Decisionmaking & the Limits of Disclosure: The Problem of Predatory Lending (Working Paper)

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Table of Contents

I. Introduction
II. Predatory Lending & the Evolution of the Home Loan Market
III. The Price Side
   A. Impediments to Price Shopping
      1. The Rational Actor Decisionmaker Model & the Decisionmaker Model Envisioned by the Law
      2. How the Law Fails to Meet Its Own Decisionmaker Model
      3. Beyond the Law’s Decisionmaking Model
         a. Decisionmaking Heuristics
         b. Cognitive Biases
         c. Emotional Coping Mechanisms
   B. How to Solve the Price Problem
      1. Why the Market Will Not Solve the Price Problem
      2. Simplification of Loan Products to Achieve Meaningful Transparency Through Simple, Timely Disclosures
      3. Bringing Price Competition to the Borrower

IV. The Risk Side
   A. Impediments to Good Decisionmaking About Risk
      1. The Rational Actor Decisionmaker Model & the Decisionmaker Model Envisioned by the Law
      2. How the Law Fails to Meet Its Own Decisionmaker Model
      3. HOEPA’s Decisionmaking Model Applied More Thoroughly, & Beyond
         a. Decisionmaking Heuristics
         b. Cognitive Biases
         c. Emotional Coping Mechanisms
   B. How to Solve the Risk Problem
      1. Why the Market Will Not Solve the Risk Problem
      2. Why Decision-Process Regulation Will Not Solve the Risk Problem
      3. Defining & Enacting Enforceable Substantive Risk Limits

V. Conclusion

* Any citation should include the “Working Paper” designation. Thank you.
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Former Finance Company Employee: Finance companies try to do business with blue-collar workers, people who have not gone to college, older people who are on fixed incomes, non-English-speaking people, and people who have significant equity in their homes. In fact, my perfect customer would be an uneducated widow who is on fixed income, hopefully from her deceased husband’s pension and Social Security, who has her house paid off, is living on credit cards, but having a difficult time keeping up with her payments...

To flip [a small unsecured loan] into a … home equity loan, we were trained to sell the monthly “savings” — that is, how much less per month the customer would be paying off if we flipped the loan. In reality, the “savings” that we were trained to sell were an illusion. The uneducated customer would jump for the “savings”, thinking he would have more money to buy other things. What the customer would not figure out, and what we would not tell him, is that he would be paying a for a longer period of time and, in the end, would pay a whole lot more...

Delinquent customers made good flipping candidates, because we could put additional pressure on them... We knew that these customers would almost always agree to refinance, because they did not have the money to pay on their current loan and did not want the finance company to institute foreclosure …

Our entire sale is built on confusion. Blue-collar workers tend to be less educated... They can be confused in the loan closings, and they look to [loan brokers] as professionals who can handle their bills and their incomes as total financial representatives. So they are more trusting of us.

[People having difficulty meeting their present debt obligations] are desperate. They will sign at whatever rate you give them and however many points you give them...

Senator Breaux: Is it not required by Federal regulation or State regulation that … information be clearly presented to the customer – that … if you refinance with us, here is how long it is going to take you and here is how much you are going to pay – in simple English?

Former Finance Company Employee: It is written in simple English, and it is on all the loan documents, but I can get around any figure on any loan sheet...

1 1998 Senate Hearing Testimony of former finance company employee, testifying anonymously

1 Excerpts from Testimony of “Jim Dough” in “Equity Predators: Stripping, Flipping and Packing Their Way to Profits,” Hearing Before the Special Committee on Aging, U.S. Senate, 105th Cong., 2d Sess., March 16, 1998 [hereinafter 1998 Senate Hrg.], at 30-38. Stories from borrowers, brokers, loan officers, and others who have been witness to predatory lending practices appear here to provide some context, to make the data here more “available” than it would be if presented in only dry statistical form.
I. Introduction

Obtaining a home loan is the most significant, complex, and long-term economic transaction many Americans will ever engage in. Summing to 6.8 trillion dollars at the close of 2003, over half of that debt was originated or refinanced in the prior year. Despite the importance of the transaction to the households and neighborhoods involved and the nation’s economy as a whole, however, many Americans are not making optimal home loan decisions, in two important respects. First, many borrowers are not obtaining home loans at optimal price terms, prices that a competitive market of borrowers engaged in effective price-shopping would produce. Second, the home loan decisions of many borrowers are not optimal choices with regard to risk of loss of the home, both in that the benefits of the loan are outweighed by the risk of loss of the home imposed by the loan, and in that borrowers are failing to take advantage of alternatives that are preferable, in cost-benefit terms, to shouldering that risk of loss. The sale of these overpriced and overly risky home loans constitutes what has come to be known as “predatory lending.” Two indicators that predatory lending became a problem in the late 1990s are: (a) studies indicating that large numbers of borrowers were receiving loans at prices beyond what the cost and credit risk presented by the borrower would garner from a competitive market, and (b) dramatic increases in foreclosure rates, despite economic boom times in the mid- to late-1990s, with no reason to think that borrowers’ preferences regarding risking foreclosure changed dramatically, if at all, during that period.

The 1990s saw the rise of subprime home lending, meaning loans at higher subprime rates, justified in theory by the higher risks presented by less credit-worthy borrowers. Within

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2 The definition of the term “home-secured loan” or “home loan” used here is an extension of credit secured by a borrower’s primary residence. “Home loans” thus intentionally encompasses a wide variety of credit products – purchase money loans, refinancing loans, home improvement loans, home equity loans, home equity lines of credit, and other similar products that exist now or may be developed in the future.

3 As of the close of 2003, home loan debt stood at $6.8 trillion, $3.8 trillion of which had been originated or refinanced in that year. Harvard Univ. Joint Center for Housing Studies, State of the Nation’s Housing 2004 5 [hereinafter, State of the Nation 2004]. Debt outstanding on single-family properties was estimated at over 5 trillion dollars in 2001, exceeding total corporate or government debt at that time. Nicolas Retsinas & Eric Belsky, Examining the Unexamined Goal, in LOW-INCOME HOME OWNERSHIP: EXAMINING THE UNEXAMINED GOAL 1, 2 (Retsinas & Belsky, eds., 2002).

4 Risk of loss here refers to the expected loss from the borrower’s perspective, that is, the probability of foreclosure multiplied by financial, emotional, and logistical costs imposed on the borrower by foreclosure.

5 I thus define predatory lending by reference to its two root harms to consumers, excessive price and excessive risk of foreclosure. Others have defined predatory lending as outright fraud, or by a list of predatory practices. The former is incomplete – although some instances of outright fraud have come to light, most sellers need not go so far to sell these loans – and the latter is doomed to become out-of-date as lending practices quickly mutate in response to changed legal or market conditions.

6 Industry data indicates that subprime loans between 1998 and 2001 averaged 3.7 points higher than prime loans. See Elizabeth Laderman, FRBSF Economic Letter: Subprime Mortgage Lending & the Capital Markets (Federal Reserve Bank of San Francisco, December 2001), www.frbsf.org/publications/economics/letter/2001/el2001-38.pdf, at 2. While a 3.7 point larger loan price in a home loan can amount to significantly greater monthly and total loan payments, anecdotal evidence shows subprime lenders in the past decade making loans with prices much higher than that. Between 1995 and 2005, the national monthly average interest rate on a 30-year home loan has never exceeded 9.15%, and monthly average fees and points have never exceeded 1.9%, see Freddie Mac, 30-Year Fixed Mortgages
the decade, subprime lending went from less than one percent of the market to ten percent of originations, and in 2004 stood at twenty-four percent of the market with over six hundred billion dollars in originations. Although the higher prices of subprime loans are justified in theory by higher anticipated costs to the lender, many subprime loans exhibit signs of excessive price, more than would be justified by the borrowers’ risk and cost. It is estimated that between ten and fifty percent of borrowers with subprime loans were qualified for lower prime interest rate loans, based on their credit history and loan profile, and many of those with subprime credit

Since 1971, www.freddiemac.com/pmms/pmms30.htm, but subprime lenders have charged rates of 25% or more, see, e.g., Washington State Department of Financial Institutions, Expanded Report of Examination for Household Finance Corporation III passim (April 30, 2002) [hereinafter Household Examination] (in examination of one of the largest subprime lenders in the U.S., finding home loans with interest rates ranging from 10 to 25%, in many cases in addition to 7.25% in points). In 2003, the average prime loan was originated at 5.83% interest with .6% in points and fees, yet Citigroup and Wells Fargo originated home loans in California with annual percentage rates (APRs) over 20%, and some Household loans exceeded 30% APR. See Kevin Stein, Who Really Gets Home Loans? Year Eleven: Mortgage Lending to African-American & Latino Borrowers in 5 California Communities in 2003 2 & 25 (California Reinvestment Coalition, March 2005) (using data reported by the lenders to the California Department of Corporations).

7 Department of Housing & Urban Development & Department of Treasury Joint Report on Recommendations to Curb Predatory Home Mortgage Lending 28-29 (June 20, 2000) (citing almost ten-fold increase in number of subprime home loan originations between 1993 and 1998) [hereinafter, HUD-Treasury Report]; Anthony Pennington-Cross, Anthony Yezer & Joseph Nichols, Credit Risk and Mortgage Lending: Who Uses Subprime and Why?, Research Institute for Housing America Working Paper No. 00-03 (2000), at 1 (citing Home Mortgage Disclosure Act data that subprime home loan market share grew from .74 % to almost 9% between 1993 and 1998). Market share for subprime originations as at late 2002 was about 8.25% of the market in terms of dollar volume and 10% in terms of number of originations, as subprime loans are on average smaller than prime loans. See, e.g., Amy Crews Cutts & Robert A. Van Order, On the Economics of Subprime Lending, 30:2 J. REAL ESTATE FIN & ECON 167, 171 Tbl. 1 (2005).


9 See James H. Carr & Lopa Kolluri, Predatory Lending: An Overview, FINANCIAL SERVICE IN DISTRESSED COMMUNITIES: ISSUES & ANSWERS 37 (Fannie Mae Foundation Aug. 2001); Business Wire, Fannie Mae Has Played Critical Role in Expansion of Homeownership (March 2, 2000) (50% estimate); Freddie Mac, Automated Underwriting: Making Mortgage Lending Simpler and Fairer for America’s Families, 5-6 & Ch. 5 (Sep. 1996) at www.freddiemac.com/corporate/reports/moseley/chap5.htm (10 to 35% estimate). See also Pennington-Cross et al., supra n. 7 at iv (industry-sponsored study noting that borrowers “may not be consistently or appropriately assigned the right mortgage by the market”); Kevin Stein, supra n. 6 at 9 (explaining that Citigroup’s 2003 review of borrowers who received loans from its subprime unit, Citifinancial, revealed that over 25,000 of them were qualified for a lower cost prime loan, but only less than half of one percent of them had obtained a lower cost loan).

A vice president at a subprime subsidiary of Countrywide, the largest mortgage lender in the US, was recently caught having sent a memo “encourag[ing] loan officers … to downgrade borrowers’ credit ratings in order to steer them into more expensive loans” and “suggest[ing] five ways loan officers can steer borrowers, including those with good credit, into the sub-prime category, including listing only one income when there are two wage earners, increasing the amount of the loan and not listing any of a borrower’s assets.” Annette Haddad, Countrywide Fires Manager, Citing Ethics, L.A. TIMES C1 (Nov. 20, 2004). Another subprime lender told investors that more than three-quarters of its high cost loans went to people with relatively good credit, and a former loan officer confirmed that customers with good credit would pay the same prices as customers with poor credit. See Diana B. Henriques & Lowell Bergman, Mortgaged Lives: A Special Report: Profiting From Fine Print With Wall Street’s Help, N.Y. TIMES A1 (March 13, 2000) (quoting former loan officer with First Alliance Mortgage Corporation as saying that “‘customers with ‘A’ credit would pay the same high loan fees as customers with ‘D’ credit’”). The manner in which loans are graded varies by lender, but generally prime home loans are graded as “A” quality paper. Subprime
profiles are being charged much more than what their higher risk and cost should garner. An analysis of “A-minus” loans, loans at the lowest risk level and lowest price level for subprime loans, found that at least one percent of the note interest rate alone being charged to these borrowers could not be explained by risk or cost of the loans.\footnote{Howard Lax, Michael Manti, Paul Raca & Peter Zorn, \textit{Subprime Lending: An Investigation of Economic Efficiency}, 15:3 \textit{Housing Policy Debate} 533, 569 (2004). This study examined note interest rates only, and did not consider the further differentials in pricing caused by higher origination points and fees paid by subprime borrowers.} In addition to interest, origination fees and points charged on predatory loans are frequently greatly in excess of the slightly higher origination and servicing costs to be expected for subprime risk loans, and without any reduction in interest rates as is typically bought by points paid in the prime market.\footnote{Id. at 540. Eric Stein cites a report that one major subprime lender, Household, adds a standard charge of 7.25\% in fees, and cites other sources reporting fees of 7\% to over 10\% for subprime loans. Eric Stein, \textit{Quantifying the Economic Cost of Predatory Lending} 14-15 \& nn. 50-51 (Coalition for Responsible Lending, March 2001), reprinted in \textit{Predatory Mortgage Lending: The Problem, Impact, and Responses}, Hearing Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, 107\textsuperscript{th} Congress, 1\textsuperscript{st} Sess. (July 26, 2001) [hereinafter 2001 Senate Hrg]. The State of Washington Department of Financial Institutions Examination of Household confirms the 7.25\% figure, which was reported as “points” but which did not buy down the borrower’s interest rate and therefore should be properly viewed as an origination fee. \textit{See} Household Examination, supra n. 6 at 5, 7, 9, 16, 18 \& 48.} The CEO of one predatory lender told \textit{The New York Times} that his company “had recently reduced its origination fees to an average of about 10 percent because of … the ‘sound-bite effect of the high origination fees.’”\footnote{Henriques & Bergman, supra n. 9 at A1. This is in contrast to origination fees on conventional loans that are typically about 1\%, and rarely exceed 2\%. \textit{Id. Internal documents indicate that as of 1999, the lender, First Alliance Mortgage Company, started all loan negotiations at 15.9 points, and would negotiate with borrowers back to an average of 12 points. \textit{See} Lehman Brothers’ Report on First Alliance Mortgage at 3 (on file with author).} This was after it had come to light that the lender had been charging fees as high as twenty-five percent, in addition to high interest rates.\footnote{Henriques & Bergman, supra n. 9 at A1. The same article reported the story of a woman who thought she had borrowed about $51,000, but later discovered she had signed for over $64,000, because 26\% in fees were added to the loan at origination.}  

On the risk side, despite economic boom times in this country and record homeownership rates, foreclosures on owner-occupied dwellings during the mid- to late 1990s more than doubled in many of the central cities where predatory loans are concentrated.\footnote{\textit{See}, e.g., Testimony of William Apgar, Assistant Secretary for Housing & Federal Housing Commissioner, in “Predatory Lending Practices,” Hearing Before the Committee on Banking and Financial Services, U.S. House of Representatives, 106\textsuperscript{th} Cong., 2d Sess., May 24, 2000 [hereinafter 2000 House Hrg.], at 199, 203 (citing studies demonstrating that: in Chicago, foreclosures doubled between 1993 and 1998, and foreclosures of subprime loans increased by a factor of 40; and in Atlanta, although foreclosures overall decreased between 1996 and 1999, subprime foreclosures more than tripled, and by 1999 were 16\% of all foreclosures but only 9\% of originations); \textit{ACORN, Equity Strippers: The Impact of Subprime Lending in Philadelphia} (May 2000), reprinted in 2001 Senate Hrg., supra n. 11 at 410, 414 (foreclosures in Philadelphia increased over 100\% between 1995 and 2000, due to increase in subprime originations and prevalence of subprime foreclosures).} The New York Times reported in April 2003: “[I]n the last nine years, despite a decrease of 20 percent in foreclosures
on prime-rate mortgages, the national foreclosure rate has risen by 68 percent...”

