 U.S. at 31; Cipollone, 505 U.S. at 516; Jones v. Rath Packing Co., 430 U.S. at 525.

[286]12 U.S.C. § 1735f-7a(a)(1) (2000).

Ney-Kanjorski bill currently before Congress that would expressly preempt state predatory lending statutes.[287]

If a statute does not contain explicit preemption language, courts must determine "whether the federal statute's 'structure and purpose,' or nonspecific statutory language, nonetheless reveal a clear, but implicit, pre-emptive intent."[288] The courts have found two different types of implied preemption, called conflict preemption and field preemption. [289]

Conflict preemption occurs when there is an actual conflict between state and federal law.[290] A conflict exists when compliance with both state and federal law would be a "physical impossibility"[291] or when state law "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."[292] The Supreme Court in *Barnett Bank v. Nelson* found a conflict where federal law gave national banks in small towns the authority to sell insurance and a Florida statute prohibited national banks from selling insurance.[293] The Court did not find a direct conflict since the federal statute did not require banks to sell insurance, but did find that the Florida statute was an obstacle to the accomplishment of one of

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[287]Responsible Lending Act, H.R. 1295, 105th Cong. (2005).

[288]Barnett, 517 U.S. at 31 (citing Jones, 430 U.S. at 525 and Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta, 458 U.S. 141, 152-53 (1982)).

[289]*See* McGreal, *supra* note 284, at 832; Caleb Nelson, 86 VA. L. REV. 225, 226 (2000).

[290]Cipollone, 505 U.S. at 516 (citing Pacific Gas & Elec. Co. V. State Energy Resources Conservation & Dev. Comm'n, 461 U.S. 190, 204); Hillsborough County v. Automated Med. Lab., Inc., 471 U.S. 707, 713 (1985).

[291]Florida Lime & Avocado Growers, Inc. v. Paul, 373 U.S. 132, 142-43 (1963), *cited in* Barnett, 517 U.S. at 31.

[292]Hines v. Davidowitz, 312 U.S. 52, 67 (1941), *quoted in* Barnett, 517 U.S. at 31.

[293]Barnett, 517 U.S. at 31, 37.

the objectives of the federal statute.[294] HOEPA preempts state law to the extent that state law is more tolerant than the federal requirements for loans covered by HOEPA.[295] For example, if state law permits a lender to charge a higher interest rate on default in a home mortgage loan regardless of the loan's interest rate, HOEPA's prohibition against a higher interest rate on default in a HOEPA high-cost loan[296] would preempt state law.

Field preemption occurs when a federal statute completely occupies a particular field which implies that Congress has withdrawn the power of states to legislate in that field.[297] Courts find field preemption when the scheme of federal regulation is "so pervasive as to make reasonable the inference that Congress left no room for the States to supplement it" or the field is one "in which the federal interest is so dominant that the federal system will be assumed to preclude enforcement of state laws on the same subject."[298]

Federal regulations can preempt state law to the same extent as federal statutes.[299] The Supreme Court has held that "'a federal agency acting within the scope of its congressionally delegated authority may pre-empt state regulation' and hence render unenforceable state or local

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[294] *Id.* at 31.

[295] *See* Ill. Ass'n of Mortgage Brokers v. Office of Banks & Real Estate, 308 F.3d 762, 766 (2002) ("[HOEPA] does not itself preempt any state law–except that state laws about the mortgage transactions defined in § 1602(aa) may not be more tolerant than the federal floor adopted in § 1639.")

[296] 15 U.S.C. § 1639(c).

[297] *See* Nelson, *supra* note 289, at 227.

[298] Rice v. Santa Fe Elevator Corp., 331 U.S. at 230, *quoted in* Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta, 458 U.S. 141, 152-53 (1982).

[299] City of New York v. FCC, 486 U.S. 57, 63 (1988); Fidelity Fed., 458 U.S. at 153. *See also* United States v. Shimer, 367 U.S. 374 (1961) (holding that VA regulations permitting the

laws that are otherwise not inconsistent with federal law."[300] Congress can expressly delegate to an agency the power to preempt state law. For example, the Parity Act gives authority to the OCC and the OTS to designate which of its regulations preempt state law.[301]

The power of an agency to preempt state law does not require express congressional authorization.[302] If Congress has not expressed its intent that the agency preempt state law, the question becomes whether the agency intended to preempt state law, and if so, whether the agency is acting within the scope of its delegated authority.[303] If regulatory preemption of state law "represents a reasonable accommodation of conflicting policies that were committed to the agency's care by the statute, [the court] should not disturb it unless it appears from the statute or its legislative history that the accommodation is not one that Congress would have sanctioned."[304]

When a regulation expressly states its intent to preempt state law,[305] the question arises as to the deference to be given the agency's interpretation. This inquiry is complicated by the

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VA to pursue a deficiency judgment after foreclosure and payment on its guaranty preempted Pennsylvania's anti-deficiency statute).

[300]City of New York v. FCC, 486 U.S. at 63-64 (quoting Louisiana Public Service Comm'n v. FCC, 476 U.S. 355, 369 (1986)).

[301]*See supra* note 248 and accompanying text.

[302]Fidelity Fed., 458 U.S. at 154.

[303]*Id.*

[304]United States v. Shimer, 367 U.S. 374, 383 (1961), *quoted in* City of New York v. FCC, 486 U.S. at 64.

[305]Both the OCC and the OTS regulations do just this. *See* Bank Activities and Operations; Real Estate Lending and Appraisals, 69 Fed. Reg. 1904, 1917 (Jan. 13, 2004) (to be codified at 12 C.F.R. § 34.4(a) (2005)) (OCC); 12 C.F.R. § 560.2(a) (2005) (OTS).

sometimes conflicting mandates of Rice v. Santa Fe Elevator Corp.[306] and Chevron v. Natural Resources Defense Council.[307] In Rice, the Supreme Court adopted a presumption against preemption of state law.[308] In Chevron, which was not a preemption case, the Court held that courts should defer to agency interpretations of statutes.[309] Therefore, when an agency preempts state law, the question is whether the presumption against preemption trumps deference to the agency interpretation or vice versa. The law is not clear as to how the mandates of these two cases should be reconciled.[310] Some commentators have suggested that Chevron deference should yield to the Rice presumption in preemption cases.[311] The issue arises in the context of the OCC and OTS regulations.

D. Authority of the OTS and OCC to Preempt State Predatory Lending Laws

The question arises as to the authority of the OCC and the OTS to preempt state lending laws including laws regulating predatory lending practices. While OTS authority to issue broad regulations preempting state law is settled,[312] the law regarding OCC authority under its new regulations remains untested.

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[306]331 U.S. 218 (1947).

[307]467 U.S. 837 (1984).

[308]331 U.S. at 230.

[309]467 U.S. at 866.

[310]*See* Mendelson, *supra* note 284, at 739; McGreal, *supra* note 284, at 887.

[311]Mendelson, *supra* note 284, at 799-800.

[312]*See infra* notes 316-19 and accompanying text.

Both OCC and OTS regulations include express statements of preemption.[313] Therefore, it is clear that both agencies intend to preempt state predatory lending statutes. The question then becomes whether the agencies are acting within the scope of their delegated authority. However, the analysis of OTS regulations issued under HOLA and OCC regulations issued under the National Banking Act (NBA)[314] is not the same.[315]

The Supreme Court has held that section 5(a) of HOLA gave the predecessor agency to the OTS "plenary authority to issue regulations governing federal savings and loans."[316] The National Banking Act, however, does not give the OCC comparable authority.[317] One court stated the difference as follows: "As to national banks, Congress expressly left open a field for state regulation and the application of state laws; but as to federal savings and loan associations, Congress made plenary, preemptive delegation . . . leaving no room for state supervision."[318]

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[313]*See* 12 C.F.R. § 560.2(a) (2005) (providing that the regulation "occupies the entire field for regulation of federal savings associations"); 12 C.F.R. § 34.4(a) (providing that"states laws that obstruct, impair, or condition a national bank's ability to fully exercise its Federally authorized real estate lending powers do not apply to national banks.").

[314]12 U.S.C. §§ 21 *et seq.* (2000).

[315]*See* Wilmarth, *supra* note 24, at 321-24.

[316]Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta, 458 U.S. 141, 160 (1982) (quoted in Wilmarth, *supra* note 24, at 322).

[317]*See* Wilmarth, *supra* note 24, at 322. *But see* Howard N. Cayne & Nancy L. Perkins, *National Bank Act Preemption: The OCC's New Rules Do Not Pose a Threat to Consumer Protection or the Dual Banking System,* 23 ANN. REV. BANKING & FIN. L. 365, 391-96 (2004) (arguing that the OCC does have authority to preempt state law).