Because between eighty and ninety percent of subprime loans are refinancings or second mortgages, not home purchase loans, subprime lending has not substantially increased homeownership rates. To the contrary, the most comprehensive national study of foreclosures and subprime loans indicates that over twenty percent of all first-lien subprime refinance loans originated in 1999 had entered foreclosure by December 2003, a mere four years later; sixty percent of these borrowers had lost their homes and another ten to twenty percent were still in foreclosure as at December 2003. Some securitized subprime loan pools have foreclosure rates as high as twenty-eight percent, and the rate at which subprime loans enter foreclosure quarterly is over

15 Dennis Hevesi, Jump in Subprime Loans Spurs Fight Over Abuses, N.Y. TIMES B10 (Apr. 25, 2003). Because these figures are based on MBAA statistics, they probably understate the true foreclosure rate of subprime loans. MBAA statistics underestimate subprime foreclosures because they exclude statistics on loans from finance companies, a fertile source of subprime and predatory loans. See, e.g., Office of the Comptroller of the Currency, OCC Working Paper: Economic Issues in Predatory Lending (July 30, 2003) [hereinafter, OCC Working Paper] at 7 n.‡ (“predatory lending abuses are largely confined to the subprime mortgage market” consisting mostly of “mortgage companies and finance companies” (internal citation omitted)). The MBAA data also do not reflect which loans ended in foreclosure or deed-in-lieu of foreclosure, and which loans were redeemed out of foreclosure.

16 See, e.g., HUD-Treasury Report, supra n. 7 at 29 & 31 (80% of subprime loans in HMDA data, and 82% according to industry data, are refinancing loans, while an additional number are home improvement loans); id. at 3 (“A majority of mortgages in the subprime market are used for consumer debt rather than housing [purchase or home equity] purposes.”); Testimony of Professor Cathy Lesser Mansfield, 2000 House Hrg., supra n. 14, at 378, 386 (reporting that for the top sixteen subprime lenders, who together issue just under half the outstanding subprime home equity debt in the U.S., only 10% of the loans were purchase money loans); The Reinvestment Fund, Mortgage Foreclosure Filings in Pennsylvania 34-35 (March 2005) (reporting data showing that increases in foreclosures between 2000 and 2003 outstripped housing ownership gains in Pennsylvania).

17 Roberto G. Quercia, Michael A. Stegman & Walter R. Davis, The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties & Balloon Payments at 2, 21 & 22 (Kenan Institute for Private Enterprise, Jan. 2005). The database used for this analysis, consisting of only securitized subprime loans, represents 39% of the subprime market in 1998 and 67% of that market in 2002. Id. at 12. See also Pennsylvania Dept of Banking, Losing the American Dream: A Report on Residential Mortgage Foreclosures and Abusive Lending Practices in Pennsylvania 23-27 (March 15, 2005) (explaining that between 2000 and 2003, the number of sheriff foreclosure sales in Pennsylvania was over 55,000, more than the number of households in Pennsylvania’s third-largest city, Allentown, and attributing the majority of these foreclosures to subprime loans). Even industry voluntary survey figures, which as noted in note 15, supra, underestimate subprime loan foreclosures, report high subprime loan foreclosure rates. On average for 2004, the Mortgage Bankers Association released data that .49% of prime loans were in foreclosure each quarter, but almost eight times as many (3.98%) of subprime loans were in foreclosure. See www.mortgagebankers.org/news/2005/pr0317.html.

18 Mansfield Testimony, supra n. 16 at 385. The loans in the particular pool examined were originated in 1998 and examined in 2001, meaning that in about two years these loans were already failing at these high rates. The loans were securitized by WMC Mortgage, formerly Weyerhaeuser Mortgage Company, a wholesale lender started in 1955 that in the third quarter of 2002 was the first internet-based lender to hit the billion dollar mark for quarterly loan volume. www.prweb.com/releases/2002/10/prweb48712.php. See also Sandra Fleishman, Landmark Predatory Lending Suit Settled, WASH POST E1 (Feb. 24 2005) (noting a foreclosure rate of one in three loans made over a three year time period by one mortgage lender). The Mortgage Information Corporation, an industry financial database firm, reported in 2000 that the rate at which home loans were becoming “seriously delinquent” (presumably 90 days) was .53 percent for prime mortgages, 6.8 percent for B-rated loans and 20.5 percent for D-rated loans. Pennington-Cross et al., supra n. 7 at iv.
ten times the rate at which prime loans enter foreclosure.\textsuperscript{19} Subprime lenders are responsible for a tremendous proportion of foreclosures, given that at the time most subprime borrowers received the loans, they had a successful track record of mortgage payments to their previous lender.\textsuperscript{20} Further, the risk of foreclosure for many of these loans should have been evident at the time of origination; subprime loans that result in foreclosure do so about twice as quickly, in terms of time from origination to foreclosure, as do prime loans that end up in foreclosure.\textsuperscript{21}

Moreover, the households paying these high prices and facing this high risk of foreclosure are disproportionately African-American, Latino, and low to moderate income,\textsuperscript{22} households that already have fewer financial resources to spare and significantly lower homeownership rates\textsuperscript{23} to begin with. The elderly have also been particularly hard-hit.\textsuperscript{24}

\textsuperscript{19} Quercia \textit{et al.}, supra n. 17 at 2.

\textsuperscript{20} See, \textit{e.g.}, Harold L. Bunce, Debbie Gruenstein, Christopher E. Hebert & Randall M. Schleeselle, \textit{Subprime Foreclosures: The Smoking Gun of Predatory Lending?}, in \textit{Housing Policy in the New Millennium}, U.S. Department of Housing & Urban Development Conference Proceedings 257, 266-67 (Susan Wachter & R. Leo Penne eds., 2001). Although one would expect subprime loans to default at higher rates than prime loans, because many subprime loans are made to higher risk borrowers, there is nothing to indicate that subprime borrowers know how very much higher their likelihood of foreclosure is.

\textsuperscript{21} See, \textit{e.g.}, id. at 264-65 (reporting mean delay from origination to filing of foreclosure petition of 1.8 years for subprime foreclosures, but 3.2 years for prime foreclosures in Baltimore in first quarter of 2000; median delay of 2 years versus 4 years in Atlanta in June 1996 through 1999; and median delay of 3 years versus 7 years in Boston in 1995 through 1999).

\textsuperscript{22} See National Community Reinvestment Coalition, \textit{The 2004 Fair Lending Disparities: Stubborn & Persistent 3} (April 2005) (reporting that of conventional home loans received by African-Americans in 2004, almost 30% were subprime, whereas only about 10% of loans to whites were subprime, and that African-Americans received 18% of the subprime loans but only 6% of the prime loans originated); \textit{id.} at 8 (21% of loans to low-to-moderate income borrowers are subprime, whereas 18.5% of loans to middle-income borrowers are subprime); James R. Hagerty, \textit{Blacks Are Found to Pay High Rates for Home Loans}, \textit{Wall Street J.} D2 (March 30, 2005) (finding for one of the nation’s largest lenders, National City Corp., that over 20% of the first-lien home loans it made in 2004 to blacks, but less than 10% of such loans to whites, had APRs at least 3 points above the yield for comparable Treasury securities); Joseph Nichols, Anthony Pennington-Cross & Anthony Yezer, \textit{Borrower Self-Selection, Underwriting Costs, and Subprime Mortgage Credit Supply}, 30:2 J. REAL ESTATE FIN. & ECON. 197, 214 (Apr. 2005) (finding African-Americans, Indians, Hispanics, and Asians more likely to use subprime mortgages than Whites, even after controlling for borrower income, debt, and credit history); Pennington-Cross \textit{et al.}, supra n. 7 at 16 (in home purchase loans, after controlling for credit risk factors, black and Asian borrowers more likely to use subprime mortgage loans than whites, all other things being equal; note that this study was issued by the Research Institute for Housing America, an arm of the Mortgage Bankers Association of America); U.S. Department of Housing & Urban Development, \textit{Unequal Burden: Income & Racial Disparities in Subprime Lending in America}, passim (2000).

\textsuperscript{23} Although national homeownership rates are at an all-time high of about 69%, gross disparities exist within that number; the homeownership rate for non-Hispanic whites is just over 75%, but the homeownership rates for Blacks and Latinos are just under 50%, and for Asians is about 60%. U.S. Census, \textit{Homeownership Rates by Race and Ethnicity of Householder, Annual Statistics:} 2004, Tbl 20 (Feb. 2005).

\textsuperscript{24} Marsha J. Courchane, Brian J. Surrette & Peter M. Zorn, \textit{Subprime Borrowers: Mortgage Transitions & Outcomes}, 29:4 J. REAL ESTATE FIN & ECON. 365; 372 (finding in a 1999-2000 sample that 20% of subprime borrowers are over age 55, whereas only 13% of prime borrowers are this old); HUD-Treasury Report, supra n. 7 at 36 (finding for 1998 that borrowers over age 55 were 32% of subprime mortgages but only 21% of prime mortgages); U.S. General Accounting Office, \textit{Consumer Protection: Federal & State Agencies Face Challenges in...
sum of interest and fees charged on predatory loans at levels above what a competitive market would produce is conservatively estimated to cost affected U.S. consumers $9.1 billion annually, an average of $4,600 per household affected per year.25 Compare the $4,400 per household loss caused by predatory loan overpricing to the median African-American household wealth of less than $8,000 as of the 2000 Census.26

From a legal and policy perspective, what is puzzling about this problem is that borrowers are agreeing to these overpriced and overly risky home loans against their own self-interest and despite extensive federal regulation, including mandated disclosures regarding loan price, and, for some loans, risk of foreclosure. This paper argues that the problem is not so puzzling when the structure of the home loan market and consumer decisionmaking within that market are carefully analyzed. Federal law regarding home lending is based on a rational actor model of borrower decisionmaking, with some allowances for bounded rationality. But borrowers frequently depart from the law’s model in a variety of ways, leading to a failure to price shop and a failure to make considered, good decisions regarding risk when they obtain home loans. These departures from the rationality assumption include widespread and quite steadfast cognitive limitations, heuristics, biases, and emotional coping mechanisms. This paper explains how sellers are able to take advantage of these impediments to optimal decisionmaking and the structure of the market to convince significant numbers of borrowers to take loans that are overpriced and overly risky, and why these borrowers agree to these loans that are not in their own best interests.27 Only an analysis rooted in the empirical information we have about decisionmaking, not only in the laboratory but also more specifically in the modern home loan market, can guide sound future lawmaking in this area. Such an analysis must be sensitive to how different historical experiences and sociological and market conditions impact the decisionmaking of different segments of consumers.

The impediments to optimal rational decisionmaking can be roughly divided into those that inhibit borrower price shopping, and those that inhibit good borrower decisionmaking about

25 Eric Stein, supra n. 11 at 128-42. These figures include financed single premium credit insurance, excessive up-front fees, prepayment penalties, and excess interest, but do not include equity lost in foreclosures. Some of the excess interest and fees undoubtedly cross-subsidizes the cost to lenders of truly subprime risk borrowers in the subprime pool, but drawing the line between pure rents and such cross-subsidization is probably impossible. The $9.1 billion figure for the costs of predatory lending does not include borrowers’ lost equity, from which lenders can recoup at least some of their costs on defaulted loans, and more so in the subprime market where loans tend to have a lower loan to value ratio (LTV) than in the prime market, such that more equity remains for the lender at foreclosure. See, e.g., Lax et al., supra n. 10 at Ex. 4.

26 See U.S. Census, Net Worth & Asset Ownership of Households: 1998 & 2000, at 12 (May 2003). The net worth of white households was just over $80,000. Id.

27 Cf. Arthur Leff, SWINDLING & SELLING 179-182 (1976) (explaining his use of both microeconomics to provide a snapshot picture of the structure in which actors act, and social psychology to provide a dynamic film of the way in which those actors act within that structure, thus: “marrying the insights of those who consider the overall structure of transactions generally with the perceptions of those who focus attention on the dynamics of particular transactions may increase the amount of truth available to the world at large— which world exists, after all, in the midst of the individual and the mass all at once”).
risk, although price and risk are closely related in any loan product from both the sellers’ and the borrowers’ perspectives. Encouraging price shopping and price efficiency, and awarding any surplus from the transaction to the consumer, are fairly uncontested social goals. The most difficult questions on the price side are how to overcome decisionmaking barriers to achieve efficient, competitive pricing, and why the market will not operate to achieve such pricing on its own. On the risk side, the impediments to good decisionmaking about risk of loss of the home create the same dilemma found in other risk contexts; giving consumers more risk information is, depending on the disclosure itself and the particular consumer’s psychology, likely to be useless for some and an over-deterrent to others, due to bimodal responses to risk. Moreover, at both a normative and a conceptual level, defining reasonable, acceptable, or good levels of risk is tricky. We have not confronted this issue historically, because uniformity of loan products, credit rationing, and usury laws hemmed in home loan risk. But because we cannot rely on disclosures to resolve this issue, to formulate good public policy in today’s credit market, we must define the maximum risk levels we are willing to allow consumers, their families, and their neighborhoods to bear.

II. Predatory Lending & the Evolution of the Home Loan Market

Recent high default and foreclosure rates run counter to national policies of promoting homeownership and stable and efficient financial markets, the bases for the federal government’s involvement in the home loan market since the Depression. Until the late 1960s, the federal government’s involvement in the market expanded the availability of home loan credit through providing and facilitating liquidity and encouraging standardization of loan terms into the traditional 30-year fully amortizing product. During the same period, government capital reserves requirements for depository institutions, usury limits, and both government and private race discrimination in home lending limited the availability of home loan credit to nonwhites and borrowers who were perceived to be potentially high risk. Credit rationing as a result of the

28 Risk impacts pricing on the seller’s side because sellers attempt to price loans so as to ensure at least a competitive (if not higher) rate of return, over a pool of loans, based on default and prepayment likelihood (i.e., risk from the seller’s perspective) and cost of origination and servicing. Generally, loans with higher probabilities of default should be priced higher to cover the probabilistically anticipated losses of both principal and future interest payment stream caused by default, although equity obtainable at foreclosure can also cover these losses in whole or in part.

From the borrower’s perspective, inflated opportunistic price terms can create higher risk terms to the extent that a borrower, who might have a high likelihood of being able to make payments on fair terms, is less likely to be able to afford the monthly payments on an overpriced loan, and therefore is placed at high risk of default. Risk of default is partly endogenous to the loan transaction in a number of other respects as well. Not only larger monthly payments, but also the longer length of some larger loans, balloon payment features, and larger total loan size can increase the risk of default. The longer the loan period the more opportunities for adverse life events to interfere with ability to make payments. A large balloon payment can create a risk of default if refinancing or payoff is not possible when the balloon comes due. (A balloon is a large lump sum payment due on a loan; a simple balloon loan would be a loan on which only interest payments are made over the life of the loan, with the principal due in a lump sum “balloon” at the end of the loan term. However, a loan can be partially amortizing as well, such that some of the principal is paid during the life of the loan, or a loan can involve negative amortization, such that the principal increases during the life of the loan.) A larger total loan means that there is less equity in the home to extract through a refinancing to tide a borrower through loan payments during an adverse life event.
inability of the market to sort borrowers well by cost and risk (and the resultant potential for adverse selection by costly, risky borrowers), also restricted the availability of home loan credit.

In response to the interest rate disintermediation crisis\textsuperscript{29} of the 1970s, most state usury limits were raised significantly, abolished, and/or preempted for home loans by federal law.\textsuperscript{30} Beginning in the late 1980s, the federal government began to enforce laws prohibiting discrimination in home lending,\textsuperscript{31} although consolidation in the banking industry in the same time period also led to the withdrawal of brick and mortar presence of depository institutions from some minority communities.\textsuperscript{32} Data collection and computer processing advances in the 1980s and 1990s revolutionized the ability of lenders to model borrower behavior so as to more accurately forecast lending costs, including costs imposed by borrower risk of default. As a result, lenders gained the ability to better sort borrowers according to risk and cost and engage in risk-based pricing rather than credit rationing.\textsuperscript{33} Large scale securitization of home loans starting

\textsuperscript{29} In the 1970s, most lenders were dependent on deposits as a source of loan funds, because home loans had not yet been widely securitized. The credit crunch of the 1970s caused interest rates to rise, such that lenders with outstanding fixed rate home loans were taking in less interest income than they needed to give out in interest on deposits to convince depositors to keep their deposits at the lender instead of in alternative, higher-interest-earning investment vehicles. This phenomenon is referred to as disintermediation. See, e.g., Jonathan McCarthy & Richard W. Peach, Monetary Policy Transmission to Residential Investment, FEDERAL RESERVE BANK OF N.Y. ECONOMIC REVIEW 139, 140-41 (May 2002).

\textsuperscript{30} The Depository Institutions Deregulation and Monetary Control Act (DIDMCA), 12 U.S.C. §1735f-7a, preempted state regulation of first mortgages by all federal lenders and their subsidiaries and all large lenders (i.e., lending over $1 million/year). The Alternative Mortgage Transactions Parity Act (AMTPA), 12 U.S.C. §§ 3801-3806, preempted state regulation of all “alternative” mortgages, including first and second mortgages, whether made by federally or state chartered lenders or subsidiaries, regardless of the lender’s size. To fall within AMPTA’s preemption ambit, the loan must be a more complex loan product beyond the traditional fixed-rate amortizing loan, such as an adjustable-rate mortgage or a fully or partially non-amortizing (balloon) mortgage. See William N. Eskridge, Jr., One Hundred Years of Ineptitude: The Need for Mortgage Rules Consonant with the Economic and Psychological Dynamics of the Home Sale and Loan Transaction, 70 VIRGINIA L. REV. 1083 (1984); Cathy Lesser Mansfield, The Road to Subprime ‘HEL’ Was Paved with Good Congressional Intentions: Usury Deregulation & the Subprime Home Equity Market, 51 S.C. L.Rev. 589 (2000).


\textsuperscript{32} One study by U.S. News and World Report found that in 1970, the number of bank branches per 100,000 residents in minority and white neighborhoods was roughly equal, but by 1993, there were three times as many branches per 100,000 residents in white neighborhoods as for every 100,000 residents in predominately minority neighborhoods. Penny Loeb, Warren Cohen & Constance Johnson, The New Redlining, U.S. NEWS & WORLD REPORT (April 17, 1995).

\textsuperscript{33} Asymmetric information and adverse selection, with the borrower having more information about her default risk and doing the selecting, form the underpinnings of Stiglitz and Weiss’s model of credit rationing. See Joseph E. Stiglitz & Andrew Weiss, Credit Rationing, 71 AM. ECON. REV. 393 (1981); Michael Klausner, Market Failure, 143 U PA L. REV 1561, 1566-68 (1995). Due to advances in creditworthiness data collection and processing, the asymmetric information and “adverse” selection assumptions today frequently run in the opposite direction, with the originating lender having greater information and doing the “selecting.” The observable result, as theory would predict, has been a move toward risk-based pricing and away from credit rationing. See Wendy Edelberg, Risk-Based Pricing of Interest Rates in Household Loan Markets 1-4 (Federal Reserve Board Working Paper 2003).
in the 1990s, made possible both by the availability of capital looking for investment opportunities and by the ability of securities markets to use computer data modeling to more accurately price loan pools, further expanded the availability of credit, particularly from nondepository lenders not regulated by federal banking authorities.34

Collectively, these changes ushered in what is called “subprime” lending, meaning home loans at prices higher than those available in the traditional low-risk “prime” market, to account for increased costs and risks entailed in lending to a broader and less creditworthy borrower market. Within the 1990s, subprime lending went from less than one percent of the market to over ten percent in number of originations, and in 2004 was nearly a quarter of market originations. Subprime loans tend not to be used for home purchases, particularly not for first-time homeowners, and instead between eighty and ninety percent of subprime loans are home equity loans or cash out refinancings, meaning that the borrower is taking equity out of the home, primarily for general consumer credit purposes. The reason for this is that most homebuyers, particularly first-time homebuyers, have not amassed large downpayments, so most purchase money loans do not involve large up-front fees or points, and are at high loan to value ratios (“LTVs”), with little equity remaining in the home as security for the loan. Because subprime loans generally rely more heavily on the equity in the home and up-front fees, in addition to higher interest rates, to cover higher origination, servicing, and default risk costs, than do prime loans, subprime loans are less likely to be used for home purchase.

Although subprime loans obviously can be made on fair price and reasonable risk terms, a subset of subprime loans are overpriced and overly risky.35 These predatory loans would include: high-priced subprime loans given to borrowers who present a prime, low risk and cost profile to the lender; subprime loans to borrowers who present a subprime risk and cost profile, but at prices beyond what these risks and costs should garner; and loans that present a high risk of foreclosure and loss of home to the borrower when other, less harmful and on the whole preferable, alternatives to such a loan exist.36 Alternatives could include: declaring bankruptcy but taking a homestead exemption; selling the home on the open market rather than losing it at a foreclosure sale37; and/or foregoing the benefits of the loan, i.e., the loan proceeds. Even more

34 See, e.g., OCC Working Paper, supra n. 15 at 5 (attributing “skyrocket[ing]” of subprime lending in 1990s in part to “increased securitization of subprime loans which facilitated expanded capital flows to the subprime market”). In 1995, $18.5 billion in subprime loans was securitized; in 2000, that figure was almost $56 billion. See HUD/Treasury Report, supra note 7 at 40.

35 Although a prime loan could be predatory if it were overpriced and/or overly risky, as a practical matter, the prime market is quite price-competitive and involves very low risk. Therefore, as a practical matter, predatory lending is a subset of subprime lending.

36 The line between overpriced and competitively priced loans can thus be drawn by reference to market data (although perhaps only by lenders themselves, given their control over the relevant loan-level borrower data). The line between higher-than-prime-risk subprime lending and overly risky predatory lending is not possible to draw without a defined normative ceiling of maximum acceptable risk levels, and/or a cost-benefit analysis of the loan and alternatives to that loan, as explained further below.

37 A foreclosure sale being likely to be both: (a) more emotionally costly than an ordinary sale, over which the homeowner has some sense of agency and control; and (b) less financially profitable than an ordinary sale, given the inefficiency of foreclosure markets.
than subprime loans generally, predatory loans are almost always refinancings or second mortgages, because they involve large up-front fees financed by existing equity and are typically made at low LTVs so that equity remains in the home for the lender to recover at foreclosure.

Because subprime lending is by definition riskier than prime lending, one story that could be told about recent increases in foreclosure rates is that this is not a sign of predatory lending, but rather reflects the unleashing of a pent-up, rational demand for risky loans, previously denied entry to the market by credit rationing. However, such a story would require riskier borrowers to understand the risk presented by these loans, and to prefer to take that risk over alternatives to the loan. The data from the field paint a different picture. Not only do brokers and loan officers actively work to convince borrowers to “lower their guard” and to trust that these are “risk-free” loans, but fifteen percent of all home borrowers, when asked in a national survey about the

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38 An exception to this rule occurs when a predatory lender refinances or “flips” a borrower repeatedly, charging large financed fees and prepayment penalties at each flip, until there is no equity left in the home, preventing the borrower from refinancing elsewhere. A foreclosure after repeated flipping would appear to cost the lender because equity does not cover the face value of the loan plus foreclosure costs. However, the lender could find such a series of loans very profitable on account of multiple financed origination fees and prepayment penalties.

39 Because subprime lending is largely refinancings and seconds, these loans are primarily made to people who already own their homes; only between 10 and 20% of subprime loans are purchase money loans, and only some of these are to new homeowners. The gains in homeownership, starting in the early 1990s for whites and in the mid-1990s for African-Americans and Latinos, have occurred primarily due to expanded prime lending, and only to a lesser extent due to non-predatory subprime lending. Predatory loans would virtually never be used to expand homeownership, because the lender relies heavily on equity in the home, which is rarely present for a first-time homebuyer. Recent expansion in homeownership has been largely due to the strong economy in the 1990s, automation of application processing resulting in a decrease in origination costs, and the decrease and near elimination of downpayment requirements for prime purchase money loans. Prime lenders have been able to decrease downpayment requirements because of a recognition that most borrowers will not strategically default even when the LTV exceeds 100%, both because people have moral (or ego-related) and prospective credit history reasons not to default, and because people display an endowment effect of valuing their own homes, once they live in them, at a greater than market value. Further, rising home prices, particularly in the late 1990s in inner cities, has meant that the window during which a prime no-downpayment loan is near 100% LTV is quite short; within a couple of years of rising home values, the LTV decreases, giving the lender adequate equity in case of foreclosure.

Eliminating downpayment requirements helps achieve homeownership for all people who lack the ability (due to rental housing costs) or willpower to save but have an income on which they could afford monthly mortgage payments. It also helps families achieve homeownership at younger ages, before they could have saved for a downpayment (which increases total instantaneous homeownership rates but does not increase lifetime homeownership rates). Eliminating downpayment requirements has been especially crucial for African-American and Latino homebuyers, because they lack the intergenerational wealth transfers frequently used by whites to make downpayments. African-American and Latino families have dramatically lower median levels of household wealth than whites (2000 Census figures are just under $8,000 for African-American households and just over $80,000 for whites), leaving little money available for intergenerational wealth transfers.

Thus, while at first blush, increasing homeownership rates combined with increasing default rates in the 1990s might seem to be evidence for a story here of expanding homeownership by making facially riskier subprime loans, some of which fail but others of which do not, a careful look at the data does not support this view. To the contrary, homeownership rates would have increased more during the 1990s, absent the loss of homeownership caused by predatory refinancings and second mortgages.

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40 The instructions given in training manuals to loan officers at one predatory lender include: “Establish a common bond. Find this early in the conversation to make the customer lower his guard’ using topics such as family, jobs, children or pets – ‘It’s really important to get them laughing,”’ Henriques, supra n. 9 at A1, and, “The maximum
worst thing a lender could do if they missed several monthly payments, did not come up with foreclosure or loss of the home as an answer.\textsuperscript{41} Although these respondents certainly knew that foreclosure was a possibility, this risk was not something they consciously contemplated in connection with their loans. Among those with overly risky predatory loans, the disproportionate prevalence of the elderly, who display a higher degree of risk aversion generally in psychological studies, would indicate that consumer desire for risk-taking is unlikely to be driving the increase in risky loans and the increase in foreclosures. No lender tells borrowers how much risk the borrower is taking on; although in the last couple of years, consumers have been given greater access to their own credit reports and credit scores,\textsuperscript{42} a consumer has no means to translate a credit report or score into a statement about her own probability of default on a particular loan without access to proprietary information and models held by lenders. In 1994, after hearing testimony from and about borrowers who had lost their homes to foreclosures, Congress passed a statute, the Home Owners Equity Protection Act (HOEPA), requiring that high cost loan borrowers be told in writing that they could lose their homes if their loans are not paid. Regardless of the efficacy of such a disclosure, discussed further below, Congress’s passage of legislation requiring it demonstrates that Congress found that some consumers do not adequately consider the risk of foreclosure when borrowing.

The HOEPA risk of foreclosure disclosure is typical of current federal home loan regulation. With the removal of the constraints on price and risk of foreclosure previously created by usury laws, the remaining law governing home loans is primarily a disclosure regime. Implicit in this form of regulation is the premise that borrowers are, or enough of them to make it economically rationally for loan sellers to treat them as if they were, financially-knowledgeable wealth maximizers, competent and motivated to comparison shop for credit and alternatives to credit by searching for, reading, understanding, and using information. The disclosure regime admits of some boundedness to consumer rationality – if borrowers were unboundedly rational and the market perfectly competitive then there would be no need for the government to intervene in the market by requiring disclosures at all– but the regime assumes that the main correction the market needs is informational. The informational fix assumes that consumers will make self-interested, well-informed, rational probabilistic financial choices, and in particular, that they will not agree to take a loan: (a) if a cheaper one can be found at a tangible search cost that does not exceed the difference in price, and (b) if a reasonable projection of their future income stream indicates that they will not be able to afford to make the prospective payments, and the probable losses to the borrower from foreclosure are greater than the cost of alternatives


\textsuperscript{42} Credit scores are scores based on past credit history; to predict default risk, a lender would combine a credit score with data about the loan that will be taken and other information about the borrower, and run this information through a model based on past performance of other loans.
to obtaining the loan. In reality, for significant numbers of borrowers, neither assumption holds. 43

III. The Price Side

A. Impediments to Price Shopping

1. The Rational Actor Decisionmaker Model & the Decisionmaker Model Envisioned by the Law

The rational *homo economicus* model of individual decisionmaking, when stated as more than a nonfalsifiable postulate that people’s actions reveal their rational choices, assumes that the decisionmaker will choose the option that will maximize her expected utility. This means engaging in a total cost-benefit analysis of the outcome expected from each alternative in the choice set, and then choosing an alternative based on a total weighted assessment of net costs and benefits. The thicker versions of rational choice theory would add that people make marketplace decisions based on their own financial self-interest. The *homo economicus* model, in its most traditional form, assumes that people are motivated to and able to price shop, that they will costlessly observe and evaluate all potential alternatives with reference to a pre-existing set of internal preferences, and that when they at first do not understand an attribute such as price, they will costlessly obtain the necessary information to understand the attribute.

A string of acronyms – TILA, RESPA, and HOEPA – forms the core federal law of home loans: the Truth-in-Lending Act 44 (TILA), the Real Estate Settlement Procedures Act 45 (RESPA), and the Home Owners Equity Protection Act 46 (HOEPA). The model upon which these statutes are based embraces the thicker conception of rational choice theory, but with a more realistic conception of consumer decisionmaking; while it admits people are not unboundedly rational, and thus need the assistance of disclosures due to prohibitive information search costs, it also assumes that they will, once given that financial information, use it to choose whether and which loan to take based on a rational calculus of their own financial self-interest

43 In general terms, much of what is described here is equally applicable to other types of consumer credit, such as credit cards, payday loans, auto financing, and rent-to-own arrangements, all of which have been criticized for predatory deployments. Federal law governing all forms of consumer credit is based on the wealth-maximizing rational economic actor model, and real world evidence undermines the applicability of this model to vast segments of the borrower markets for all forms of consumer credit. The suggestions here for bringing the law governing the home loan borrowing process into alignment with real consumer behaviors, and reining in the manipulation of those behaviors by sellers of credit, can be tweaked to apply to these other forms of consumer credit as well. Examining home loan borrowing merely provides a focused look at one site where the effects of the current gulf between the law’s model of homogenous borrower behavior and real heterogeneous borrower behaviors has particularly pernicious effects.


46 HOEPA amends TILA. The regulation defining HOEPA loans is at Section 32 of Regulation Z, 12 C.F.R. § 226.32.
(or the self-interest of their families). The legal model of decisionmaking recognizes that, due to a lack of comprehension, an unwillingness to incur the necessary search costs, and/or information overload, consumers may fail to accurately extract price information from a stack of loan documents full of complicated and nonstandardized terms conveyed in arcane legal vocabulary. The disclosures are intended, on the price side of the decision, to put the crucial price information on a few sheets of paper in a standardized way, such that consumers can understand the price of the loan, and can comparison price shop.

RESPA is aimed at helping borrowers price shop for settlement services. It requires lenders and brokers to give most home loan borrowers information about a plethora of settlement costs, including origination fees, points, and broker fees that will be charged to the borrower upfront, charges imposed by third parties such as appraisal or title insurance fees, and amounts the borrower must escrow for taxes and property insurance. Prior to settlement, these disclosures are given on a good faith estimate (“GFE”), in which the figures may be expressed as a range of estimated dollar values. At closing, these figures must be disclosed in a statement of actual settlement costs, typically listed on the settlement sheet (the uniform settlement statement or “HUD-1”). Section 8 of RESPA prohibits unearned kickbacks and referral fees, such as payments by third party settlement services providers to lenders or from lenders to brokers for referring borrower business. The anti-kickback provision is an implicit recognition that the disclosures alone will not always lead to price shopping, at least not when the lender and settlement providers collude.

TILA requires creditors to give borrowers a single page, standardized format disclosure that includes:

- (a) the annual percentage rate (“APR”) of the loan, intended to express the total annual cost of borrowing, including interest and other scheduled charges and fees imposed by the broker, lender, and related entities, such as origination fees and points;
- (b) the finance charge, a dollar figure expressing the total cost of borrowing charged by the broker, lender, and related entities;
- (c) the amount financed, meaning the proceeds of the loan and certain charges and fees, typically those imposed by third parties, when these are financed;
- (d) the total of all payments that will be made on the loan, including principal, interest, and other charges and fees;

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48 See Herbert A. Simon, Rationality as Process and as Product of Thought, 68:2 AMER. ECON. REV. 1, 13 (May 1978); see also James R. Bettman, AN INFORMATION PROCESSING THEORY OF CONSUMER CHOICE (Addison-Wesley 1979) (“In general, consumers do not have the resources or the abilities necessary to process the total amount of information which might potentially be available for making any particular choice.”).

49 For a variable rate loan, the lender must provide a booklet on adjustable rate mortgages, various facts about the index and/or formula used to adjust the rate, and either a historical example or an example based on the maximum possible interest rate based on a $10,000 loan amount illustrating how the loan would be affected by interest rate changes. 12 CFR § 226.19.
(e) the number and amount of monthly loan payments, exclusive of taxes and insurance, and the amount of any balloon;
(f) the amount of any late charge;
(g) whether credit insurance is required and at what price; and
(h) whether a borrower “may” or “will not” have to pay a prepayment penalty if she pays the loan off early.

TILA is aimed at helping borrowers understand the price of credit, to facilitate price shopping for loans.

To further facilitate price shopping, HOEPA requires additional disclosures for high cost closed-end (meaning a lump sum loan, not a line of credit) non-purchase money home loans. These include:

(a) the APR,
(b) the monthly payment amount,
(c) for variable rate loans (adjustable rate mortgages or “ARMs”) the maximum monthly payment possible under the contract,
(d) the amount of any balloon, and
(e) a statement that the applicant is not required to complete the transaction even though she has signed the application.