[318]People v. Coast Federal Savings & Loan Ass'n, 98 F.Supp. 311 (S.D. Cal. 1951). Although only a district court case, other courts including the Supreme Court have cited Coast Federal for its holding as to the expansive authority of the OTS and its predecessor. *See* Wilmarth, *supra* note 24, at 323 (citing Fed. Fed. Sav. & Loan v. de la Cuesta, 458 U.S. 141, 145 (1982); Conference of Fed. Sav. & Loan Ass'ns v. Stein, 604 F.2d 1256, 1260 (9th Cir. 1979),

Other federal courts have distinguished the "broad preemptive authority of the OTS and the much more circumscribed power of the OCC."[319]

Commentators differ on whether the new OCC regulation is within the scope of Congressionally delegated power.[320] The focus of this article, however, is not on whether the OCC is authorized to preempt state predatory lending statutes, but rather on the normative issue as to whether the OCC should preempt state predatory lending laws. Part of the answer lies in the involvement of banks in predatory lending abuses. The OCC claims that banks have not been involved in predatory lending except to a very minor extent, but evidence to the contrary exists.

V. INVOLVEMENT OF FEDERALLY-SUPPORTED LENDERS IN THE SUBPRIME AND PREDATORY LENDING MARKETS

A. Banks and Thrifts

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aff'd mem., 445 U.S. 921 (1980); Bank of Am. v. San Francisco, 309 F.3d 551, 558-59 (9th Cir. 2002), cert. denied, 538 U.S. 1069 (2003)).

[319]Wilmarth, *supra* note 24, at 323 (citing North Arlington National Bank v. Kearny Federal Savings & Loan Ass'n, 187 F.2d 564, 567 (3rd Cir.), cert. denied, 342 U.S. 816 (1951); Bank of Am. v. San Francisco, 309 F.3d 551, 558-59 (9th Cir. 2002), cert. denied, 538 U.S. 1069 (2003); Nat'l State Bank v. Long, 630 F.2d 981, 989 (3rd Cir. 1980)).

[320]*See* Cayne & Perkins, *supra* note 317, at 391-96 (arguing that the OCC does have authority to preempt state law); Wilmarth, *supra* note 24, at 287-316 (arguing that the regulations are not within OCC's authority); Nicholas Bagley, Note, *The Unwarranted Regulatory Preemption of Predatory Lending Laws,* 79 N.Y. L. REV. 2274, 2274 (arguing that "the OCC overstepped its congressionally delegated authority when it promulgated the regulation").

Banks and thrifts are in fact involved in predatory lending in a number of ways. Some banks and thrifts or their subsidiaries and affiliates do originate predatory loans.[321] Furthermore, banks and thrifts can profit from predatory lending by purchasing predatory loans or securities backed by predatory loans, by lending to predatory lenders and thus financing their predatory lending practices, by providing securitization services to predatory lenders, and by steering customers who could qualify for prime loans to subprime loans.[322]

Some banks and thrifts are subprime lenders,[323] and some have practiced predatory lending abuses.[324] Banks and thrifts are increasingly involved in the subprime mortgage market through subsidiaries and affiliates,[325] and some of the subsidiaries and affiliates engage in

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[321] *See* NCLC Comments, *supra* note 24, at 3-6; Kathleen C. Engel & Patricia A. McCoy, *The CRA Implications of Predatory Lending,* 29 FORDHAM URB. L.J. 1571, 1575-76 (2002).

[322] *See* NCLC Comments, *supra* note 24, at 3-6; Engel & McCoy, *supra* note 321, at 1577-78. *See also* HUD/TREASURY JOINT REPORT, *supra* note 26, at 45 (discussing bank and thrift involvement in the subprime market).

[323] At the time of HUD/Treasury Joint Report, one percent of FDIC insured institutions were subprime lenders, defined as lenders with more than 25 percent of their equity capital in subprime loans. HUD/TREASURY JOINT REPORT, *supra* note 26, at 44.

[324] *See, e.g.,* McCarthy v. FDIC, 348 F.3d 1075, 1077 (9th Cir. 2003) (stating that the OTS closed Superior Bank because of its predatory lending practices); State of Arizona v. Hispanic Air Conditioning & Heating, Inc., CV 2000-003625 (2003); In the Matter of Clear Lake National Bank, San Antonio, Texas, OCC Enforcement Action 2003-135 (Nov. 7, 2003), *available at* http://www.occ.treas.gov/FTP/EAs/ea2003-135.pdf (finding violations of HOEPA, RESPA, TILA and the FTC Act). *See also* OCC, News Release, OCC Issued Final Rules on National Bank Preemption and Visitorial Powers, NR 2004-3 (Jan. 7, 2004) (quoting John Hawke as saying, "We have seen only isolated cases of abusive practices among national banks."); NCLC Comments, *supra* note 24, at 3-6 (listing cases against national banks for alleged predatory practices).

[325] *See* HUD/TREASURY JOINT REPORT, *supra* note 26, at 45. Banks, savings associations, and their affiliates originated approximately one quarter of all subprime loans in 1998, *id.,* and eight of the ten largest subprime lenders in 2000 were affiliated with banks, Engel & McCoy, *supra* note 321, at 1585 (citing Robert Julavits, *Subprime Risks Extending Beyond Borrowers,* AM. BANKER, Mar. 27, 2000, at 9).

predatory lending practices.[326] Bank affiliates, including Citigroup and Household, have paid huge sums in settlement of allegations of predatory lending practices.[327] Borrowers have sued national banks, their operating subsidiaries, or their affiliates for practices including fraud and misrepresentation, loan flipping, and violations of HOEPA, the Truth in Lending Act, the Real Estate Settlement Procedures Act, and state consumer protection laws.[328]

When banks make subprime loans or have affiliates that make subprime loans, they can steer customers who would qualify for a prime loan to a subprime loan or to their subprime affiliate.[329] Citifinancial is currently under investigation by the New York attorney general for steering customers to subprime loans.[330] Banks profit when borrowers pay more for credit than they should have to pay based on their credit histories.

Banks and thrifts also purchase predatory loans to hold or securitize or purchase securities backed by predatory loans.[331] When banks purchase predatory loans, they can generally take advantage of the holder in due course doctrine unless the loans are high cost mortgages as defined by HOEPA. When banks securitize loans, they generally employ various contractual forms of recourse that require the originator or seller to repurchase the loans in the

[326] *See supra* notes 23-24 and accompanying text.

[327] *See supra* notes 12, 17, and 23 and accompanying text.

[328] *See* NCLC Comments, *supra* note24, at 4-6.

[329] *See* Engel & McCoy, *supra* note 321, at 1578-80.

[330] *See Citigroup Violated Policy, supra* note 20, at C1.

[331] *See* NCLC Comments, *supra* note 24, at 3; Engel & McCoy, *supra* note 321, at 1576.

event they do not conform to certain standards.[332] Thus, banks and thrifts can profit from purchasing predatory loans or securities backed by predatory loans without concern for liability.

Banks have recently played an important role in securitizing subprime loans "because of their access to credit markets and their expertise in securitizing mortgages."[333] Banks may "serve as underwriters, trustees, registrars and paying agents for securitizations of subprime loans, some of which may be predatory."[334] National banks have served as trustees for notorious predatory lenders including Associates, Household Finance, Delta Funding, and First Alliance.[335]

Finally, banks may finance predatory lenders through warehouse lines of credit secured by the predatory loans.[336] With a warehouse line of credit, a mortgage company uses borrowed funds to originate mortgage loans that will eventually be packaged and sold on the secondary market or securitized.[337] Therefore, banks can facilitate the practices of predatory lenders by lending them the funds they use to make predatory loans. When banks hold predatory loans as security for a line of credit, they again can take advantage of the holder in due course doctrine unless the loans are high cost mortgages as defined by HOEPA.

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[332] *See* Eggert, *supra* note 144, at 548.

[333] HUD/TREASURY JOINT REPORT, *supra* note 26, at 45.

[334] Engel & McCoy, *supra* note 321, at 1577.

[335] *See* NCLC Comments, *supra* note 24, at 6-7.

[336] *See* HUD/TREASURY JOINT REPORT, *supra* note 26, at 45; Engel & McCoy, *supra* note 321, at 1577.

[337] *See* NELSON & WHITMAN, *supra* note 147, at 487. After each mortgage loan is made, the note and deed of trust are temporarily pledged to the bank as collateral for the line of credit. It is called a warehouse line of credit because "the mortgage loans are 'parked' in the bank's 'warehouse' for a short period (perhaps 30 to 90 days) until the mortgage company is ready to sell them to secondary market investors or securitize them." *Id.*

Banks and thrifts receive a number of federal benefits not available to others involved in the business of home mortgage lending. Banks and thrifts receive a gross federal subsidy from the federal safety net, which includes federal deposit insurance as well as access to the Federal Reserve's discount window and payment system.[338] First, the Federal Deposit Insurance Corporation (FDIC) insures deposits of member institutions up to $100,000,[339] and deposit insurance is backed by the full faith and credit of the federal government.[340] As a result, banks and thrifts can attract deposits for lower interest rates than uninsured institutions because the deposits are insured by the federal government. Even uninsured deposits have protection through the federal government's bank resolution practices.[341] In addition, banks and thrifts have access to the federal reserve system. The Federal Reserve's discount window provides a backup source of credit to banks,[342] and the Federal Reserve's payment system includes

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[338] *See* Engel & McCoy, *supra* note 321, at 1586; Frederick Furlong, *Federal Subsidies in Banking: The Link to Financial Modernization,* Fed. Res. Bank of S.F. Econ. Ltr. No. 97-31 (Oct. 24, 1997), *available at* http://www.frbsf.org/econrsrch/wklyltr/el97-31.html; Kenneth Jones & Barry Kolatch, *The Federal Safety Net, Banking Subsidies, and Implications for Financial Modernization,* 12 FDIC BANKING REV. 1, 1 (1999); Bevis Longstreth & Ivan E. Mattei, *Organizational Freedom for Banks: The Case in Support,* 97 COLUM. L. REV. 1895, 1895, 1917 (1997); Bernard Shull & Lawrence J. White, *The Right Corporate Structure for Expanded Bank Activities,* 115 BANKING L.J.446, 466 (1998); John R. Walter, *Can a Safety Net Subsidy Be Contained?,* 84 FED. RES. BANK OF RICHMOND ECONOMIC Q., Winter 1998, at 1, 2.

[339] *See* PATRICIA A. MCCOY, BANKING LAW MANUAL: FEDERAL REGULATION OF FINANCIAL HOLDING COMPANIES, BANKS AND THRIFTS § 8.03 [1][b][ii] (2nd ed. 2001 & cum. supps.). Bank deposits are insured by the Bank Insurance Fund and thrift deposits by the Savings Association Insurance Fund, both of which are administered by the FDIC and are funded with premiums paid by banks and thrifts, respectively. Jones & Kolatch, *supra* note 338, at 3 n.3.

[340] Jones & Kolatch, *supra* note 338, at 3. Resort to the full faith and credit of the U.S. Treasury was necessary to resolve the savings and loan crisis of the 1980s. *See id.*

[341] *See* Engel & McCoy, *supra* note 321, at 1586.

[342] *See* Jones & Kolatch, *supra* note 338, at 3.

overdraft protection for interbank transfers on Fedwire.[343] In addition to the federal safety net, banks' and thrifts' charters give them a quasi-oligopoly because entry by new competitors is controlled by government regulators.[344]

In exchange for the benefits they receive, banks and thrifts are highly regulated. National banks are regulated by the Office of the Comptroller of the Currency.[345] A primary aim of bank regulation is "to ensure the safe and sound practices and operations of individual banking institutions" and therefore to protect taxpayers and depositors.[346] "Banks have high regulatory compliance costs, including examination and reporting requirements, reserve requirements, and risk-adjusted deposit insurance premiums (although risk-adjusted premiums have been essentially toothless in recent years because most banks pay zero premiums)."[347] Thrift institutions also are heavily regulated by the Office of Thrift Supervision (OTS).[348]

Whether federal banks and thrifts receive a net federal subsidy, in other words, whether federal benefits that banks and thrifts receive outweigh regulatory costs, is the subject of

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[343] *See id.*

[344] *See* MCCOY, *supra* note 339, § 3.01; Engel & McCoy, *supra* note 321, at 1586.

[345] *See* MCCOY, *supra* note 339, § 2.02[2][a]. State chartered banks are regulated by their state's banking agency as well as by the Federal Reserve, in the case of state member banks, or the FDIC, in the case of state nonmember banks. *Id.*

[346] NELSON & WHITMAN, *supra* note 147, at 900 (quoting U.S. GENERAL ACCOUNTING OFFICE, BANK OVERSIGHT STRUCTURE: U.S. AND FOREIGN EXPERIENCE MAY OFFER LESSONS FOR MODERNIZING U.S. STRUCTURE (1996)).

[347] Engel & McCoy, *supra* note 321, at 1587.

[348] *See* MCCOY, *supra* note 339, § 2.02[2][b].

debate.[349] Some commentators have concluded that a net subsidy exists in bad economic times and that the subsidy is zero or slightly negative in good economic times.[350] The fact that banks choose to retain their charters provides some evidence that they at least believe that the federal subsidy outweighs the regulatory cost, and the same goes with respect to thrifts.[351]

Recent federal preemption of state law changes the balance in determining the existence of a net federal subsidy because federal preemption reduces regulatory costs for national banks and for thrifts. In fact, some predatory lenders have sought federal charters because of the benefits of federal preemption of state law.[352] "Associates and Commercial Credit applied for thrift charters in late 1997 and early 1998. Both companies stated that federal preemption of individual state regulations accorded federal savings associations was one reason for their application."[353] The OTS preemption of state lending laws for thrifts used to be an advantage of choosing a thrift charter over a bank charter.[354] The OCC has now evened the playing field by similarly preempting state laws for the benefit of banks which will reduce the regulatory compliance costs of banks. The visitorial powers preemption also reduces regulatory compliance

[349] *See* Engel & McCoy, *supra* note 321, at 1586-88; Furlong, *supra* note 338; Jones & Kolatch, *supra* note 338, at 9-10; Longstreth & Mattei, *supra* note 338, at 1918-19; Walter, *supra* note 338, at 9.

[350] *See* McCoy, *supra* note 339, § 4.02; Engel & McCoy, *supra* note 321, at 1587; Shull & White, *supra* note 338, at 466-67. In addition, banks engaging in riskier activities receive a larger subsidy than do safer banks. Jones & Kolatch, *supra* note 338, at 9.

[351] *See* Engel & McCoy, *supra* note 321, at 1587; Furlong, *supra* note 338.

[352] HUD/Treasury Joint Report, *supra* note 26, at 45 n.54.

[353] *Id.*

[354] *See* McCoy, *supra* note 339, §3.02.

costs. Thus, the reduction in regulatory costs increases the likelihood that a net federal subsidy does exist.

What is the relationship between any net federal subsidy and bank involvement in predatory lending? Certainly when banks or thrifts make predatory loans, purchase predatory loans, purchase securities backed by predatory loans, finance predatory lenders with warehouse lines of credit, they are profiting to the detriment of affected homeowners. In addition, bank affiliates involved in predatory lending activities may enjoy a spillover of any net federal subsidy.[355] A spillover can occur when a bank lends money to its affiliate or shifts riskier activities from an affiliate to the bank.[356]

Regardless of whether predatory lenders receive a benefit from any federal subsidy, banks and thrifts should avoid direct or indirect involvement in predatory lending activities. Banks enjoy a special status of trust in the minds of the public, which is perpetuated by the gross federal subsidy. Banks should not betray that trust by engaging in predatory lending activities or advancing the interests of predatory lenders. Thrifts and national banks should not be exempt from state consumer protection laws aimed at stemming the tide of predatory lending activities.

Banks are not the only entities involved in residential mortgage lending that receive special federal benefits. Fannie Mae and Freddie Mac also receive federal benefits and are subject to more federal regulation than purely private entities involved in mortgage lending. But Fannie Mae and Freddie Mac have taken an entirely different approach to the problem of predatory lending.

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[355] *See id.* § 4.02; Walter, *supra* note 338, at 9-10.

B. Fannie Mae and Freddie Mac

Fannie Mae and Freddie Mac are government sponsored enterprises--privately owned corporations operating under federal charters that impose restrictions on their activities and grant benefits that other private corporations do not enjoy. The President appoints five of the eighteen directors of both Fannie Mae[357] and Freddie Mac,[358] while the rest are elected by shareholders. Both Fannie Mae and Freddie Mac are regulated by the Office of Federal Housing Enterprise Oversight (OFHEO) and the U.S. Department of Housing and Urban Development (HUD). The benefits they receive as GSEs include exemption from state taxes except for real property taxes[359] and exemption from federal securities laws.[360] Since Fannie Mae and Freddie Mac are not government agencies, their guarantees are not backed by the full faith and credit of the federal government; however, there is an assumption that the federal government would honor their obligations in the event of financial trouble.[361]

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[356]*See* MCCOY, *supra* note 339, § 4.02; Engel & McCoy, *supra* note 321, at 1587-88; Walter, *supra* note 338, at 9-10.