HOEPA was passed in response to predatory lending, and is intended to provide high cost loan consumers with disclosures that will encourage price shopping. HOEPA, using high interest rates and fees as a proxy for decisionmaking impediments, recognizes that consumers who agree to high cost loans may mistakenly believe that they are obligated to take the loan at whatever price is quoted once they have signed the application. HOEPA also substantively prohibits adding unfavorable terms – interest rate escalations triggered by borrower default, balloons on loans shorter than five years, negative amortization, and some prepayment penalties – to high cost loans. In effect, this prevents lenders from “piling on,” i.e., heaping unfavorable terms, terms that can exact quite a price from borrowers, onto borrowers from whom a high price is already being exacted. HOEPA thus recognizes that those consumers who have agreed to loans with high rates and fees may not fully take account of the price implications of

50 Currently, a high cost loan under HOEPA is defined as one with: (a) an APR of more than eight percentage points above the yield on Treasury securities of comparable maturities, or (b) points and fees, including mortgage broker fees but excluding other third party charges, that exceed eight percent of the loan amount or the current equivalent of $400 1994 dollars, whichever is greater. 12 C.F.R. § 226.32.

51 HOEPA’s provisions are also intended to discourage taking risky loans, as discussed further below.

52 Or perhaps bad luck, as other consumers may suffer the same impediments yet not have had the misfortune to be offered a loan on such high rate and fee terms.

53 Thus far, HOEPA’s prohibitions on piling on appear to be successful in stopping this specific practice, which is easy for a lender or court to identify. To enforce these provisions, HOEPA also leverages the power of the secondary market, which under HOEPA does not have the full protection of the holder in due course doctrine for loans that, on the face of the required loan documents, violate HOEPA.

54 And risk implications, discussed below.
prepayment penalty and default interest rate escalation provisions when making the loan decision.

The federal statutes also have a number of timing requirements. The GFE under RESPA must be given within three days of receipt of a borrower’s application. For a non-purchase money home loan, the TILA disclosures must be given at closing, or the day before where the borrower so requests. For high cost loans, the additional HOEPA disclosure must be given three days before closing. The timing requirements for these written disclosures recognize that, either due to a lack of understanding on the borrowers’ part, or oral gamesmanship on the sellers’ part, consumers may fail to demand and receive complete price information from sellers of loans before accepting the loan. However, the law assumes that once consumers receive the correct information through disclosures, their home loan decisions will reflect their own price-minimizing and wealth-maximizing self-interested choices.

2. How the Law Fails to Meet Its Own Decisionmaker Model

I am a senior citizen and I am working. I was substitute teaching… But because of retirement ages for teachers, I am now working as a secretary, which I find to be an interesting and challenging occupation as well.

I first heard about American Equity Mortgage\(^{55}\) in August 2000… According to the loan officer at American Equity Mortgage, even though I wanted a home equity loan to pay off some bills and do some minor home improvements, it was in my best interest to do a consolidation, which meant refinancing my old mortgage loan. The mortgage loan officer of American Equity Mortgage explained that it was best for me because I would only have to make one payment instead of two, it would all be tax deductible, and with my bills paid off, I should be able to handle the new payment. In addition, he implied that I would have difficulty getting a second mortgage because of my credit history. Not being a financial whiz, I relied on his expertise.

My old mortgage loan had a remaining balance of about $74,000 [and] an interest rate of about 7.5 percent. … My home is worth about $151,000. My new mortgage is for $100,750, has an interest rate of 12.85 … and [has] a prepayment penalty…. The $100,750 new mortgage was comprised of the $74,000 payoff of the old mortgage, $18,656 in additional funds to pay off bills and perform minor improvements on my home, and points and fees totaling $8,105.

I did not understand the full cost of the additional money I received until several weeks later when I finally discussed the situation with one of my sons. Based on my son’s calculations,

\(^{55}\) American Equity Mortgage is not a small or fringe institution. As its website touts: “[W]e are one of the leading mortgage bankers in the country, and we have been providing financial solutions that help thousands of homeowners get back on track every year. We have a variety of programs for debt consolidation, refinancing, and purchases, which allows us to help almost anyone. Even if you have had credit problems, we can put together a program to meet your needs. Through our award-winning customer service and strong advertising, we have established ourselves as an industry leader. You can trust American Equity Mortgage to provide you with the best possible service, now and in the future. And with our state of the art software, we make the process fast and easy.” www.americaneqmtg.com/about.htm. It originated over $1.3 billion in loan volume in 2002, and has won various awards. See, e.g., www.americaneqmtg.com/CAAEM.pdf.
American Equity Mortgage and their loan officer thought it was in my best interest: To pay $8,105 in points and fees to receive $18,645 in additional funds; to pay an effective interest rate of 44 percent on the ... additional funds; ... and to pay an additional $201,608 in interest over the life of the loan for the $18,645 in additional funds.

– July 2001 Senate Hearing Testimony of borrower Carol Mackey

Current law does not ensure that consumers will engage in informed price shopping that will result in competitive home loan pricing at marginal lender cost levels, even accepting the decisionmaker model presupposed by current law. First, federal law does not cover all home loans, the legal fix for which needs no explanation. Next, borrowers do not understand even the current disclosures, in part due to lack of financial literacy. Current legal rules recognize consumers’ inability to comprehend underlying loan documents, but fail to recognize that the same problem infects the responses of some borrowers to the disclosures themselves. For example, regarding loan price disclosures, only ten percent of respondents in a survey of recent home loan borrowers understood the concept of APR well enough to accurately answer whether the APR is higher, the same, or lower than the note or contract interest rate, fewer than would have correctly guessed the answer by chance. The disclosures are not presented in simple enough lay terms, and many borrowers, encouraged by loan sellers to do so, ignore the disclosures as incomprehensible legally-mandated gobbledygook.

Third, other than the GFE, none of the disclosures are provided early enough in the process to truly facilitate price shopping, even under the current law’s assumption that borrowers will try to use the information provided to make the loan decision. The law recognizes that consumers need written price disclosures to make a decision, yet then fails to give them the disclosures until a point in time when, as both a practical matter and as a matter of decisionmaking psychology, many consumers will not be in a position to price shop. Without shopping, consumers have no reference points for evaluating the price disclosed and making an informed decision. The TILA and HOEPA disclosures are provided for purchase money loans and for high cost refinancings and second mortgages only three days before closing. Although with automated underwriting, the loan approval and pricing decision can be fairly quick in the prime market, in the subprime market typically more borrower information must be collected and analyzed before a lender will make a pricing decision, meaning that three days is not enough time to obtain competing loan price offers. For refinancings and second mortgages that fall

56 Excerpts of Statement of Carol Mackey, 2001 Senate Hrg., supra n. 11 at 14-15.


58 In the predatory market, this borrower information could include information about whether the borrower is likely to be exploitable, willing to accept a loan at a higher price than risk and cost to the lender would dictate.

59 Legally, the lender need not give the potential borrower any competing price disclosure (in the form of the GFE) until 3 days after receiving the application, so obtaining the final disclosures 3 days before closing may be
below the HOEPA triggers, the only required written disclosure of the APR and finance charge need be given until closing, after which all the borrower has to use for price shopping purposes is the three day right of rescission, not a realistic shopping window. Psychologically, the borrower will typically be in a decisionmaking mindset or “frame” only until she completes the application or receives informal price information such as an estimated monthly payment amount; at three days before closing through three days after closing she is likely to be in a post-decisional implementation frame, and will be motivated to justify, but not revise, her prior decision.61

HOEPA recognizes something close to this phenomenon for high cost loan borrowers, and gives them a disclosure explaining that they are not obligated to accept a loan once they have signed the application. While, as explained below, the disclosure itself is largely ineffective, there is no reason to think this misperception affects only high cost borrowers, yet the law does not require that this corrective information to be given to other borrowers.

Fourth, some of the disclosures do not include all the information needed to price shop. The GFE is not hard and fast, and in some cases lenders, not being subject to any legal liability for failure to prepare an accurate GFE, disclose a range of potential settlement costs rather than the specific prices that will be charged, such that consumers cannot truly rely on the GFE to shop for settlement services. Motivated reasoning would also be likely to cause consumers to focus on the lower end of the range, giving lenders an incentive to low-ball their estimates. The APR does not allow for accurate comparisons of total loan costs, because it excludes the price of title insurance and application, appraisal, and document preparation fees, all of which are part of the true cost of credit. Moreover, it is only accurate if the borrower holds the loan to term, or if the entire price is charged through interest, both unlikely scenarios. The prepayment penalty statement on the TILA disclosure is opaque, stating only that the loan “may” result in a prepayment penalty, but without any explanation that refinancing the loan is the equivalent of physically too late. And in any case, such competing offers would not necessarily be binding, because the GFE needs only to be an estimate, and can be disclosed as a range.


61 Accord HUD-Treasury Report, supra n. 7 at 65 (“Currently, consumers receive the GFE within 3 days after application[,] after they have paid an application fee and are committed to a loan provider.”).


63 All figures on the TILA and early HOEPA disclosure exclude the cost of credit insurance where credit insurance is not “required” by the lender. The problem with this is that lenders frequently slip credit insurance into loans such that borrowers perceive it to be required, and to be part of the price they must pay for credit, yet it is not included in the disclosed aspects of loan price. This is particularly problematic in the case of single premium credit insurance, a product that, where financed, is significantly more expensive than monthly credit insurance premiums would be, particularly where the borrower does not hold the loan for the term of the insurance, with no additional benefit to borrowers, but with benefits to the lender of being able to collect interest on the financed premium.
repaying it, nor any indication of how much such a penalty will cost the borrower. The failure to require a statement of the prepayment penalty amount reflects an underlying substantive issue – these penalties can be structured in so many ways, that no one uniform short disclosure can convey all the information needed to make a fully informed price decision.

Fifth, and in tension with the foregoing, even the current disclosures contain too much information, which poses both a process problem and a substantive problem. On the process side, the amount of information alone overloads consumers, regardless of whether it is buried in the documents or in a few dense sheets of paper, even though it is perhaps less overwhelming than it would be if presented as a stack of long legal documents without the disclosures. At a more substantive level, the reason the disclosures contain so much information is because borrowers need all of this information to make a fully informed decision, because the loans themselves are complexly structured. But understanding why this complexity is a problem requires moving beyond the law’s model.

3. Beyond the Law’s Decisionmaking Model

Through more than 50 interviews with borrowers and inspection of loan documents, a pattern emerged. All of the borrowers interviewed knew the amount of their monthly payments, but none understood all of the financial details in their loan such as adjustable interest rates, balloon payments and points.


a. Decisionmaking Heuristics

Heuristics, or rules of thumb, are frequently adaptive tools that simplify the decision process by providing a short-cut alternative to engaging in a total cost-benefit analysis of outcomes expected from each alternative choice option. To take just one example here, most people use only four or five salient decision attributes in making complex decisions; beyond that number, decisionmaking quality goes down. When under stress, people reduce the number of

64 Faced with an ambiguous disclosure, motivated reasoning may cause the borrower to consider only the positive possibility that there “may” not be a prepayment penalty incurred, engaging in what has been dubbed “elastic justification.” See Christopher K. Hsee, Elastic Justification: How Tempting but Task Irrelevant Factors Influence Decisions, 62 J. ORG. BEHAV. & HUMAN DECISION PROCESSES 330, __ (1995).

65 For example, prepayment penalties can be structured to vary over time, as a percentage of the remaining principal, or as a proportion of the as-yet-unpaid interest payment stream the lender had been hoping to receive. For such a loan, the disclosure of the prepayment penalty would have to contain quite a lot of information, none of which is well-understood by people with low financial literacy.

66 Paul D. Davies, Anything for a Deal, PHILADELPHIA DAILY NEWS (February 6, 2001).

67 In laboratory experiments – ideal informational conditions not present in real world home loan decisionmaking in that (a) subjects are given information about all relevant attributes (and thus subjects have no search costs) and (b) that information is presented in a format that is easily understood and encoded (and thus subjects have low information processing costs) – subjects typically consider a maximum of five attributes (including price and quantity terms) of a product. See Denis A. Lussier & Richard W. Olshavsky, Task Complexity and Contingent
attributes under consideration even more radically, to fewer attributes.\textsuperscript{68} In the home loan context, a common heuristic is to use the monthly payment amount as the sole price assessment criterion. By reducing the loan to a single attribute, the consumer eliminates any less tangible, more uncertain, or more difficult to calculate loan attributes from the decision process.\textsuperscript{69} The monthly payment is an easily understood attribute of the loan, one for which the borrower has available reference points of prior mortgage or rent payments.\textsuperscript{70}

\textit{Processing in Brand Choice}, 6 J. CONSUMER RES. 154, 155 (1979); see also id. at 155 (noting that past research indicates that consumers consider only three brands and five attributes when making purchase decisions); id. at 162 (in product choice experiment, subjects usually reduced the number of brands considered to three or four, and then analyzed five or fewer attributes, even when information was readily available on other relevant attributes). Even given this restricted set of information, there appears to be significant heterogeneity among subjects in choice strategy, id. at 163, and in which and how many attributes are considered. See, e.g., Alfred S. Boote, \textit{Market Segmentation by Personal Values and Salient Product Attributes}, 21 J. ADVERTISING RES. 29, 30-31, 34-35 (1981); Danielle Timmermans, \textit{The Impact of Task Complexity on Information Use in Multi-attribute Decision Making}, 6 J. BEHAV. DECISION MAKING 95, 100 (1993). In marketing studies designed to determine which attributes consumers consider in making real world product purchasing decisions, under more realistic conditions of search costs and information processing costs, even fewer attributes are typically considered. See sources cited in Appendix to David M. Grether, Alan Schwartz & Louis L. Wilde, \textit{The Irrelevance of Information Overload: An Analysis of Search and Disclosure}, 59 S. CAL. L. REV. 277, 302 (1986) (listing studies showing that, in addition to price, consumers consider anywhere from a single attribute of batteries (durability) to 3 attributes of tires (puncture resistance, quality of tire and guarantee) in making purchase decisions); id. at 300 (noting studies indicating that “the number of salient or determinat product attributes . does not exceed five, and is often less”). Studies of more complex decisions than purchases of common consumer products indicate that as complexity increases, the use of suboptimal simplifying strategies increases. See, e.g., Barbara E. Kahn & Jonathan Baron, \textit{An Exploratory Study of Choice Rules Favored for High-Stakes Decisions}, 4:4 J. CONSUMER PSYCHOL. 305, 325-26 (1995) (in study of highly educated subjects, although subjects indicated that a complex compensatory decision strategy should be used, and that they wanted professionals to use such rules, they themselves chose to use simplifying strategies when making decisions).

\textsuperscript{68} Giora Keinan, \textit{Decision under stress: Scanning of alternatives under controllable and uncontrollable threats}, 52:3 J. PERSONALITY & SOC. PSYCHOL. 639, 642 (1987). See also Noel Capon & Marian Burke, \textit{Individual, Product Class, and Task-Related Factors in Consumer Information Processing}, 7:3 J. CONSUMER RES. 314, 324 (Dec. 1980) (finding in consumer choice experiment that low socioeconomic status (SES) subjects sought less information, ignored some choice alternatives, relied more on brand name, and even used less price information than mid/high SES subjects).

\textsuperscript{69} Relying on certain, well-understood choice attributes to make a decision while ignoring other attributes has been named the “evaluability bias.” See Christopher K. Hsee, \textit{The Evaluability Hypothesis: An Explanation for Preference Reversals Between Joint and Separate Evaluations of Alternatives}, 67 ORG. BEHAV. & HUMAN DECISION PROCESSES 247, _ (1996); see also Christopher K. Hsee, \textit{Less is Better: When Low Value Options Are Valued More Highly Than High Value Options}, 11:2 J. BEHAV. DECISIONMAKING, 107, 116-17 (1998).