[357]12 U.S.C. § 1723(b) (2000).

[358]*Id.* § 1452(a)(2)(A).

[359]*Id.* § 1433.

[360]*Id.* § 1455(g) , 1723(c).

[361]*See* U.S. GENERAL ACCOUNTING OFFICE, HOUSING ENTERPRISES: POTENTIAL IMPACTS OF SEVERAL GOVERNMENT SPONSORSHIP 17 (1996). *See also* Edmund L. Andrews, *Fed Chief Urges Cutback in Scale of 2 Big Lenders,* N.Y. TIMES, Feb. 18, 2005, at C1 ("Mr. Greenspan, who has long criticized both companies, said they had been able to borrow almost unlimited amounts of money at below-market rates by virtue of the widespread by false impression among investors that the federal government would ride to their rescue if necessary.")

Fannie Mae was the first GSE and had its origins during the Great Depression under the New Deal leadership of President Franklin D. Roosevelt. In response to problems of widespread foreclosures during the Depression and wide variation across the country in interest rates and availability of mortgages, President Roosevelt's National Emergency Council recommended the establishment of a program for long-term, federally-insured mortgages and the creation of national mortgage associations to purchase these mortgages.[362] Congress responded by creating the Federal Housing Administration (FHA) to insure home mortgage loans and by authorizing the charter of mortgage associations to purchase the insured mortgages.[363] In 1938 Congress chartered the Federal National Mortgage Association (FNMA, now called Fannie Mae).[364] FNMA was initially a government agency that issued bonds to raise funds for the purchase of FHA-insured mortgages and, beginning in 1944, Veteran's Administration (VA)-guaranteed mortgages as well.[365] In 1968 Congress divided the functions of Fannie Mae between two entities--Fannie Mae, which became a GSE and was allocated the secondary market operations of the former entity, and the Government National Mortgage Association (Ginnie Mae), which

[362]Regulations Implementing Authority of HUD Over Conduct of Secondary Market Operations of FNMA, 43 Fed. Reg. 36,200, 36,200 (Sept. 14, 1978). Until the 1930s, the typical home mortgage loans was for only a three- to five-year term. *Id.* Homeowners were required to refinance their homes frequently, and during the Great Depression when refinancing was not available, many lost their homes to foreclosure.

[363]*See id.* at 36,200-01 (citing National Housing Act of 1934, Pub. L. No. 479, 48 Stat. 1252 (1934)).

[364]*See id.* at 36,201. The association was originally named the National Mortgage Association of Washington, but was renamed the Federal National Mortgage Association later the same year. *Id.*

[365]*See id.*

remained a division of HUD and was given the special assistance and the management and liquidation functions of the former Fannie Mae.[366]

In 1970 the Emergency Home Finance Act created a new GSE, the Federal Home Loan Mortgage Corporation (Freddie Mac), and also authorized Fannie Mae to purchase conventional mortgages.[367] Freddie Mac started the trend towards mortgage securitization in the 1970s, while Fannie Mae continued to purchase mortgage loans to be held in its portfolio. Fannie Mae became involved in securitization in the 1980s. Today Fannie Mae and Freddie Mac are almost identical in their charters and functions. They both purchase home loans to hold in their portfolios but securitize even more loans.

When Fannie Mae and Freddie Mac securitize loans, the GSEs themselves issue the securities.[368] The securities are backed by a pool of mortgage loans, and holders of the securities generally receive their pro rata share of principal and interest payments.[369] In some cases the securities are guaranteed by Ginnie Mae. In most cases no credit enhancement in necessary because of the implied federal guarantee of Fannie Mae and Freddie Mac's obligations.

Through their purchases and securitization of residential mortgage loans, Fannie Mae and Freddie Mac together provide the largest source of home mortgage financing in the nation. For example, in 2001 Fannie Mae and Freddie Mac together purchased or securitized forty percent of

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[366]*See id.* (citing Housing and Urban Development Act of 1968, Pub. L. No. 90-448, § 802(c), 82 Stat. 476, 536 (1968) (codified at 12 U.S.C. § 1716(h) (2000)).

[367]Pub. L. No. 91-351, § 201, 84 Stat. 450, 450-51 (1971) (codified as amended at 12 U.S.C. § 1717 (2000)).

[368]Private securities offerings are usually made by a special purpose entity created for the purpose of issuing the securities. *See infra* notes 164-66 and accompanying text,

all conventional mortgages originated that year.[370] Fannie Mae purchased $568 billion of residential mortgage loans and issued $515 billion of mortgage-backed securities in 2001, while Freddie Mac purchased $393 billion of residential mortgage loans and issued $387 billion of mortgage-backed securities in the same year.[371] Fannie Mae and Freddie Mac thus facilitate the flow of money into the residential mortgage market in accordance with the purposes set out in their charters.

In the late 1980s, housing advocates believed that the underwriting guidelines used by Fannie Mae and Freddie Mac favored white suburban homebuyers.[372] In response Congress enacted the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (FHEFSSA) to give Fannie Mae and Freddie Mac incentives to increase their purchase of loans to low and moderate-income families and in low and moderate-income neighborhoods.[373] The Act required HUD to set affordable housing goals for loans purchased by Fannie Mae and Freddie Mac,[374] and mandated that Fannie Mae and Freddie Mac "lead the industry in affordable lending."[375] It also prohibited them from discriminating on the basis of prohibited factors.[376]

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[369]These securities are called "pass-through" securities. The GSEs also issue other types of securities.

[370]OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT, MORTGAGE MARKETS AND THE ENTERPRISES IN 2001 13 (2002).

[371]*Id.* at 13, 17.

[372]BRENT W. AMBROSE & THOMAS G. THIBODEAU, HUD, AN ANALYSIS OF THE EFFECTS OF THE GSE AFFORDABLE GOALS ON LOW-AND MODERATE-INCOME FAMILIES 2 (2002).

[373]Pub. L. No. 102-550, tit. 13,

[374]*Id.* §1331(a) (codified at 12 U.S.C. § 4561(a) (2000)). HUD set goals for loans secured by homes of low- and moderate-income homeowners/renters at 50 percent and loans located in underserved areas at 31 percent. *See* AMBROSE & THIBODEAU, *supra* note 372, at vii.

[375]*See* SENATE REPORT 102-282 § 35.

Finally, the Act established the Office of Federal Housing Enterprise Oversight as an office of HUD to monitor both Fannie Mae and Freddie Mac.[377]

A recent study sponsored by HUD considered the impact of the affordable housing goals required by the FHEFSSA on low and moderate-income families.[378] The study found that the goals helped make homeownership more attainable for these families.[379] In response to FHEFSSA, Fannie Mae and Freddie Mac adopted more flexible underwriting standards and introduced automated underwriting systems which reduced underwriting costs. As a result, lenders that sell loans to Fannie Mae and Freddie Mac began using more flexible underwriting standards that permitted more borrowers to qualify for the loans.[380] In addition, purchases by Fannie Mae and Freddie Mac of loans to lower income borrowers and in target neighborhoods increased liquidity and allowed additional lending activity to these borrowers and in these neighborhoods.[381] The study suggests that the affordable housing goals have thus helped make homeownership more attainable to low and moderate-income families.

In the late 1990s, both GSEs were accused of being involved in the predatory lending problem by purchasing and securitizing subprime loans that could be characterized as predatory. Both Fannie Mae and Freddie Mac responded immediately with initiatives to avoid purchasing

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[376] *See* Pub. L. No. 102-550, tit. 13, § 1325(1) (codified at 12 U.S.C. §4545 (2000)).

[377] *Id.* § 1311 (codified at 12 U.S.C. §4511 (2000)).

[378] AMBROSE & THIBODEAU, *supra* note 372, at vii.

[379] *Id.* at ix.

[380] *Id.* at vii-ix.

[381] *Id.* at ix.

or securitizing predatory loans.[382] Fannie Mae will not purchase or securitize loans with points and fees in excess of five percent, loans identified as "high-cost" mortgages under HOEPA, loans with prepaid single premium credit insurance, or loans with prepayment premiums unless the borrower has received a benefit.[383] Fannie Mae requires its lenders to determine the borrower's ability to repay, to avoid steering borrowers to higher-cost loans if they qualify for a lower-cost loan, to report a borrower's entire payment history to credit repositories (to improve the borrower's credit history), and to maintain escrow deposit accounts.[384] Freddie Mac will not purchase HOEPA loans, loans with single premium credit insurance, loans with prepayment penalties that continue for more than three years, or loans with mandatory arbitration clauses.[385] Freddie Mac requires its lenders to report a borrower's entire payment history to credit repositories and refuses to purchase loans from lenders that engage in predatory lending practices.[386]

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[382] *See* Fannie Mae, News Release, Fannie Mae Chairman Announces New Loan Guidelines to Combat Predatory Lending Practices (Apr. 11, 2000) *at* http://www.fanniemae.com/newsreleases/2000/0710.jhtml [hereinafter Fannie Mae News Release] (citing Lender Letter LL03-00, Eligibility of Mortgages to Borrowers with Blemished Credit Histories, 4/11/00); Freddie Mac, News Release, Freddie Mac Announces Steps to Protect Borrowers from Predatory Lending Practices (Mar. 24, 2000), *at* http://www.freddiemac.com/news/archives2000/predatory.htm.

[383] *See* Fannie Mae News Release, *supra* note 382.

[384] *See id.*

[385] *See* Freddie Mac, Combating Predatory Lending, Freddie Mac's Efforts to Protect America's Consumers, *at* http://www.freddiemac.com/singlefamily/anti-predatory.html

[386] *See id.*

More recently, the GSEs have been criticized on the basis that they are failing to "lead the industry in affordable housing."[387] While the GSEs have become involved in the subprime market, their involvement has been primarily limited to purchasing loans to A- borrowers.[388] They have not purchased or securitized loans to B, C, and D rated borrowers. HUD has encouraged both GSEs to become involved in subprime mortgage lending to a greater extent.[389]

Several states exempted the GSEs from the application of their predatory lending statutes or limited the application of the statutes to the GSEs.[390] The GSEs sought exemption from Georgia's statute before it was enacted, but received negative publicity for doing so.[391] As a result, they withdrew their proposal and have since avoided seeking additional exemptions or limitations.[392] Thus, the GSEs have continued to purchase and securitize loans in all fifty states in compliance with state predatory lending statutes in those states that have such statutes and have not exempted the GSEs.

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387 David S. Hilzenrath, *HUD Chief Criticized Fannie Mae,* WASH. POST, July 2, 2004, at E02. In recent years, Fannie Mae and Freddie Mac have been criticized on numerous fronts. They have been criticized on the basis that they have an unfair competitive advantage over wholly private mortgage investors, based on concerns about their financial stability and the feared effects of their failure on the national economy, and because of misleading financial disclosures. *See* Andrews, *supra* note 361, at C1; Stephen Labaton, *Limits Urged in Mortgage Portfolios,* N.Y. TIMES, Apr. 7, 2005, at C1.

388 *See* GAO REPORT, *supra* note 26, at 74; HUD/TREASURY JOINT REPORT, *supra* note 26, at 46. The GSEs also purchase loans to "Alt-A" borrowers, "prime borrowers who desire low down payments or do not want to provide full documentation for loans." *Id.* at 46 n.56.

389 *See* Hilzenrath, *supra* note 387, at E02.

390 *See, e.g.,* D.C. and California ; *see also* Donald C. Lampe, *Predatory Lending Initiatives, Legislation and Litigation: Federal Regulation, State Law and Preemption,* 56 CONSUMER FIN. L.Q. REP. 78, 84 (2002).

391 Patrick Barts, *Fannie Mae in Tiff Over Abusive Loans,* WALL ST. J., Apr. 24, 2002, at A1.

The GSEs, therefore, have taken a very different approach to the problem of predatory lending from that of banks and thifts. The GSEs have become involved in the purchase and securitization of subprime loans, have adopted policies designed to avoid the purchase of loans with predatory terms, and have for the most part remained subject to compliance with state laws. National banks and thrifts on the other hand have claimed their hands to be clean and have now avoided the requirement of complying with state law. In the defense of banks, they have been involved in the subprime market beyond the A- credit level. However, by avoiding compliance with state law, some banks can remain a part of the problem.

VI. FEDERAL LAW SHOULD NOT PREEMPT STATE PREDATORY LENDING STATUTES

Although the validity of the OCC's preemption of state lending laws for national banks is still in question,[393] no doubt exists that Congress may if it chooses preempt state predatory lending statutes altogether or may expressly grant to federal agencies the power to preempt the statutes as applied to banks and thrifts. The issue then is the normative case for federal preemption of state predatory lending laws; that is, whether Congress should preempt state predatory lending laws for all lenders, as would the bill currently before it, and whether federal agencies should preempt the laws for thrifts, banks, and their operating subsidiaries.

A. States Traditional Role in Real Estate Finance and in Consumer Protection

[392] *See* Lampe, *supra* note 390, at 84.

[393] *See supra* Part IV.D.

Real estate finance law was traditionally an area governed by the states. Although the federal government became involved in creating housing policies and housing programs during the New Deal, it was only in the 1960s that the federal government first became involved in direct regulation of real estate finance.[394] Most of the early statutes were disclosure laws that created a minimum standard.[395] Congress made it clear that these statutes were only to preempt state law to the extent of a conflict.[396] Although Congress has acted in several areas to expressly preempt state law,[397] the bulk of law governing real estate finance is still state law.

Consumer protection also has traditionally been primarily a state responsibility. While the federal government has also been involved in specific areas of consumer protection, particularly through the FTC, these measures have traditionally been in addition to state consumer protection laws and have been treated as creating a minimum standard rather than preempting the field. HOEPA creates a minimum standard, but does not otherwise preempt state law.[398]

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[394] *See* Alexander, *supra* note 225, at 311-13.

[395] *See, e.g.,* Truth-in-Lending Act of 1968 (TILA), Pub. L. No. 90-312, tit. I, 83 Stat. 146 (codified as amended at 15 U.S.C. §§ 1601-1665 (2000)); Real Estate Settlement and Procedures Act of 1974 (RESPA), Pub. L. No. 95-533, § 4, 88 Stat. 1724, 1725 (1974) (codified as amended at 12 U.S.C. § 2603 (2000)). *See also* Kathleen Keest, *The Consumer Lending Revolution: Economic Consequences, The Regulatory & Legislative Framework, available at* www.responsiblelending.org ("[TILA and RESPA] were additions to, not substitutes for, the substantive regulation in state law. Disclosure was not the endgame, and federal law generally set the floor, not the ceiling.").

[396] *See* Alexander, *supra* note 225, at 315.

[397] *See* DIDMCA, 12 U.S.C. § 1735f -7a (2000); Parity Act, 12 U.S.C. § 3803 (2000); Garn-St. Germain Depository Institutions Act of 1982, 12 U.S.C. § 1701j-3 (2000).

[398] *See* Ill. Ass'n of Mortgage Brokers v. Office of Banks & Real Estate, 308 F.3d 762, 766 (2002), quoted *supra* in note 295.

Because of the tradition of state governance of real estate finance and consumer protection laws, advocates of federal preemption of state law bear the burden to support a change in policy and show that federal regulation would be superior. While there are advantages to uniformity, they are not outweighed by the benefits of letting each state choose its approach to the problem of predatory lending.

B. The Role of State and Federal Government

1. Our Federal System

Numerous advantages exist to a system of varying state laws, and the Supreme Court outlined those advantages in *Gregory v. Ashcroft*:

> This federalist structure of joint sovereigns preserves to the people numerous advantages. It assures a decentralized government that will be more sensitive to the diverse needs of a heterogenous society; it increases opportunity for citizen involvement in democratic processes; it allows for more innovation and experimentation in government; and it makes government more responsive by putting the States in competition for a mobile citizenry.[399]

The fact that different states have reacted differently to the problem of predatory lending indicates a need for different solutions. The fifty states vary along racial, religious, and cultural

[399] 501 U.S. 452, 458 (1991) (citing McConnell, *Federalism: Evaluating the Founders' Design,* 54 U. CHI. L. REV. 1484, 1491-1511 (1987); Merritt, *The Guarantee Clause and State Autonomy: Federalism for a Third Century,* 88 COLUM. L. REV. 1, 3-10 (1988)).

lines,[400] and the differences among the states have resulted in varying political climates and differing approaches to societal issues.[401] The differences are apparent in the types of consumer protection measures that a state may adopt for home mortgage borrowers. Some states take an activist approach to protecting consumers with statutory rights of redemption,[402] one action rules,[403] stringent limitations on deficiency judgments,[404] and strong predatory lending laws.[405] Other states take a more "hands off" approach favoring business interests.

State legislatures can be responsive to their citizens in a way that the federal government cannot. Congress may enact laws that are responsive to the needs of most Americans but that may not be responsive to the needs of the citizens of a particular state. Two empirical studies suggest that state legislators are responsive to public opinion in their states.[406] Not surprisingly,

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[400] *See* Michael H. Schill, *Uniformity or Diversity: Residential Real Estate Finance Law in the 1900s and the Implications of Changing Financial Markets,* 64 S. CAL. L. REV. 1261, 1301 (1991).