\textsuperscript{70} Unlike interest rate or APR, which are not mentally-available reference points for many borrowers, even those who have had previous home loans. One survey found that about ten percent of home loan borrowers admit that they do not know what their home loan interest rate is, even within a percentage point or two, and this probably significantly understates the true number who do not know their interest rate, because the survey did not check to see if the responses of borrowers who claimed to know their home loan’s interest rate within a percentage point or two were correct. Fannie Mae, \textit{2001 National Housing Survey} 13 (Fannie Mae Foundation 2002) [hereinafter, \textit{2001 NHS}] Borrowers were asked to report whether their home loan interest rate was less than 7 percent, between 7 and 8 percent, between 8 and 10.5 percent, between 10.5 and 12 percent, between 12 and 14 percent, or greater than 14 percent. Between 10 and 11 percent of respondents did not know where within these ranges their loan interest rate fell. \textit{Id.}
Further, many borrowers use the monthly payment heuristic not to optimize the decision by finding the loan with the lowest monthly payment, but rather use the maximum monthly payment amount as a ceiling, and will accept the first loan they find under this ceiling. Although “satisficing” in this way is motivated by a borrower concern about avoiding an unaffordable monthly payment and attendant risk of foreclosure, the result is that the broker or lender may sell the borrower the highest priced loan on the market that can be structured to meet the monthly payment satisficing heuristic. Similarly, the seller may offer a loan with a low initial monthly payment figure that meets the borrower’s ceiling, but that increases over time. Empirical study confirms the danger that borrowers who rely on monthly payment as a simplifying heuristic are vulnerable to price gouging. Using a multivariate regression analysis of the home loan search methods of prime and subprime borrowers, “borrowers whose search emphasized affordable monthly payments” were more likely to end up with a higher interest rate, subprime loan rather than a prime loan, even controlling for the cost and default risk profile presented by the borrower to the lender.

b. Cognitive Biases

A bias in decisionmaking is a failure to weight an aspect of the decision accurately. In the home loan decision, consumers may underweight the total price of the loan not only by relying exclusively on the monthly payment heuristic, but also due to common cognitive biases. For example, time discounting or myopia, a common bias causing an underweighting of events in the future through an abstracted construal of the future event, may affect price shopping. Some borrowers influenced by this bias would tend to underweight the future costs of the loan, such that in making the loan decision, a loan with monthly payments that go on for ten years might seem nearly the same as a loan with the same monthly payments extending for fifteen years. Similarly, mental “scaling” biases, including underweighting of large figures beyond the more everyday experience of the decisionmaker, can cause some borrowers to underweight, or even fail to weight at all, the total finance charge on a home loan. The total finance charge is typically a figure in the tens or hundreds of thousands of dollars, a dollar figure that for some borrowers is beyond any figure with which the borrower has familiarity and facility in evaluating.

71 Simon, supra n. 47 at 114-15.

72 Loans with monthly payment increases are discussed in more detail in connection with risk, below.

73 Courchane et al, supra n. 24 at 13.

74 See Shane Frederick, George Loewenstein & Ted O’Donoghue, Time Discounting and Time Preferences: A Critical Review, 40:2 J. ECON. LIT. 351, ___ (June 2002) (citing evidence). That people will have different ways of thinking about events depending on the level of concreteness or abstractness, near time period or far, certainty or uncertainty of the event has been termed construal level theory. See Shiri Nussbaum, Yaacov Trope & Nira Liberman, Creeping Dispositionism: The Temporal Dynamics of Behavior Prediction, 84:3 J. PERSONALITY & SOC. PSYCHOL. 485 (March 2003).

75 See Stanislas Dehaene, THE NUMBER SENSE 76 (1997) (“The mental ruler with which we measure numbers is not graduated with regularly spaced marks. It tends to compress larger numbers into a smaller space. Our brain represents quantities in a fashion not unlike the logarithmic scale on a slide rule, where equal space is allocated to the interval between 1 and 2, 2 and 4, or between 4 and 8.”).
Another cognitive bias is to overweight out-of-pocket sunk costs, due to the intersection of a number of psychological phenomena.\textsuperscript{76} This may inhibit a borrower who has filled out an application and paid an application fee from rationally reconsidering her options, even when the loan she is subsequently offered and for which she receives price disclosures appears to be very expensive. Filling out the application and paying the fee may create a sense of commitment, because to decline the loan would imply that the original decision to pay the fee to this lender was incorrect. Rather than appear wasteful and incurring a certain loss of the application fee by declining the loan and seeking another lender, some consumers may be tempted to mentally overstate the positive aspects of the loan offered, and mentally understate the price apparent from the disclosures. This may inhibit price shopping because, although the application fee is usually in the fifty to two-hundred dollar range, a cost that could easily be more than compensated for by finding a loan with even a slightly lower interest rate than the one under consideration, that application cost may loom larger, and be overweighted in the decision whether to apply to multiple lenders so as to price shop.

c. Emotional Coping Mechanisms

\textit{The Power of Yes.}

- Washington Mutual\textsuperscript{77}

Emotional coping mechanisms can interfere with decisionmaking by causing the decisionmaker to ignore or avoid emotionally threatening information.\textsuperscript{78} For example, a borrower who wants to avoid the ego threat posed by repeatedly exposing her poor credit history in the loan application process – what one broker calls “the financial strip search” – could be

\textsuperscript{76} A decision is a point between two stages: a predecisional deliberation stage, in which one is still weighing alternatives, and an implementation stage, in which one perceives oneself as implementing a decision that one has made. See Liberman & Trope, supra n.60 at __. A decision is often subjectively experienced as a commitment, giving the decisionmaker an expectation of whatever benefits and burdens she knew would be entailed when she made the decision, thereby creating a new status quo reference point from the perspective of the endowment effect. Once someone has committed to something, she is often reluctant to change, and will not pause to reconsider her decision even when new information comes about during implementation that would cause her, if she were in the predecisional phase, to weigh options very differently. To change would imply that the original decision to commit was incorrect, and therefore poses an ego threat. Even without new information, the old information is reinterpreted in light of the commitment; subjects’ probability of success estimates for an investment are higher after they have chosen the investment than before they have chosen it, even though the only new information they possess is their own decision. See, e.g., Hal R. Arkes & Laura Hutzel, \textit{The Role of Probability of Success Estimates in the Sunk Cost Effect}, 13:3 J. Behav. Decision Making 295, 301-02 & 303-05 (July-Sept. 2000).

\textsuperscript{77} “The Power of Yes” is Washington Mutual’s slogan, and much of their advertising in recent years has prominently featured the word “Yes.” See, e.g., www.wamupremierebroker.wamudashboard.com/broker/website/AboutPremiere.jsp

\textsuperscript{78} For example, people will avoid negative information about themselves, in effect denying the implications of the information, even when doing so predictably results in short term emotional gains only at the expense of long term well-being. See, e.g., George F. Loewenstein, Elke U. Weber, Christopher K. Hsee, & Ned Welch, \textit{Risk as Feelings}, 127 PSYCHOL. BULL. 267 (March 2001) (surveying evidence that smokers will avoid lung cancer information and women will avoid breast cancer information).
deterred from price shopping. The data bear out a relationship between receiving a higher cost subprime loan, and failing to price shop. In the 2001 National Housing Survey, a third of all homeowners reported that they chose their lender based on the interest rate, whereas only eleven percent of subprime borrowers reported that this was why they chose their lender. Subprime borrowers also report less search for the best interest rate they could obtain than prime borrowers – about a third of subprime borrowers yet half of prime borrowers report that they searched “a lot” for the best rate. No money down and a quick decision were more frequently-cited by subprime borrowers than by borrowers overall as reasons for choosing a particular lender or broker.

This avoidance coping mechanism will have a disparate impact on African-American consumers, because they have, on average, worse credit histories, and because they more frequently than whites misperceive themselves as having poor credit histories when their credit is good. According to a 1999 national survey, approximately fifty percent of African-American borrowers, and thirty percent of white borrowers, who had good credit believed they had poor credit. Similarly, the fear of discrimination causes some African-American and Latino borrowers to avoid potential discriminatory denial of credit by shopping based on “guaranteed approval” rather than attempting to obtain a loan from a prime lender that advertises low rates.

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79 Borrowers who believe their credit is impaired are more likely than prime borrowers to choose a lender based on high likelihood of being approved for the loan, with fifteen percent of credit-impaired borrowers in the 2001 National Housing Survey admitting that this was the reason they chose their lender, versus only four percent of all borrowers giving this as a reason. 2001 NHS, supra n. 70 at 14; see also Lee & Hogarth, supra n. 57 at 279 (“‘[H]igh-risk’ consumers may be less willing to engage in [home mortgage] search in order to avoid being turned down…. [I]f they are turned down or obtain a smaller loan than needed, they may be forced to engage in further search activities.”).

80 2001 NHS, supra n. 70 at 14.

81 Courchane et al, supra n. 24 at 11.

82 2001 NHS, supra n. 70 at 14.


84 One study found that as at 1992, 40% of African-Americans and 10% of whites in a major U.S. metropolitan area thought banks and lenders would “very often” not loan money to African-Americans, and another approximately 45% of African-Americans and 40% of whites thought banks and lenders “sometimes” would not loan money to African-Americans. Reynolds Farley, Racial Differences in the Search for Housing: Do Whites and Blacks Use the Same Techniques to Find Housing,? 7:2 HOUSING POLICY DEBATE 367, 381 (1996).

85 Although the absolute numbers of borrowers who reported using this as their primary basis for decision was small, more than twice as many borrowers who have higher-cost subprime home loans than borrowers overall reported that they picked their lender based on the fact that the lender did not discriminate. 2001 NHS, supra n. 70 at 15. A recent industry focus group study of African-American and Latino recent purchase money home loan borrowers fleshes out these findings, and sheds some light on why even upper-income nonwhites are disproportionately likely to end up with subprime loans: A majority reported that they were not provided with, and did not seek, a variety of mortgage options:
The marketing campaigns of subprime lenders play on these emotional coping mechanisms, emphasizing “the power of yes” and the guarantee of approval, without advertising the interest rate or APR of the loans being offered. The fear of a loan denial, whether due to real or imagined credit history or discrimination, can lead consumers to quickly agree to any loan offer, regardless of price. Fannie Mae’s 2001 National Housing Survey found that ten percent of all homeowners, and a third of all credit-impaired borrowers “did not care whether they received the lowest cost loan for which they were qualified. They were just happy to be approved for a mortgage.”

B. How to Solve the Price Problem

1. Why the Market Will Not Solve the Price Problem

As is evident from the current lack of price advertising for subprime loans, sellers know that price is not a top concern for significant market segments. More importantly, sellers benefit from keeping borrowers in the dark about subprime loan prices. Without reference points for what loan price to expect, subprime borrowers generally must rely on the loan prices given to them by the sellers, who know much more about what price would be available in the marketplace for that borrower’s risk and cost profile. In a sense, adverse selection is turned on its head – the lenders are doing the adverse selection here, picking buyers who will generate the highest surplus to the lenders. The “informed minority” of super-rational borrowers has no effect on any of the terms a vulnerable borrower receives, because the benefit to the lender of setting individualized contract price terms outweighs the costs, and therefore lenders and brokers carefully differentiate among borrowers and price the loans offered to them based on not only the lender’s costs, but also the borrower’s vulnerability. By discriminating between informed super-rational borrowers and vulnerable borrowers, lenders can sell more expensive and riskier loans to the latter. Further, because broker and loan officer compensation is tied to volume and markups (both interest rate markups, called “yield spread premiums,” and markups on other price

[They] did not actually comparison-shop for the best terms for their mortgage. Many did not think such comparisons were possible. A substantial number were just happy to get a “yes” to their mortgage application, so they did not even consider the possibility of getting better terms for their mortgage. The few participants who considered multiple mortgage applications to permit closer comparisons were discouraged from doing this by the penalties associated with repeated requests for credit scores.

Research Institute for Housing America, Insights into the Minority Homebuying Experience: The Mortgage Application Process 8-9 (2003). Too many inquiries can reduce a credit score, because some credit scoring models view a number of closely-spaced inquiries as an indication that the consumer has been turned down for credit.

86 2001 NHS, supra n. 70 at 12.

87 See, e.g., Pennington-Cross et al., supra n. 7 at iv (“[W]hy do subprime lenders not advertise more, and why do local newspapers not publish, as they do for prime lenders, current interest rates and fees for local subprime lending institutions?”).

88 Howell Jackson, Jeremy Berry, & Laurie Burlingame, Kickbacks or Compensation: The Case of Yield Spread Premiums, ANNUAL REV. BANKING (forthcoming 2005).
components of the loan package, such as points, fees, and credit insurance\textsuperscript{89}), there are incentives for them to sell borrowers a larger loan than the borrower needs, at a higher price than otherwise available on the market.

Why is there so little advertising of subprime and predatory loan prices? First, because loan products and their pricing today are simply too complicated for many borrowers to easily understand and use in decisionmaking. Borrower education is a public good, giving no one lender an incentive to provide it. The home loan borrowing process is not a frequently repeated game for most, giving consumers few opportunities to learn from the process, and leaving the likelihood of ending up at a maximizing decision strategy equilibrium nil. The heuristics, biases, and coping mechanisms that cause many borrowers to misunderstand, ignore, or fail to sufficiently weight aspects of the price of a home loan, have generally been found to be very stable and resistant to change. No lender or broker will find it in its interest to advertise and then offer low prices to vulnerable borrowers, because these borrowers will accept higher prices.

Although anticipation that borrowers with overpriced loans will refinance elsewhere could lead to interest rate competition,\textsuperscript{90} it will not lead to competition over prices for prepayment penalties or up-front fees, which in this market can be the lion’s share of the price. Average origination fees in the prime market are between one and one and a half percent, but predatory lenders have been known to charge fees (typically financed into the loan) of twenty-five percent.

Second, even a competitive pricing structure for subprime loans will result in a range of prices according to the cost and risk presented by each borrower and loan. Such prices can not be effectively advertised, because there are no generic standards defining which borrower qualifies for which price, and the formulae are too complicated and too quickly evolving for the information to be transmitted in an advertisement from which a borrower might identify which price she would qualify for from a particular lender. No lender will find it in its interest to assist borrower shopping by giving the borrower complete price information about the loan offer early in the process, long before closing, because that would only open up the possibility that the borrower will find a cheaper loan elsewhere. This is not to say that there are no subprime borrowers who shop; the A-minus market is actually becoming more competitive, apparently due to price shopping by a segment of subprime borrowers. But other segments of this market are

\textsuperscript{89} Brian Collins, \textit{Citi Pays $215 Million to Settle Alleged Fraud at Associates} National Mortgage News (Sep. 23, 2002)( reporting that “[i]t was not uncommon for Associates to charge $5,000 for credit insurance on a $35,000 loan and add it to the loan amount); Affidavit of Gail Kubiniec, Exhibit K to Federal Trade Commission’s Opposition to Citigroup’s Motion to Dismiss, \textit{FTC v. Citigroup et al.}, CV ____ (U.S.D.C. N.D. GA., filed May 16, 2001) (“All CitiFinancial branches had quotas for the sale of credit insurance. These quotas increased over time. At the time I left CitiFinancial in February 2001, the quota was $102 of credit insurance for every $1000 of loan held by CitiFinancial...”); Former CitiFinancial Employee, email to Inner City Press (June 7, 2004) at www.innercitypress.org/citi.html (“Thirty percent of a branch’s profit is attributed to the sales of insurance products. In fact, from the credit insurance premiums that a branch sold, they received 35% commission if Accident & Health or Involuntary Unemployment Insurance, and 30% commission if for credit life insurance. All of the ancillary products - which included something called Home and Auto - are worth 40% commission back to the branch.”).

\textsuperscript{90} However, subprime refinancings do not appear to be very responsive to interest rates. Although prime refinancings mirror market rate changes, subprime refinancing activity is fairly flat, driven by cash-out refinancings rather than by rate refinancings. OCC Working Paper, \textit{supra} n. 15 at 11; see also Cutts & Van Order, \textit{supra} n. 7 at Fig 1 (graphing prepayment rate data for prime and subprime loans against 30-year fixed mortgage prime interest rate).
unwilling, unable, and/or unmotivated to price shop. The veneer of objectivity and legality that currently imbues the borrowing process\textsuperscript{91} lulls a surprising number of borrowers into the mistaken belief that all lenders are required to give them the lowest loan price for which they qualify, and these borrowers therefore see no reason to price shop.\textsuperscript{92}

2. Simplification of Loan Products to Achieve Meaningful Transparency Through Simple, Timely Disclosures

The overpricing issue probably can, and, in light of the volatility of financial conditions and the mutability of loan price terms, certainly should, be regulated primarily with a “framing” focus, rather than through price controls. Substantive limits on loan prices are not an appropriate remedy for the problem of overpriced loans first because loan instruments are so malleable that any limit on one aspect of price can be evaded through restructuring the loan. Second, the price of home loan money will vary with many macroeconomic factors over time, such that an absolute limit could constrain appropriately priced lending when interest rates rise. Third, even if an indexed rate were chosen as a price limit, some loans at high prices in comparison to indexed rates can be appropriately priced, depending on the specific situation; for example, a small loan would, due to the cost of making and servicing the loan, be appropriately priced at a rate higher than the indexed rate.