[401] *Id.*

[402] *See, e.g.,* ARIZ. REV. STAT. ANN. § 12-1282 (2003); CAL. CIV. CODE §§ 729.010-90, 726(e); KAN. STAT. ANN. § 60-2414 (1994); MINN. STAT. §§ 580.23, 580.24 (2000); TENN. CODE ANN. §§ 66-8-101, 66-8-102 (2004).

[403] *See, e.g.,* CAL. CIV. CODE § 726(a); NEV. REV. STAT. § 40.430 (2002); UTAH CODE ANN. § 78-37-1 (2002).

[404] *See, e.g.,* CAL. CIV. CODE § 726(b); N.C. GEN. STAT. § 45-21.36 (2003); UTAH CODE ANN. § 57-1-32 (Supp. 2005).

[405] *See supra* notes 112-22 and accompanying text.

[406] Schill, *supra* note 400, at 1311-12. One study used the percentage of votes for George McGovern in the 1972 presidential election to indicate the liberal or conservative nature of a state compared with liberal state policies. David C. Nice, *Representation in the States: Policymaking and Ideology,* 64 SOC. SCI. Q. 404, 405-06 (1983). The other study used a survey which asked residents of different states whether they considered themselves to be liberal, conservative or moderate and compared the results with state policies. Gerald C. Wright, Jr., Robert S. Erikson & John P. McIver, *Public Opinion and Policy Liberalism in the American States,* 31 AM. J. POL. SCI. 980, 985 (1987).

the studies conclude that laws of more liberal states reflect liberal policies while the laws of more conservative states reflect more conservative policies.[407] Therefore, legislatures in more liberal states may enact tougher consumer protection measures, while legislatures in more conservative states may regulate subprime lenders to a lesser degree.

Another advantage of state regulation is that it allows for experimentation with different approaches.[408] When one state finds an effective solution, others can follow.[409] When a state chooses an approach that does not work, it affects fewer people than would a federal law.[410] And states can learn from the mistakes made in other states.

Critics of state predatory lending statutes say that state legislatures cannot react quickly enough to remedy ineffective attempts at stemming predatory lending practices, and may therefore cut off the flow of legitimate credit to their states. However, experience has shown that state legislatures have been able to react quickly. For example, when state law threatened to restrict the availability of credit in Georgia, the legislature acted quickly to revise the law.[411]

Today state legislatures are more able to react quickly and responsively to state concerns. New or amended constitutions in many states now permit annual sessions of the legislature and

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[407] *See* Nice, *supra* note 406, at 408; Wright et al., *supra* note 406, at 989.

[408] *See generally* Baher Azmy, *Squaring the Predatory Lending Circle: A Case for States as Laboratories of Experimentation,* 57 FLA. L. REV. 295 (2005).

[409] For example, North Carolina's predatory lending statute has been emulated, and the assignee liability provisions of Georgia's law have been copied. *See supra* notes 122 and 138 and accompanying text.

[410] Georgia legislators obviously felt that they had made a mistake in the original statute, but only the people of Georgia were affected and only for a short time. *See supra* notes 135-36 and accompanying text.

[411] *See infra* note 136 and accompanying text.

have removed limits on the length of sessions.[412] Legislators have higher salaries and professional staffs available to assist them,[413] providing legislatures with more adequate resources to react to state needs and the desires of their constituents.

2. Law Enforcement

Federal law enforcement has been very successful in prosecuting the largest predatory lending offenders,[414] but states are more effective in prosecuting local and smaller actors.[415] It is unlikely that the FTC or the Federal Reserve Board would prosecute small, localized mortgage bankers and mortgage brokers. They are simply too small to attract the attention of these large federal actors who will generally allocate their resources to the larger offenders. Yet it is very often the local mortgage bankers, mortgage brokers, and contractors that are at the root of the predatory lending problem.[416] State attorneys general and local officials on the other hand are equipped to prosecute the small actors. Also, state and federal governments can more effectively work together if the hands of state and local officials are not tied.

3. Federal Law as a Minimum Standard

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[412] *See* ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, THE QUESTION OF STATE GOVERNMENT CAPABILITY 45-49 (1985), *cited in* Schill, *supra* note 400 at 1306.

[413] *See* Schill, *supra* note 400, at 1307 (citing Alan Rosenthal, *The Legislative Institution: Transformed and at Risk, in* THE STATE OF THE STATES 69, 73-75 (Carl E. Van Horn, ed. 1989) and JEFFREY R. HENIG, PUBLIC POLICY AND FEDERALISM 40 (1985)).

[414] *See supra* notes 12-15 and 100-03 and accompanying text.

[415] *See* HUD/TREASURY, *supra* note 26, at 83.

[416] *See supra* notes 172-77 and accompanying text.

The tradition of federal law in the areas of real estate finance and consumer protection has been to set the minimum standard.[417] HOEPA was enacted in this tradition, and states have been free to set higher standard. Thus, some state legislatures have felt a need to protect their residents by enacting additional and stronger measures. Other state legislatures have enacted state law with the same level of protection as HOEPA, while still others have not acted at all.[418]

A stronger federal law as minimum standard would eliminate the need for individual states to act. However, a significantly stronger federal law is unlikely in today's political climate.[419] One proposed bill before Congress would weaken HOEPA, while at the same time expressly preempting state predatory lending laws.[420] If Congress continues to set a low minimum standard, then states should be free to act. If Congress wants uniformity, then it needs to set a higher bar.

C. "Onerous" Provisions of State Statutes

One of the objections that proponents of preemption have to state predatory lending statutes is that their terms are too burdensome for lenders.[421] Advocates for the subprime lending

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[417] *See supra* subpart A.

[418] *See supra* Part II.B.

[419] Congress recently enacted a Bankruptcy Reform bill that is not favorable to debtors. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (codified in scattered sections of 11 U.S.C.).

[420] *See supra* notes 275-76 and accompanying text.

[421] *See Hearing on Legislative Solutions, supra* note 37, at 3-4 (statement of Steve Nadon, Chairman, Coalition for Fair & Affordable Lending), 3 (statement of Micah S. Green, President, The Bond Market Ass'n), 4 (statement of Jim Nabors, President-Elect of the Nat'l Ass'n of Mortgage Brokers).

industry argue that borrowers should have the option to choose a prepayment penalty provision in order to get a lower interest rate,[422] and that yield spread premiums should not be included in the trigger for determining a high cost loan because the fees benefit homeowners.[423] They argue that homeowners should have more choices while ignoring the reality that the unsophisticated homeowners who fall victim to predatory lenders do not have the bargaining power or the understanding to make meaningful choices.

Critics of state regulation of predatory lending are particularly opposed the extension of liability to assignees of predatory loans.[424] With regard to the issue of assignee liability, the experiences of Georgia and New Jersey are instructive. When liability for assignees went too far, the rating agencies would not rate securities, so lenders would not lend. But under Georgia's current regime of assignee liability, as well as in New Jersey, the rating agencies have continued to rate securities, and lenders have continued to lend.

Creation of assignee liability is one of the most effective means of dealing with predatory lenders. The parties that buy and securitize mortgage loans are involved in multiple transactions, while consumers are not. Consumers cannot simply go to another lender after a bad experience with the first, but the parties who purchase loans to securitize them or hold them in portfolio can. Also, investors can and do protect themselves with buyback provisions. As a result, purchasers of mortgage loans on the secondary market are the parties best equipped to police the originators.

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[422] *See id.* at 4 (statement of Steve Nadon, Chairman, Coalition for Fair & Affordable Lending).

[423] *See id.* at 6 (statement of Steve Nadon, Chairman, Coalition for Fair & Affordable Lending), 3 (statement of Jim Nabors, President-Elect of the Nat'l Ass'n of Mortgage Brokers).

[424] *See id.* at 8 (statement of Steve Nadon, Chairman, Coalition for Fair & Affordable Lending), 4 (statement of Micah S. Green, President, The Bond Market Ass'n).

Assertions of the need for uniformity may simply be a smoke screen for those who simply want lower standards of consumer protection.[425] The conservative lawmakers who are pushing for federal preemption are the same lawmakers who would usually champion states rights and favor state law over federal law. The current Republican-dominated Congress has shown itself more likely to adopt measures that are not as consumer-friendly as some states. Preemption of state law is therefore one way to support lending interests and ensure a low level of consumer protection. The result, of course, is that predatory lending practices continue with little effective curtailment.

D. Availability of Credit

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[425] *See* Christopher L. Peterson, *Federalism and Predatory Lending: Unmasking the Deregulatory Agenda,* 78 TEMP. L. REV. 1, 8 (2005).