Instead, home loans need to be simplified and standardized, and disclosures need to be provided earlier in the process, such that the vast majority of home loan borrowers will be enabled and encouraged to effectively price shop. The existing TILA and RESPA disclosures made some sense in a world of fairly simple uniform loan products. But in today’s marketplace of loans with multifarious complex structures, the disclosures have become encrusted with layer upon layer of additions to meet each new complexity in the product. As a result, too many different dimensions of the loan must be examined by the borrower for many to make a fully rational decision. We need to move back to simpler and more standardized loan products, because only easily understood pricing, in conjunction with the disclosures that make that pricing easily observable early in the process, can lead to effective price shopping.

My preliminary proposal, for home loans other than purchase money loans,\textsuperscript{93} would be to:

\textsuperscript{91} The loan price seems objective because it is presented as “this is the loan for which you qualify, according to our computer modeling of your credit report, based on objective facts about your credit history.” It seems legally-sanctioned at every turn, from the ream of government disclosures and loan documents filled with legalese, to the closing run by a formally independent settlement officer.

\textsuperscript{92} Just under 40\% of American adults, and closer to half of African-Americans and Latinos in Fannie Mae’s 2002 National Housing Survey, erroneously believe that “lenders are required by law to give a borrower the best rates possible.” Fannie Mae, 2002 National Housing Survey 9 (Fannie Mae Foundation 2003).

\textsuperscript{93} Purchase money loans tend not to be predatory, as explained above. Because more creative financing may be legitimately needed and reasonable to get someone into a home purchase, and because creative loan structuring tends to be predatory only in the non-purchase money market, my price proposal would not apply to purchase money loans. Pure rate refinancings – refinancings where the total finance charge remaining to be paid on the old loan exceeds the total finance charge to be paid on the new loan plus any prepayment penalty – might also be exempted from my proposal. Not only are pure rate refinancings not predatory, but they could be constrained by the timing provisions of my proposal, explained below.
(a) provide a simplified price shopping disclosure to the borrower early in the shopping process;

(b) substantively limit the structure of these loans such that the simplified disclosure would provide all the information needed to price shop; and

(c) bring the market to the borrower to facilitate price shopping through a centralized process through which lenders could submit competing loan offers to borrowers.

The simplified disclosure would have to be given to the borrower before the borrower has sunk anything greater than minimal application fee costs into the process, such as a $50 application fee. The idea is to give the borrower a tool to use to shop at a time when the borrower is still in a decisionmaking frame, rather than at the implementation stage. The disclosure should be made no later than one week after application and three weeks before closing, so that the borrower has enough time to effectively price shop before becoming psychologically committed to the loan. The disclosure should instruct the borrower to use it to comparison price shop among lenders, and warn the borrower that the loan she is being offered may be overpriced. Failure to provide the disclosure would nullify the mortgage or result in a comparable deterrence-aimed penalty, such that the holder of the loan in the secondary market would have an incentive to police the originating lender and broker.

The disclosure would contain only four loan terms, few enough attributes that most borrowers could effectively use them in decisionmaking. These attributes would be:

1. total loan proceeds,
2. total up-front fees, points, and costs (whether financed or not financed and whether charged by a third-party or by the lender),
3. maximum monthly payment, and
4. loan length in years.94

The tolerances for estimates on the disclosures should be very narrow, such that the lender can not disclose a broad range of possible prices or a low-balled price. The first three figures would be expressed as a dollar amount, because consumers generally understand whole dollar figures better than percentages. The up-front cost figure would include every kind of fee and cost, including single premium credit insurance and similar products bundled into loan packages, such that the total up-front fee figure added to the total loan proceeds figure would sum to the total loan amount. The maximum monthly payment figure should probably include principal, interest, taxes, and insurance (PITI), as the borrower must budget for that total, a concern on the risk side of the problem discussed below. By disclosing only the maximum monthly payment, and not the initial monthly payment, hidden interest rate and monthly payment increases would no longer be advantageous, because the maximum monthly payment would be

94 People are more familiar with and have better facility with an expression of long time periods in years, rather than TILA’s current disclosure of the loan period in months (i.e., people understand what is meant by a “20 year” loan better than a “240 month” loan).
the disclosed monthly payment the borrower would use to price shop. These four attributes are few enough, and concrete enough, for most borrowers to use in comparison price shopping among loans.

For the simplified disclosure to enable price shopping, the four attributes disclosed must fully reflect the price of the loan. Therefore, balloons and negative amortization would be prohibited, because these would not be reflected in the above figures. While it would be possible to craft an exception for balloons and negative amortization in situations where the borrower has a reasonably certain reason for expecting to be able to pay the balloon when it comes due, and from sources other than another mortgage (e.g., maturing trust fund, plans to sell house), any exception creates opportunities for deception for unscrupulous lenders. Similarly, prepayment penalties would not be permitted, because these would not be reflected in the above disclosure. By structuring loans in simpler and fairly standardized ways, loans could be meaningfully compared through examination of these few features. By simplifying the loan pricing mechanism and the disclosure documents, the home loan decision process would be reframed to require consideration of only a limited number of loan attributes to make meaningful price comparisons between loans, thus facilitating price shopping.

These are not merely process solutions; by requiring loans to be structured in simplified and standardized ways, some choice narrowing will follow. This will involve some costs, because some complexly structured non-purchase money loans that are not predatory will be eliminated by these changes. There is no way to perfectly disaggregate predatory and non-predatory uses of some loan products, absent a pricing suitability standard applied on a case-by-case basis in the courts or an administrative body, a costly and probably infeasible solution.

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95 Prohibiting monthly payment escalations other than those tied to an indexed rate (a traditional ARM) might be required, to prevent lenders from sidestepping this regime by orally contradicting the disclosure. In the case of an indexed rate, the maximum monthly payment would have to be disclosed as the “maximum foreseeable monthly payment.” The “maximum foreseeable monthly payment” would be the maximum monthly payment given the highest interest rate prevailing for the applicable index for any quarter in the number of years prior to the loan origination equal to the loan term (i.e., for a 30-year loan, the 30 years prior to origination).

96 The prohibition on balloons and negative amortization also addresses the risk side of the equation, discussed below, in that these products tend to be risky because borrowers often do not have the money to refinance the balloon payments when they come due. My proposal would exempt reverse mortgages, also called home equity conversion mortgages, highly regulated instruments through which senior citizens can extract the equity in their homes for monthly living expenses until the equity is used up. The loan instrument must permit the homeowner to stay in the home until death, without making any payments on the loan. The lender can recover the principal it has lent, with interest, when the homeowner ceases living in the home.

97 The effect of prohibiting prepayment penalties would be to virtually eliminate yield spread premiums, kickbacks to loan brokers for selling borrowers higher-priced loans than the loans for which the borrowers were credit-qualified, because lenders use prepayment penalties to cover the up-front outlay to brokers on yield spread premiums.

98 See, e.g., Kathleen C. Engel & Patricia A. McCoy, A Tale of Three Markets: The Law and Economics of Predatory Lending, 80 TEX. L. REV. 1255 (May 2002); Daniel S. Ehrenberg, If the Loan Doesn’t Fit, Don’t Take It: Applying the Suitability Doctrine to Eliminate Predatory Lending, 10 J. AFFORDABLE HOUSING & COMMUNITY DEV. LAW 117 (2001).
On the one side is the harm caused by overpriced loans, including inefficiencies, money spent capturing rents, and regressive income redistribution. On the other is the benefit of the availability of complex loan products such as balloons, negative amortization, and escalating monthly payments to allow borrowers to more completely leverage their equity and to tailor their loan payments to their projected income stream, where that income stream is increasing. On balance, particularly in light of widespread uniformity of prime loan terms, it seems that the harm that will be avoided will outweigh the harm caused by these proposals.

3. Bringing Price Competition to the Borrower

The simplified price shopping disclosure described above could be even more useful to borrowers if, once one lender had given the borrower a loan offer in the form of the disclosure, other lenders came to the borrower with competing offers, the terms of which were disclosed in the same simplified format. To bring price competition to the borrowers, I propose that a government agency, perhaps the Department of Housing and Urban Development (HUD) or the Federal Trade Commission (FTC), set up a method to facilitate such competition. A possible regulatory scheme would be for the agency to act as a neutral “bidding agent” linking borrowers and lenders. The first lender to give a borrower an offer would simultaneously transmit the simplified disclosure, along with all pertinent borrower and loan information, to the bidding agent. The information transmitted would consist of anything and everything the lender used to determine its offer, including the application and supporting documentation, appraisal, and credit score details. The agent would post the offer and supporting materials on the internet, at a website accessible only to lenders. Lenders would then submit competing bids to the bidding agent, who would transmit them to the borrower during the three-week window. Competing lenders would have to pay an administrative fee to the bidding agent and a finder’s fee to the first lender, to cover the first lender’s costs of searching for the borrower and qualifying the borrower.

99 A suitability standard would pose numerous hurdles: the borrower must realize the loan was overpriced and initiate litigation; enforcing the standard would consume significant judicial or administrative resources in determining the “correct” price for the loan; and a standard rather than ex ante disclosure rules is more difficult to use in passing liability on to the secondary market. Similar obstacles weaken enforcement of the Equal Credit Opportunity Act’s nondiscrimination standard in the lending arena, and prevent fraud claims and unconscionability doctrine from effectively policing home loan pricing. Only a process that holds the secondary market liable such as the proposal I have set forth here can work, because otherwise that market will have a holder in due course defense to liability. Placing liability on the brokers or originating lenders alone will not work, because they can set up shop and move at will. But by placing liability on the secondary market, they will have a reason to police the brokers, for example through significant bonding requirements. Bondsmen are unlikely to bond fly-by-nighters, and these brokers will then be driven out of business.

100 In addition to these simplification solutions to borrower decisionmaking difficulties, the special situation of refinancing an existing mortgage at a higher interest rate or with additional costs and fees and yet no net benefit to the borrower should be addressed. A procedural framing solution would be to require lenders to disclose not only the price figures for the new refinanced loan, but also to disclose the price figures for the additional proceeds, if any, alone. The disclosure would thus be the amount of proceeds above the amount being refinanced, the amount of up-front costs and fees being charged on the additional funds being borrowed, the increase in monthly payment amount, and the additional length added to the loan, if any. Some experimentation would be required to determine whether borrowers would effectively use such information. Another possibility would be to substantively prohibit lenders from refinancing any home loan where the resulting loan has an APR higher than the note interest rate on the existing loan (because the non-interest components of the existing loan’s APR will have already been paid by the borrower, the note rate is the appropriate comparison figure).
for the loan. The borrower would be free to accept the original offer or any competing bid, and the competing bids would not have to go through the same posting and bidding process.  

Such a system would require careful monitoring by the agency. Regulations would be needed to prevent gaming of the system, such as the first lender failing to make all information available to other lenders or engaging in side deals with borrowers, or the competing lenders going directly to the borrower rather than paying the finder’s and administrative fees. Calibrating the right size finder’s fee would also be difficult, because too high a fee would result in too few competing bids, and too small a fee would make it unprofitable for the first lender to search for and qualify some borrowers. Because those borrowers who require the greatest assistance from the lender to qualify tend to be low and moderate income borrowers with less established and documented credit history, the finder’s fee might need to be larger for these borrowers. But if the system worked, then at equilibrium very few competing bids would be made, because the first lender would have a stronger incentive than currently exists to give the borrower a competitive price.

Through a system of early, simplified price disclosures and active price competition, the power to price shop would be placed in the hands of the borrower, and true autonomy of consumer decisionmaking would be achieved. The out of pocket sunk costs of the time, fee, and effort required to submit multiple applications to various lenders that discourage price shopping in the current market would no longer be a barrier to receiving competing loan offers. Although fear of the financial strip search and of a loan denial due to poor credit history or discrimination would continue to lead borrowers to apply to the lender who advertises a guaranteed yes, that lender would no longer have a lock on the applicant. Real price competition would displace the current problems of rent seeking by lenders, price inefficiency, and regressive income redistribution from lower income (and disproportionately African-American and Latino) borrowers to lenders.

IV. The Risk Side

A. Impediments to Good Decisionmaking About Risk

1. The Rational Actor Decisionmaker Model & The Decisionmaker Model Envisioned by the Law

As explained above, the traditional model of rational choice theory posits that people make decisions so as to maximize wealth or expected utility. They do so by evaluating all choice alternatives with reference to overall resultant states of well-being, by assessing these possible end-states in light of their own internal fixed orderings of preferences, and through basing their assessments on directly probabilistically weighted evaluations of uncertain outcomes. In the

101 The model here is similar to the service provided to prime borrowers through the on-line home loan broker LendingTree, but which is currently unavailable to subprime borrowers, because LendingTree does not arrange for loans to true subprime risk borrowers. Even if a subprime LendingTree were to be created, many borrowers at risk for experiencing predatory lending would be unable to effectively use such a service, both because they fall on the other side of the digital divide (that is, lack effective access to the internet), and because they lack the ability to gather the paperwork and accurately extract and submit the detailed information required for a subprime lender to make a firm loan offer.
context of home loans, this model would mean that borrowers know their own risk preferences, that they are able to discern the risk of loss of equity and foreclosure presented by a loan, and that they will choose the loan or alternative to taking a loan that maximizes their own wealth or utility, trading off the benefits to be derived from each loan or other alternative against the price and risk posed by the loan or alternative to arrive at an optimal decision.

The decisionmaker model underpinning the federal law of home loans recognizes a degree of boundedness to borrower rationality when it comes to risk of foreclosure, although as with price, it attempts to deal with this boundedness primarily through disclosure. First and most importantly, the monthly payment figure provided on the TILA and HOEPA disclosures is an indirect but, at least in cases where the monthly payment will not rise, very effective disclosure for many borrowers about risk. The vast majority of borrowers attempt to use, frequently quite successfully, the monthly payment figure to determine the affordability, and thus implicitly the risk, of the loan. Further, the specific TILA and HOEPA disclosures of balloon terms, which can be very risky because a borrower must be able to pay off the large balloon payment at once, are a recognition that the existence of a balloon might not be salient from the underlying loan documents. As with price disclosures, risk disclosures implicitly posit a model of consumers who may have difficulty extracting risk information from loan documents, due to lack of comprehension, an unwillingness to incur the necessary search costs, or information overload. The disclosure model further assumes that once borrowers are provided with the risk information, they will use that information to make an optimal decision about whether to incur that risk or to choose an alternative to taking the loan.

HOEPA further uses high cost of loan both as an indicator of high risk, and as a proxy for borrower vulnerability, and for these loans requires a disclosure statement that the borrower could lose the home if the loan is not paid, and disclosure of the maximum amount of the monthly payment where that amount may change. The model of the borrower here is one who lacks a complete comprehension of the mortgage instrument both as to foreclosure and as to potential monthly payment amounts, or who may be unduly confident that foreclosure will not occur and the monthly payment amount will not rise, or unwilling to admit that a foreclosure might occur. These reactions to the possibility of foreclosure and the possibility that the monthly payment may increase could be caused by persistent heuristics, biases, and coping mechanisms, such as the availability and representativeness heuristics, overoptimism, loss aversion, and motivated reasoning or confirmatory bias, discussed further below. HOEPA even recognizes that this warning may be ineffective in the face of these heuristics and biases; HOEPA provides some at least theoretical protection for borrowers who are not assisted by the warning, through prohibiting lenders from engaging in a pattern of extending high cost loans without regard to the borrower’s ability to pay from sources other than home equity. This provision, called the “asset-based lending prohibition,” however, has been sparingly enforced, largely due to doctrinal difficulty in defining what extending a loan without regard to the borrower’s ability to repay means in practice, as well as due to the hurdles posed to any one borrower in attempting to prove a pattern or practice.

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102 HOEPA does not cover reverse mortgages for seniors, discussed above.

103 The law provides no guidance as to what degree of reliance by the lender on the borrower’s anticipated income is required or what degree of reliance by the lender on the equity in the home is unlawful. All home loans are “asset-based”, at least in part, because all rely on the underlying asset as security and, even where there is insufficient
Similarly, HOEPA provides some substantive limits on risky terms for high cost loans by prohibiting balloons shorter than five years, negative amortization (which, in effect, creates a balloon due at the end of the loan term), and interest rate increases triggered by default. These substantive restraints on loan terms reflect an understanding that high cost loan borrowers need protection from the risk created by short-term balloons and negative amortization, and that where a borrower has already defaulted on the high cost loan, that borrower is especially in need of protection from interest rate escalations, as these would only increase the risk (through increasing the monthly payment amount) on a loan that has already proven to be too much for the borrower to entirely handle. HOEPA’s substantive provisions implicitly acknowledge a very different decisionmaking model than posited by rational choice theory. The model here includes some borrowers who are unable use the disclosures provided to make good risk decisions for themselves, due to lack of comprehension and persistent heuristics, biases, and coping mechanisms that affect decisionmaking.