If uniformity in predatory lending laws is desirable, then another approach is through uniform state law. Through the uniform law adoption process, the National Conference of Commissioners on Uniform State Laws can consider the views of the various interest groups. They can also consider the success and failure of various state approaches. With a uniform act available, state legislatures can still be flexible and responsive to the needs of their constituents by making changes to the uniform act or by not adopting it at all.

Attempts to promulgate broad uniform statutes covering real estate finance have not been effective. No state adopted either the Uniform Land Transactions Act adopted by NCCUSL in 1974 or the Uniform Land Security Interest Act adopted by NCCUSL in 1985. *See* NELSON & WHITMAN, *supra* note 147, at 670. In 2002, the NCCUSL promulgated the Uniform Nonjudicial Foreclosure Act. It has yet to be adopted in any state. More limited attempts at reform have been effective, however, with states adopting uniform acts relating to condominiums and risk of loss in real estate contracts. *See id.*, at 91. A uniform act regulating predatory lending practices might be an effective means for making the law more uniform while preserving the ability of states to be responsive to their citizens. A disadvantage would be the lengthy time frame that drafting and adoption would require.

Critics of state predatory lending statutes say that they will reduce the amount of subprime credit available.[426] It is true that measures addressing predatory lending keep some loans from being made. However, some loans simply should not be made because their terms are too onerous or unfair. In some cases, the borrower could obtain a loan on better terms from a legitimate subprime lender. However, if the borrower cannot repay the loan, the borrower should not be extended the credit. In the legitimate subprime lending market, A- borrowers typically pay interest rates that are about a half of a percent higher than prime borrowers. C and D borrowers pay interest rates as much as four percent above prime rates.[427] Lenders who charge much higher interest rates on a fully secured home mortgage loans are simply taking advantage of borrowers.

Furthermore, critics of state predatory lending statutes have not provided evidence that the statutes have in fact reduced the availability of legitimate subprime credit. In fact, North Carolina proves otherwise. Since the North Carolina statute became effective in 2000, subprime loans have remained available, while the incidence of predatory loans and loans with unfair terms has decreased.[428] Certainly, the proponents of federal preemption who seek to remove state control over local predatory lending problems have the burden to prove that the state statutes do in fact affect the availability of subprime credit.

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[426]*See Hearing on Legislative Solutions, supra* note 37, at 3-4 (statement of Steve Nadon, Chairman, Coalition for Fair & Affordable Lending), 3 (statement of Micah S. Green, President, The Bond Market Ass'n), 4 (statement of Jim Nabors, President-Elect of the Nat'l Ass'n of Mortgage Brokers).

[427]*See* HUD/TREASURY, *supra* note 26, at 28.

[428]*See Hearing on Legislative Solutions, supra* note 37, at 2 (statement of Martin Eakes, CEO, Self-Help and the Center for Responsible Lending). *See also* notes 121-25 and accompanying text.

E. Efficiency Concerns

Proponents of federal preemption assert that the mortgage market cannot operate efficiently with a patchwork of state requirements.[429] Lenders argue that it is too burdensome for them to comply with different requirements in each state. They argue that the cost of compliance will increase the cost of credit or make it unavailable.

These concerns are not valid for two reasons. First, because origination is a local function, the originator can and should be responsible for compliance with local law. Secondly, originators and investors in mortgage loans are already required to comply with a patchwork of state laws, so the cost of additional state law restrictions should not be overestimated.

1. Horizontal Segmentation of the Mortgage Market Makes Compliance With State Law More Practical

Unlike earlier times, when mortgage markets were local, today's mortgage market is a national, or even international market. Today the market is not segmented by locale, but rather by function, with the ownership and investment functions existing separately from origination and servicing. While capital comes into the mortgage market at a national level, origination is still primarily a local function. Most mortgage bankers and mortgage brokers have offices in the markets in which they operate, particularly in the subprime market.

[429] *See Hearing on Legislative Solutions, supra* note 37, at 3-4 (statement of Steve Nadon, Chairman, Coalition for Fair & Affordable Lending), 3 (statement of Micah S. Green, President, The Bond Market Ass'n), 4 (statement of Jim Nabors, President-Elect of the Nat'l Ass'n of Mortgage Brokers).

An investor in mortgages or mortgage-backed securities does not have to know how to comply with local law, but can leave that function to the originator.[430] Since most predatory lending issues arise at origination, it is appropriate that the originator, typically with a local office, be charged with state law compliance. Purchasers of mortgages can and do protect themselves with buy back requirements –requirements that the originator buy back any loans that do not meet certain standards. So losses related to non-compliance with state law occur only when the originator is judgment proof or bankrupt. Ultimately, purchasers of mortgages can protect themselves by carefully selecting the originators with whom they do business.[431]

2. Lenders Already Comply With Varying State Requirements

Because real estate finance law has always been to a great extent state law, a patchwork of state law already exists. States differ in their mortgage theory,[432] in the availability of and requirements for pre-foreclosure remedies,[433] in the type of foreclosure permitted,[434] in the

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[430]Servicers also must comply with local law, but at a different stage of the process. Most predatory lending issues arise at origination.

[431]This is one approach that Freddie Mac has used in its efforts to combat predatory lending. *See supra* note 386 and accompanying text.

[432]Three theories of mortgages exist in the United States–title theory, lien theory and intermediate theory. *See* Robert Kratovil, *Mortgages–Problems in Possession, Rents, and Mortgage Liability,* 11 DEPAUL L. REV. 1, 4-5 (1961). In title theory states a mortgage lender is treated as having title, in a sense, to the mortgaged property. *Id.* In lien theory states a mortgage lender is treated as having only a security interest in the mortgaged property and may not take possession until after foreclosure. *Id.* In intermediate theory states a mortgage lender has a hybrid interest. which gives the lender the right to possession of the property after a default under the mortgage. *Id.* The majority of states are lien theory states. *See* GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 4.2 (4th ed. 2001).

[433]In title theory states, the lender has the right, in theory, to possess the property at the time the borrower executes the mortgage. As a practical matter, however, borrowers retain

logistics of power of sale foreclosure where it is permitted,[435] in the availability of a deficiency,[436] and in the availability and means of statutory redemption after foreclosure.[437] As a result, loan documents vary greatly from state to state. Closing practices also vary greatly from state to state with loan closings typically handled by title companies in some states, by lenders in other states, and by attorneys in still other states.[438]

Since lenders must already deal with this patchwork of laws and practices in the various states, adding requirements under a predatory lending statute is not as onerous is it would seem. Lenders must already have separate loan documents, disclosure documents, closing

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possession until default by agreement with the lender. *See* NELSON &WHITMAN, *supra* note 432, § 4.1; *see also* Mass. Ann. Laws ch. 183, § 26 (giving the borrower a statutory right to possession until default in the absence of an agreement to the contrary). In intermediate theory states, the lender has the right to possession of the property after a default. Kratovil, *supra* note 432, at 4-5. In lien theory states, the lender may only take possession after foreclosure. *Id.* at 5-6. However, many lien theory states permit the lender to take possession of the property after default by agreement with the borrower. *See, e.g.,* Kinnison v. Guaranty Liquidating Corp., 115 P.2d 450, 452 (Cal. 1941); Topeka Sav. Ass'n v. Beck, 428 P.2d 779, 782 (Kan. 1967); Central Sav. Bank v. First Cadco Corp., 181 U.W.2d 261, 264 (Neb. 1970); Carlquist v. Coltharp, 248 P. 481, 483 (Utah 1926).

States differ in the requirements that a lender must meet in order to obtain the appointment of a receiver, NELSON &WHITMAN, *supra* note 432, § 4.33, and in the effect given an assignment of rents, Julia P. Forrester, *A Uniform and More Rational Approach to Rents as Security for the Mortgage Loan,* 46 RUTGERS L. REV. 349, 361-62 (1993).

[434] About thirty states permit power of sale foreclosure, while the rest permit only judicial foreclosure. *See* NELSON &WHITMAN, *supra* note 432, § 7.19.

[435] *See id.* States vary greatly in their requirements for notice of a foreclosure sale, with variations including the method of notice, the notice period, and the parties who must be given notice. *See id.*

[436] *See id.* § 8.1. Some states prohibit a deficiency judgment under certain circumstances, while others limiting the amount of the deficiency. *See id.* § 8.3.

[437] More than half of the jurisdictions have statutory redemption, but the specifics of the various statutes vary greatly. *Id.* § 8.4.

[438] *See* NELSON &WHITMAN, *supra* note 147, at 244.

requirements, and closing practices for each state in which they do business. Therefore, adding an additional state law variable should not increase the cost to the extent that proponents of preemption claim.

Evidence exists that interest rates are relatively insensitive to the variation in state mortgage law.[439] Additional protection for mortgagors under state law does not increase interest rates to the extent that critics have proposed.[440] Therefore, it is difficult to support preemption of state law considering the longstanding tradition of state law in the areas of real estate and consumer protection and considering the advantages offered by giving states autonomy over protecting their residents.

F. The Role of Federally-Supported Lenders

1. Fannie Mae and Freddie Mac

Although Fannie Mae and Freddie Mac currently operate within the patchwork of state laws for real estate finance and the new predatory lending laws, the GSEs have been criticized for their failure to "lead the market" in loans to low-income families and in low-income neighborhoods.[441] Indeed, the GSEs should expand their role in leading the market by purchasing more than just A- subprime loans. A large majority of subprime borrowers fall into the A- category anyway, substantially fewer into the B category, and fewer still in the C and D

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[439] *See* Michael H. Schill, *An Economic Analysis of Mortgagor Protection Laws,* 77 VA. L. REV. 489, 491 (1991).

[440] *See id.*

[441] *See supra* notes 387-89 and accompanying text.

categories.[442] Therefore, a small presence in supporting loans in these lower categories will have a larger impact on the markets for these loans.

In addition, Fannie Mae and Freddie Mac can lead the market by creating standards for subprime loans. One of the roles of Fannie Mae and Freddie Mac in promoting the smooth operation of housing finance market has been to create sets of forms for home mortgage lenders to use in the various states.[443] In the prime market, even lenders who do not intend to sell their loans to the GSEs tend to use these forms because the uniformity makes their loans more marketable on the secondary market.[444] In addition, Fannie Mae and Freddie Mac have created automated underwriting systems for the prime market and more recently for A- subprime loans.[445] The GSEs can further their goal of leading the market by producing forms for subprime loans that comply with the patchwork of predatory lending laws and by creating underwriting standards for subprime lending.

2. Federally Chartered Banks and Thrifts

[442] "The National Home Equity Mortgage Association reports that the "A-minus" segment makes up 60 percent, the "B" segment 30 percent, the "C" segment 9 percent, and the "D" segment 1 percent of the market. *Inside B&C Lending* reports that the "A-minus" segment makes up 73 percent, the "B" segment 13 percent, the "C" segment 9 percent, and the "D" segment 5 percent of the market." HUD/TREASURY JOINT REPORT, *supra* note 26, at 34 (citing *Correspondents Reign Supreme in 1999*, INSIDE B&C LENDING, Mar. 10, 2000).

[443] *See* http://www.efanniemae.com/sf/formsdocs/documents/; http://www.freddiemac.com/uniform/.

[444] *See* Ronald J. Mann, *Searching for Negotiability in Payment and Credit Systems,* 44 U.C.L.A. L.REV. 951, 971 (1997).

[445] KENNETH TEMKIN, JENNIFER E. H. JOHNSON, DIANE LEVY, THE URBAN INSTITUTE, FOR U.S. DEPT. OF HOUSING & URBAN DEVELOPMENT, SUBPRIME MARKETS, THE ROLE OF GSES,

Banks and thrifts argue that they have not been part of the predatory lending problem and should therefore be exempt from state laws. While few banks may have been directly involved in originating predatory loans, they have been involved through affiliates, by purchasing predatory loans and securities backed by predatory loans, and by financing predatory lenders.[446] Further, it is likely that current federal regulations preempting banks and their operating subsidiaries from the operation of state predatory lending laws will make it easier for banks to be involved in predatory lending. For example, banks can now move their subprime lending operations into operating subsidiaries to avoid the operation of state law, and banks themselves can purchase or take security interests in predatory loans without fear of the assignee liability provisions of state law.

Theoretically, the OCC will be monitoring banks to prevent predatory lending abuses, but the OCC may not have the resources to monitor activities of national banks and their operating subsidiaries. The OCC's primary responsibility is to monitor the safety and soundness of national banks and their affiliates.[447] The agency is responsible for more than 1900 national banks[448] and in 2003 could not provide a list of their operating subsidiaries because "the number and names of the operating subsidiaries were constantly changing."[449] Today the OCC maintains

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AND RISK-BASED PRICING vii, 21 (2002), *available at* http://www.huduser.org/Publications/pdf/subprime.pdf.

[446]*See supra* notes 321-37 and accompanying text.

[447]*See* Office of the Comptroller of the Currency, About the OCC, *at* http://www.occ.treas.gov/aboutocc.htm.

[448]*See* Office of the Comptroller of the Currency, National Banks Active As of 9/30/05, *at* http://www.occ.treas.gov/foia/nblist_Name_St_City_BankNet.pdf.

[449]NCLC Comments, *supra* note 24, at 13 n.26.

a list on its website of "many of the national bank operating subsidiaries that do business directly with consumers."[450] In October 2005, the list included the names of more than 300 companies,[451] but it is constantly changing because bank holding companies reorganize their holdings on a relatively frequent basis.[452] Furthermore, the agency may not have the motivation to find and prosecute predatory lending abuses in the ranks of the institutions it regulates because its funding comes primarily from the assessments on the banks it regulates rather than from Congress.[453]

The OCC's preemption of state law is truly a "race to the bottom."[454] By providing the most lenient regime for regulating predatory lending practices, the OCC can encourage national banks to keep their federal charters and state banks to switch to federal charters.[455] Because the OCC's budget is funded primarily by large national banks whose interests are served by the preemption rule, the OCC can ensure the preeminence of the national banking system.[456] This is

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[450]Office of the Comptroller of the Currency, Operating Subsidiaries of National Banks, *at* http://www.occ.treas.gov/OpSublist.pdf.

[451]*See id.*

[452]*See* Comments of the National Consumer Law Center to Office of Comptroller of Currency, Docket No. 04-08, Apr. 26, 2004, *available at* http://www.nclc.org/initiatives/test_and_comm/04_26_04_ER.shtml.

[453]*See* Office of the Comptroller of the Currency, About the OCC, *at* http://www.occ.treas.gov/aboutocc.htm.

[454]William Cary's classic article describes Delaware's lenient corporation law as the result of its success in a "race for the bottom." William Cary, *Federalism and Corporate Law: Reflections Upon Delaware,* 83 YALE L.J.663, 666 (1974). Delaware created a favorable climate for corporate management in order to attract new business to the state. *Id.*

[455]*See* Wilmarth, *supra* note 24, at 275.

[456]*See id.* at 276-79.

further evidence that the OCC will have little incentive to prosecute predatory lending abuses among these institutions.

Banks and thrifts should be a part of the solution rather than being part of the problem. They should be subject to state consumer protection laws as the GSEs have been. Because banks and thrifts receive the benefit of the federal safety net, they have a special obligation to the public. They and their affiliates should be subject to the same standards as other lenders.

VII. Conclusion

In conclusion, the federal government should not preempt state predatory lending laws either through regulations applicable only to federally chartered banks and thrifts or through legislation applicable to all lenders. Real estate finance and consumer protection have traditionally been areas governed by state law, and where the federal government has intervened in these areas, federal statutes and regulations have typically created a minimum standard for consumer protection rather than preempting the field of regulation. When state governments regulate, they can be more responsive to the needs of their citizens and can be innovative in trying new solutions. Further, state enforcers are more likely to prosecute small actors in predatory lending that federal enforcers may ignore.

Varying state laws are not as onerous on lenders as they may claim. Since subprime loans tend to be originated by local mortgage bankers and mortgage brokers, they can comply with local law, and investors can police their originators and purchase only from those that comply with local law. The states already have varying requirements for real estate finance, so adding additional requirements is only a matter of revising forms and standards that already vary from state to state. Furthermore, Fannie Mae and Freddie Mac can further their regulatory goals of leading the market in loans to low-income families and in low-income neighborhoods by creating standards that originators can use to comply with each state's law and by purchasing more subprime loans, including loans to subprime borrowers with less than A- credit.

Banks, thrifts, and their affiliates have not earned the special treatment that they receive under new regulations. Furthermore, the OCC does not have the resources or motivation to regulate national banks and their operating subsidiaries to the extent they should be regulated. Congress should override the OCC and OTS determinations that their regulations preempt state predatory lending laws.

Federal attempts to curb the predatory lending problem have thus far been inadequate and unsuccessful. The federal government should not make the problem worse by tying the hands of state legislatures and state attorney generals who are tying to combat the problem. Federal preemption, where state laws are more restrictive, simply adds fuel to the fire by insulating predatory lenders from effective oversight and sanctions. The federal government must stop mortgaging the American dream.