2. How the Law Fails to Meet Its Own Decisionmaker Model

I grew up in West Virginia and went through the 6th grade…. When I remarried in 1987, my husband Richard and I were very proud that we were finally able to purchase our own small home. He worked as a maintenance worker and passed away in 1994. I became the sole owner. In July 1994, I paid off the $19,000 owed on the home from the insurance from my husband’s death. Before my husband’s death, I had never had a checking account or a credit card. I had always paid my bills in cash and tried to be an upstanding, responsible citizen….

In 1995, I received a letter from Beneficial Finance104 offering to lend me some money to do home improvements. I thought it was a good idea to put some new windows and a new heating system in my home. I signed a loan with Beneficial in May 1995…. My monthly income at that time was $458 from Social Security and payments were more than half of this. They took a loan on my house of about $11,921. The very next month, Beneficial talked me into refinancing the home loan for $16,256. I did not understand that every time I did a new loan, I was being charged a bunch of fees.

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104 Beneficial is a subsidiary of Household International, which, according to the Department of Housing and Urban Development, as at 2001 was either the largest or second largest subprime lender in the U.S. See www.huduser.org/datasets/manu.html. Both are well-established lenders to low and moderate-income people in the U.S.. Household was founded in 1878, and Beneficial, later acquired by Household, was formed in 1929. See Lendol Calder, FINANCING THE AMERICAN DREAM: A CULTURAL HISTORY OF CONSUMER CREDIT 148 (1999).
I began getting calls from people trying to refinance my mortgage all hours of the day and night. I received a letter from United Companies Lending telling me that I could save money by paying off the Beneficial loan. On September 28, 1995, I signed papers in their office. More fees were added and the loan went to $24,300, at an interest rate of 13.5 percent.

Just a few months later, I received a letter from Beneficial telling me I could save money by paying off United and going back to Beneficial. The loan was about $26,000. In February 1996, Beneficial advised me that it was time for me to refinance again. The loan papers show that I was charged a finance charge of $18,192 plus other fees and an interest rate of 14 percent. By the end of February, I had five different loans in ten months.

After that I was called by Equity One by telephone to refinance the loan. On May 28, 1996, I signed papers with Equity One... The new loan paid off the Beneficial loan – which was for 60-months – and replaced it with a loan for $28,850 for 180 months which I understand increased my total loan from $45,000 to over $64,000. I got $21.70 cash out of the loan. My monthly payments were $355.58. They charged me closing costs of over $1,100. Then on June 13, Equity One suggested that I needed another loan to pay off a side debt and they loaned me $1,960, at over 26 percent interest. Monthly payments were $79. This loan brought my monthly payments to Equity One to $434 a month. My monthly income was $470.

In August 13, Equity One started me on another loan. I was later told that Equity One was acting as a broker for an out of state lender – Cityscape. This new loan was all arranged through the Equity One office to help me by lowering my payments. The loan included $2,770 in new fees and costs. The payments were still too much. I missed my first payment... in December 1996. Cityscape said they would not take a late payment from me unless I made up for the missed payment. I could not do it. Later in 1997, I lost my home to foreclosure by Cityscape.

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105 United Companies started in 1946, and “ascended to Wall Street darling status in the early 1990s” when it began selling bonds securitized by its mortgages to investors. See Tom Guarisco, Who’s to blame?, GREATER BATON ROUGE BUS. REP. (June 10, 2003). In 1996 it made profits of $81.6 million. See Big Shoes, Big Steps, GREATER BATON ROUGE BUS. REP. (July 22, 2003). But due to accounting irregularities, it took a “$605 million write-off that stunned investors and triggered its bankruptcy in 1999,” leading to liquidation in 2000. Id.

106 Equity One is not a small or fringe lender. As stated on their web site: Equity One is a diversified consumer lending institution offering a complete line of real estate secured, home improvement and unsecured loan products. An affiliate of Popular Inc, a $33 billion company, Equity One has been in business over 12 years helping families and businesses all across the United States. Come and experience the Equity One difference- honesty, fairness, and complete customer satisfaction. www.equityone.com/our_company.html.

107 Cityscape is a defunct lender that had trouble when its securitized loan pools started performing worse than investors had expected, including foreclosure rates of over ten percent without adequate collateral to cover losses. www.fool.com/DTrouble/1997/DTrouble971003.htm.

108 Excerpts from Statement of Mary Podelcom, in 2001 Senate Hrg, supra n. 11 at 18-19 (paragraphing altered).
Even given its own implicit model of decisionmaking, the law does not do enough to ensure that consumers will engage in good decisionmaking about risk when it comes to determining which loan to take, or whether to take one at all. As with price-related information, many borrowers lack the financial literacy needed to make sense of the disclosures. For example, many borrowers do not know what a balloon is, and the balloon disclosure is therefore no more useful to them than a balloon term buried in the documents. Moreover, giving the borrower the bare information that the loan may result in foreclosure is likely to be useless. Borrowers already know that they could lose their homes if they do not pay the loan, so the risk disclosure is not really informing the borrower of anything, just highlighting the risk with the aim of increasing the weight the borrower places on risk in determining whether to take the loan. But a dry and abstract disclosure is unlikely to be enough to compel borrowers to weigh that information sufficiently into decisionmaking, because, as the substantive prohibitions in HOEPA implicitly recognize, common heuristics, biases, and coping mechanisms may interfere.

HOEPA’s model of borrower decisionmaking counsels that all loans should be covered by HOEPA’s regulations. There is no reason to think that borrowers of loans that are not high cost are not affected by some of the same heuristics, biases and coping mechanisms experienced by high cost loan borrowers. All consumers may fail to appreciate the potential for a rise in the monthly payment amount where there is a default rate escalation in the note.

Finally, HOEPA’s recognition that disclosures may be ignored, misinterpreted, or insufficiently weighted, such that substantive limits on balloons on loans shorter than five years, negative amortization, and default interest rate increases are needed, calls for regulation not only of these three loan terms, but also of the risk posed by home loans more generally. A home loan without any of the features prohibited by HOEPA may pose too great a risk of default, for example due to an escalating or variable monthly payment amount that could result in an unaffordable monthly payment, or an unaffordable balloon in year six. Any home loan borrower might fail to take these possibilities into account due to the heuristics, biases and coping mechanisms that HOEPA only very partially attempts to address.

3. HOEPA’s Decisionmaking Model Applied More Thoroughly, & Beyond

a. Decisionmaking Heuristics

Quite a number of common decisionmaking heuristics may cause consumers to fail to recognize the risk posed by a loan, even in the face of disclosures. For example, the availability and representativeness heuristics may cause consumers to ignore foreclosure risk. The availability heuristic is the tendency to ignore statistical data in favor of estimating probabilities

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109 Some loans are structured to have rising interest rates or otherwise rising monthly payment amounts at specific months or years in the repayment period. These are sometimes called graduated payment mortgages ("GPMs"), or are more generically referred to as ARMs. Although a traditional ARM is a mortgage with an interest rate that fluctuates only with an indexed rate, more complicated ARMs have been developed with interest rates that are scheduled to rise regardless of any indexed rate. HOEPA prohibits rate escalations triggered by default, but does not prohibit rate escalations built into the loan at specific months or years.
based on the mental “availability” – how easily the event is called to mind, whether due to personal experience or vividness of the image – of an event or occurrence. Information regarding foreclosure is unlikely to be mentally available for most borrowers because there are few if any vivid portrayals of foreclosure in the media, and because someone who is foreclosed upon may experience shame and embarrassment about the financial and personal failure that foreclosure implicates, such that the person would be unlikely to advertise her experience of foreclosure. Without even second-hand experience or vivid images available to most borrowers, the risk of foreclosure is likely to be under-weighted or ignored in their decisionmaking. For HOEPA loans, the disclosure statement that the loan creates a mortgage and the borrower could lose her home if she fails to pay the loan is minimal and dry, and therefore likely to be underweighted in decisionmaking.

The representativeness heuristic is the tendency to evaluate the probabilities of an unfamiliar event or occurrence based on the degree to which it resembles other familiar events or occurrences, even where the probabilities of the events may bear no relationship to how similar the events seem. A home loan borrower who has previous experience with a home loan, including the great majority of subprime borrowers and nearly all borrowers who receive predatory loans, might, using the representativeness heuristic, conclude that the risk of foreclosure posed by the home loan being considered is about the same as the risk of foreclosure experienced by the borrower in prior loans. Unless this borrower has personally experienced foreclosure, the prior home loans would not appear to have been very risky, and so the borrower may underweight the risk of foreclosure posed by the new loan under consideration.

110 When making a decision involving a future contingency, people seem to need to form an internal perceptual image of the contingency and to experience an internal conscious or unconscious emotional response to that image in order to give that contingency sufficient weight in decisionmaking. Antonio Damasio, DESCARTES’ ERROR: EMOTION, REASON, AND THE HUMAN BRAIN 96-98 (1994) (discussing formation of perceptual images). These perceptual images can arise from any or multiple sensory modalities, not only vision. “[P]eople only care about the delayed or uncertain consequences of their decisions to the degree that contemplating such consequences evokes immediate affect.” Loewenstein et al, supra n. 78 (citing sources and discussing evidence); see also Colin Camerer, George Loewenstein & Drazen Prelec, Neuroeconomics: How Neuroscience Can Inform Economics, J. ECON. PERSP. 29 (2005) (discussing evidence); Cass R. Sunstein, Probability Neglect: Emotions, Worst Cases, and Law, 112 YALE L. J. 61, 71 (2002) (“When it comes to risk, a key question is whether people can imagine or visualize the worst-case outcome.”). People therefore tend to ignore statistical data in favor of estimating probabilities based on the mental “availability” of an event or occurrence. Amos Tversky & Daniel Kahneman, Availability: A Heuristic for Judging Frequency and Probability, in JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 163, passim (Daniel Kahneman, Paul Slovic, & Amos Tversky, eds. 1982) [hereinafter, JUU]; see also Valerie S. Folkes, The Availability Heuristic and Perceived Risk, 15:1 J. CONSUMER RES. 13, 18 & 21 (June 1988).

111 Amos Tversky & Daniel Kahneman, Judgment Under Uncertainty, in JUDGMENT UNDER UNCERTAINTY, supra n. 109 at 4-7. In the consumer setting, the representativeness heuristic can lead to inferior learning by consumers with high prior knowledge of a type of product when they are presented with a new similar product, when the new product does not have significant cues that it is quite different from past products. Those consumers with prior knowledge learn less about the new product than consumers without prior knowledge, because those with high prior knowledge “incorrectly generalize from knowledge of existing products and assume that they already know how to use the new product properly.” Stacy L. Wood & John G. Lynch, Jr., Prior Knowledge & Complacency in New Product Learning, 29 J. CONSUMER RES. 416, 424 (Dec. 2002).

112 Recall that subprime loans generally, and predatory loans particularly, are mostly refinancings or second mortgages obtained by homeowners who have previously had a purchase money mortgage and perhaps other refinancings or seconds.
Another heuristic frequently used in home loan borrowing is to rely too heavily on the loan officer or broker to assist in the loan decision. This can occur at two points in the decision process—constructing the decision choice set and selecting among alternatives. The first is related to a more general heuristic of acceptance of the choice set of alternatives as that choice set is presented (or “framed”) by circumstance or by others. In the home loan context, loan sellers are unlikely to construct a choice set that includes alternatives to taking out a mortgage. Thus, the loan risk information presented in TILA and HOEPA disclosures is insufficient for the borrower to make a fully informed decision about whether to undertake that risk, because the borrower may not know what alternatives to the loan are available. Without an explanation of the costs and benefits of foregoing the loan, obtaining a less-risky loan, declaring bankruptcy, and selling the house, the borrower is unlikely to even consider these options as part of the decision process. Further, the lender has a financial interest in downplaying risk as a nonexistent or negligible aspect of the loan decision. Once the impoverished choice set is presented to the borrower, often consisting of only one or two loans, the borrower may further rely on the seller to recommend which loan to select, or, if only a single loan choice is presented, may assume the lender has already selected the appropriate loan for the borrower. Data from the field bear out these predictions: subprime borrowers frequently report that they had little or no opportunity to make choices during the home loan borrowing process, and that the lender or broker was in control of the process.

b. Cognitive Biases

Widespread and persistent biases in interpreting risk information have been documented in a host of settings. Risk tends to evoke a bimodal response; it is either ignored, particularly when perceived to be controllable, or overweighted, in a fear response. For risks perceived to

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113 See, e.g., Robyn A. LeBoeuf & Eldar Shafir, Deep Thoughts and Shallow Frames: On the Susceptibility to Framing Effects, 16 J. BEHAV. DECISION MAKING 77, 87 (Feb. 2003) (presenting evidence that people high in need for cognition were no less susceptible than people low in need for cognition, and that asking subjects to justify their choices, and thus think more deeply about the decision, did not substantially lessen framing effects); James R. Bettman, Mary Frances Luce & John W. Payne, Constructive Consumer Choice Processes, 25:3 J. CONSUMER RES. 187, 202 (Dec. 1998) (noting that people will use information in the form it is explicitly displayed, without transforming it).

114 Less risky loans could include smaller or lower-priced and thus more affordable loans, or loans without risky features such as balloon payments.

115 A study of recent home loan borrowers shows that those borrowers who did not have loan options are disproportionately receiving loans in the subprime market. Half as many subprime as prime borrowers reported that they “have a lot of choice about the options, terms or conditions” in a home mortgage, and those borrowers who reported that they did not have choices in mortgage options when they obtained their loan had a significantly greater likelihood of ending up with a high rate subprime loan, rather than a prime loan, ceteris paribus. Courchane et al., supra n. 24 at 13.

116 See, e.g., Daniel Kahneman & Amos Tversky, Choices, Values and Frames in CHOICES, VALUES AND FRAMES 8 (Daniel Kahneman & Amos Tversky, eds., 2000) [hereinafter CVF] (“[V]ery low probabilities are either overweighted quite grossly or neglected altogether, making decision weights highly unstable in that region.”); Daniel Kahneman & Amos Tversky, Prospect Theory, in CVF at 37 (“[T]he simplification of prospects . . . can lead the individual to discard events of extremely low probability and to treat events of extremely high probability as if they were certain. Because people are limited in their ability to comprehend and evaluate extreme probabilities,
be low-level risks (and, although risk of foreclosure may be as high as twenty percent or more for some loan pools and classes of loans, on average the risk of foreclosure is still perceived to be a low level risk), the risk may be seen as unavoidable, and ignored out of necessity. The biases causing decisionmakers to discount risk, and overconfidently assume that they can manage the home loan presented, are overoptimism and the illusion of control. Overoptimism and the illusion of control are a bias toward underweighting the risk of harm posed to oneself, even where one recognizes that the situation poses significant risk to others, due to a belief that one can control the situation and avoid the danger. Overoptimism and overconfidence appear linked to the availability and representativeness heuristics, in that people use past positive experiences of safety and memories of their own self-protective behaviors to estimate future susceptibility to harm. It also appears linked to motivations to avoid anxiety and to maintain self-esteem.

In the home loan context, overoptimism and the illusion of control are reflected in the testimony of borrowers who lost their homes at foreclosure. When they took the loan, many of these borrowers thought they “could manage” the loan, thought they would find the overtime hours or second job to make the payments, or thought they could tighten their spending on other expenses so as to have enough money each month to make the payments. Even when their ability to make the payments has more to do with the condition of the local economy and the availability of overtime, borrowers may misperceive that they can control their own income, and therefore overoptimistically believe they can ensure the loan payments will be made.

c. Emotional Coping Mechanisms

As on the price side, the common coping mechanisms of using denial and avoidance to deal with ego threats may impair some borrowers from making good risk decisions. Fear of discrimination or the ego threat posed by revealing past credit history may result in seeking any lender that offers guaranteed approval, regardless of both loan risk and loan price. A borrower may even affirmatively seek a higher loan amount than needed, viewing the extension of credit itself as a statement of not only amoral creditworthiness, but also a statement of trust from the lender and worth in society. To escape pressure from unsecured creditors and to avoid the ego threatening “deadbeat” label, borrowers may pay off unsecured creditors with secured home loan debt, ignoring the risk undertaken in the bargain. Rather than admitting the high risk of foreclosure that the loan may present, a risk that may threaten not only the borrower but also her highly unlikely events are either ignored or overweighted, and the difference between high probability and certainty is either neglected or exaggerated.”); Sunstein, supra n. 109 at 71 & 75. See also Garg H. McClelland, William D. Schulze & Don L. Coursey, Insurance for Low-Probability Hazards: A Bimodal Response to Unlikely Events, 7:1 J. RISK & UNCERTAINTY 95, passim (1993).

117 See, e.g., Neil D. Weinstein, Optimistic Biases About Personal Risks, 246 SCIENCE 1232, 1232 (1989); Paul Slovic, Do Adolescents Know the Risks?, 47 DUKE L. J. 1133, 1137 (1998) (“Optimistic biases are greatest for hazards judged to be controllable by personal action, such as lifestyle risks.”); Paul Slovic, Baruch Fischhoff & Sarah Lichtenstein, Facts Versus Fears: Understanding Perceived Risk, in JUU, supra n. 109 at 463, 468-70 (describing people’s belief in face of risk of injury that “it won’t happen to me”). What is characterized here, and in much of the law and behavioral science literature, as overoptimism, might more accurately be called denial. Rather than being overoptimistic about their ability to control their finances, people may be in denial about their inability to do so.
family, some borrowers may refuse to consider risk, may think that the HOEPA disclosure about foreclosure is not directed at them, and may thus end up with an overly risky loan.

B. How to Solve the Risk Problem

1. Why the Market Will Not Solve the Risk Problem

The problem on the risk side is that the risk assumed by borrowers is too high, given the borrowers’ own preferences, the externalities caused by risky loans, and the choices borrowers would make in place of taking the loan if the borrowers fully understood the costs and benefits of the loan and of alternatives. Market mechanisms will not directly limit risk, because the market using today’s computer modeling tools can simply price risk rather than rationing credit to constrain risk. There is no mechanism by which the market would internalize the externalities caused by too much risk, such as concentrated neighborhood blight and long-term effects on society of families who become homeless. No market forces exist to motivate consumers to pursue, or even to inform consumers of, alternatives to risky loans, such as obtaining a less-risky loan, declaring bankruptcy, selling the home on the open market, or foregoing the loan. In fact, unsecured creditors have every reason to encourage consumers who might otherwise declare bankruptcy, to obtain home loan debt to pay their unsecured debts, so that these creditors will not face charge-offs in bankruptcy. Reports have surfaced that companies with both credit card lending units and home loan lending units run credit card debtor data through models to predict who is likely to declare bankruptcy, and then target those at high risk of bankruptcy to convince them to refinance their dischargeable debt with home loan debt.

No lender in the market has an incentive to try to compete for borrowers by advertising low risk as a selling point on a home loan. By advertising low risk, the issue of risk is highlighted, and borrowers may associate risk, a negative product trait, more strongly with the lender doing this advertising, rather than ignoring risk, as many borrowers currently do. The lending industry as a whole has no incentive to undertake a home loan risk education campaign, because industry is currently profiting by selling risky loans. If consumers understood the risk levels of some of these loans, they might engage in more search for alternatives to the loans, and if consumers knew that there were alternatives to these loans they might borrow less, which would hurt the lending industry’s bottom line.

2. Why Decision-Process Regulation Will Not Solve the Risk Problem

From a consumer psychology perspective, the two types of information the consumer is not adequately considering or weighing in the loan risk decision are the alternatives to the loan,

118 Other than, if competitive pricing were achieved, then the endogenous risk of a loan created by overly high prices themselves would be eliminated.

119 In theory, realtors could be a market force to encourage people to sell their homes rather than lose the homes at foreclosure, but in practice, realtor advertising would be unlikely to overcome the average borrower’s overoptimism/denial, her belief that she will avoid the foreclosure sale and keep the house. The possibility of incurring borrower wrath at the suggestion that she is a deadbeat in danger of foreclosure would explain why realtors do not attempt to market themselves this way.
and the risk of loss posed by the loan. As to the first, the problem with any disclosure that
generically outlines the risks and benefits of the loan and alternatives to the loan, is that such a
disclosure would present too much information for many borrowers to read, understand, encode,
and use during the loan search process. In addition to posing lack of comprehension and
information overload problems, generic information about these options will be ignored because
many borrowers will not see the relevance of the information to their own loan decision.
Specific information about the alternatives to the loan, tailored to each borrower’s situation,
would be quite costly for any lender to develop, and lenders will always have an incentive to
downplay the risk from, and alternatives to, the loan the lender is selling.

Disclosing the level of risk presented by the loan is also not likely to be an effective way
of facilitating rational loan risk decisionmaking, because borrowers are likely to either under- or
overreact to the risk level disclosed. Pallid or abstract statistics about risk are unlikely to
influence the choices of large segments of the population, due to the tendency to ignore dry data
in favor of more available images of the concrete positive results the loan will bring. Even if the
warning is vivid, if borrowers believe the risk level presented is low and/or unavoidable, they
may treat the risk presented here as people frequently treat other low level risks such as health
risks of smoking or driving – by ignoring the risk. On the other hand, a scary, salient message –
filming footage of families being evicted from the homes they lost to foreclosure, for example –
although likely to make an impression, could over-deter potential borrowers from taking loans
that are within reasonable risk bounds. That is, a scary warning could trigger a reaction in some
borrowers akin to the reaction some people display towards airplane flight, and could over-deter
some borrowers from taking loans that are in the borrowers’ best long-run interests. The
optimism of some academics120 that a middle ground can be found for disclosures that neither
under- nor over-deter risky but frequently socially desirable behavior is misplaced; the bimodal,
poorly-calibrated behavioral response of most of the population to risk is well-established, and
no warning will change that.

Moreover, different risk warnings are optimal for different segments of consumers, such
that crafting a warning that reaches all segments may be impossible. The availability heuristic
counsels that warnings must be vivid and dramatic to be easily brought to mind and thus to bear
on decisionmaking. Yet the common coping mechanism of avoiding information in response to
ego threat counsels in favor of positive imaging – messages along the lines of “To increase safety
and happiness, take a low risk loan…” rather than the negative “danger” messages that would
inhere in the vivid warning. Different mood states can affect decisionmaking such that even a
single borrower may react to different warnings differently depending on mood.

Finally, even if we could fine-tune a warning message that resulted in loans at no more
than a certain risk level, say risk level x, we would need to decide what risk level x should be, a
societal decision illusive in many realms, including home loans. In the absence of a defined
maximum level of acceptable risk, there is no way to know whether any particular warning
disclosure has hit the optimal level of deterrence of overly risky loans. The legal scholars
advocating “scary” warnings come close to recognizing this in their discussion of the

120 See, e.g., Christine Jolls, Cass R. Sunstein, & Richard Thaler, A Behavioral Approach to Law and Economics, 50
malleability of preferences, yet they do not appreciate the extent to which this malleability means that the shaping of decisionmaking by the disclosures and the seller of the loan is inevitable. For risk of loss of home, there may be no foreclosure probability preference internal to each consumer waiting to be instantiated by free and informed consumer choice. There is only the risk level or levels we as a society decide or allow to reign, depending on whether we regulate the risk of home loans or allow the lending industry, in effect, to do so. Whether and when “people make choices that serve their best interests” is not only, as these scholars recognize, “a question to be answered based on evidence,” but a question that can be answered only with some substantive notion of what level of risk is in people’s best interests. To say that the risk level in people’s best interests is whatever risk people choose when “fully informed” is no more than the tautology of the thin version of rational choice theory (that decisions are utility-maximizing) where, as here, we have reason to think that people fail to fully incorporate risk into their decisionmaking. We have no way to measure people’s success at adequately weighting risk in their home loan decisionmaking apart from determining whether the decisions they arrive at after being given the risk information are, in fact, good decisions.

3. Defining & Enacting Enforceable Substantive Risk Limits

At both a normative and a conceptual level, defining reasonable, acceptable, or good levels of risk of foreclosure is very difficult, in part because we have not directly faced this issue in the past. To lay an outline of how we might start to define an acceptable risk level, there are at least two types of harm to consider in determining maximum acceptable risk levels: the injuries to the borrower and her household (“internalities”), and the injuries to her neighborhood or community (“externalities”) caused by foreclosure.

Internalities caused by foreclosure include stress, instability, self-blame, and losses of housing (possibly homelessness), personal value in attachment to home, identity as a homeowner, a wealth-generating asset (due to appreciation and tax deduction for mortgage interest), a forced savings mechanism, equity (through inefficient foreclosure sales), and autonomous ability to shape one’s own environment. These losses can mean the difference between feeling like a successful member of society who has achieved the American Dream of homeownership and an unsuccessful one. Studies of families prior to and after attaining homeownership have shown an increase in self-esteem, which would presumably be lost after foreclosure. The literature on the benefits of homeownership also indicate that, controlling for parental and neighborhood characteristics, children have better scholastic and social outcomes when they live in homes owned by their families, and thus loss of homeownership would have negative effects on child outcomes. But because predatory loans do not control for parents

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121 Id.


and neighborhood, but rather are more prevalent among low-income and minority borrowers, the internalities of foreclosure can be magnified by a lack of other financial and social supports.

Externalities caused by foreclosure include neighborhood instability and loss of positive externalities that flow from homeownership (greater community involvement and property investment and care levels by homeowners\textsuperscript{124}), especially for communities where foreclosures are concentrated. Externalities also can include the social costs of homelessness and the social costs of meeting basic human needs (medical care, education, retirement) that would otherwise be covered by home equity. Gross national statistics about foreclosure are in this regard less informative than neighborhood statistics; if foreclosures were spread evenly throughout this country’s owner-occupied housing stock, they would have a negative impact on the particular families foreclosed upon, but would probably not create significant externalities. Because, however, predatory lending and resultant foreclosures are concentrated in low-income and minority urban and rural communities, they result in significant neighborhood negative externalities.\textsuperscript{125}

Weighing these costs of risky loans resulting in foreclosure directly against the benefits of risky loans is probably impossible; we lack social consensus on how to measure the benefits of risky loans,\textsuperscript{126} and we lack any way to quantify the risks and benefits, making it difficult to weigh them against one another. An easier and more relevant question might be what levels of risk are worth the benefits of a particular home loan instead of alternatives to that loan. Alternatives could include a smaller and less risky loan, a loan with fewer risky features (such as an amortizing loan rather than a balloon), bankruptcy with a homestead exemption, selling the

\textsuperscript{124} Donald R. Haurin, Robert D. Dietz, Bruce A. Weinberg, The Impact of Neighborhood Homeownership Rates: A Review of the Theoretical and Empirical Literature (2002).

\textsuperscript{125} Historically, one potential period of concentrated foreclosure activity that, at a neighborhood level, may parallel the foreclosure activity found in some neighborhoods today, is the late 1970s. It was at that time that the foreclosure rates, while not terribly high compared to today’s rates nationally, were relatively high within concentrated areas in a number of cities plagued by fraud in the Federal Housing Authority (“FHA”) and Veteran’s Administration (“VA”) lending programs. FHA and VA loans are home loans to low- and moderate-income families and veterans. Under the FHA and VA loan programs, private lenders make these loans, but the government insures them, so as to bring down the cost to the lender and the price to the borrower of these loans through shifting the lender’s risk of losses from any default to the government. If a borrower defaults on an FHA or VA loan and the lender forecloses on the property, a government insurance pool will pay the lender the principal remaining unpaid on the loan up to the insured principal amount, in exchange for the property. Although the programs permit lenders to make these loans only under specified conditions that demonstrate borrower creditworthiness, lenders have market incentives to make these loans, which are risk-free to the lender, without regard to creditworthiness, where HUD and the VA are not engaging in sufficient oversight to make sure the creditworthiness conditions are met. These foreclosures are not entirely parallel to the foreclosures of conventional (a loan that is not government-insured) subprime predatory loans today, because upon foreclosure, these homes went to HUD, a non-rational market actor that has historically failed to turn over foreclosed-upon and abandoned properties in its portfolio at the rates the private sector must to remain profitable. However, the negative neighborhood effects of these foreclosures are worth examining in trying to determine an appropriate maximum level of foreclosure risk for home loans today.

\textsuperscript{126} We might have some inkling of agreement that benefits vary depending on whether the proceeds are used to fund a small business, medical care, legal needs, education, or consumer purchases (and that as to the last, that very little risk of long-term loss of home would be worth the short-term benefits of most consumer credit uses).
home, or foregoing the loan. The costs of these alternatives might be usefully compared to the costs of foreclosure risk, to arrive at some sense of how much risk is acceptable in a home loan.

For practical implementation of such a risk level, there are various possibilities that would be prospective, and therefore useful for leveraging the power of the secondary market to police brokers and lenders. The first possibility is to use a risk modeling system, whether a federal model established by HUD, a model established by Fannie Mae or Freddie Mac, or the lender’s own risk models, with some controls to ensure that the models used by the lender for this purpose are the same used by any secondary market buyers of the loan. Another possibility is to use a net residual income test, requiring that a certain level of monthly income continue to be available to support each household member after the monthly loan payment.

Less direct methods of constraining risk could include insurance requirements or changes to foreclosure processes. A requirement that borrowers must purchase some level of credit disability, life, and unemployment insurance could reduce risk to the extent that disability, death, and unemployment cause defaults and foreclosures. Because credit insurance at present is not competitively priced (and is therefore overpriced), minimum loss ratios for credit insurers or direct price controls would have to be established. Credit insurers that experience high losses from loans originated by particular lenders or brokers might also refuse to insure those loans, driving some risky originators out of the lending market. The price of insurance that insurers would be willing to offer on particularly risky loan transactions might also effectively price risky transactions out of the market. Increasing the competitiveness of bidding in foreclosure markets, or increasing the cost to the lender of foreclosing, could also effectively hem in loan risk levels. By increasing the competitiveness of the foreclosure process, more equity will be returned to borrowers, and, to the extent that foreclosing lenders have been the beneficiaries of the lemons problem in the foreclosure market, these lenders would no longer receive a windfall. This would make foreclosure and risky loans less attractive to the lender. Making the foreclosure process more expensive for the lender in other ways could also decrease the attractiveness of foreclosure, and decrease the risk levels of loans that lenders are willing to make. Although insurance requirements and foreclosure process reforms do not seem like constraints on borrower choice, and thus may be more politically palatable, they would effectively narrow choice because lenders would no longer offer some risky loans. In fact, the parameters of any insurance requirement or foreclosure reform should be determined by reference to the loan risk ceilings they would in effect create.

We have not been required to confront the risk issue historically, because uniformity of loan products, credit rationing, and usury laws hemmed in home loan risk and limited the borrowing population to those population segments presenting very little risk. But because we cannot rely on disclosures to resolve this issue, to formulate good public policy in today’s deregulated and broadly-supplied credit market, we must define, substantively, the risk levels we seek. In the end, the line-drawing here must probably be somewhat arbitrary – no precise risk level could ever be the precisely correct one. But the same is true for the individual, if she were to grapple with the question of the right level of risk in making the loan decision for herself.

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127 Risk of loss of the home could never be fully insured, of course; without eliminating home loans entirely, it is precisely the home equity collateral that provides the basis for the home loan market.
Given that many borrowers neither grapple with this question, nor deliberately make loan decisions based on the answer, some kind of floor on risk placed there by the government would be the better approach.  

V. Conclusion

Some of the recent “law and behavioral science” adherents, in an attempt to match the parsimoniousness and modelability of the rational choice theory of law and economics, miss the more realistic implications of the psychological findings – that in decisionmaking, people vary from each other, and vary over time and in differing situations. Specifically, these scholars have argued that the heuristics, biases, and coping mechanisms recently identified in psychology call for a weak form of paternalism in legal regulation, a “paternalism lite.” They display a sanguine belief in the ability of the law to procedurally manipulate framing effects to guide consumers’ choices in the right directions, without substantive constraints on choice. In the area of consumer lending, some of these authors have claimed that the disclosures required by TILA and HOEPA pose only minimal costs to society in the form of small administrative costs to lenders. They claim that the TILA price disclosure and the HOEPA foreclosure disclosure “enormously” benefit the vulnerable consumer by protecting her from unscrupulous lenders through educating her about the price of the loan and letting her know that she could lose the home if she does not make the loan payments, which in turn will help her to “act more properly in her own best interest.” They base these claims on their understanding of human decisionmaking generically, without so much as a peek at data about home loan decisionmaking in the real world.

A closer look at home loan decisionmaking in action paints a very different picture. The disclosures do not help a significant segment of consumers to price shop, because these consumers do not understand the disclosures, do not make use of the disclosures to price shop, and even misinterpret the price information provided in the disclosures. Borrowers already know that they could lose their homes if they do not pay the loan, so the risk disclosure is not informing the borrower of anything, just highlighting the risk with the aim of increasing the weight the borrower places on risk in determining whether to take the loan. But the disclosure is too dry and abstract, and given too late in the application process, to impact borrower decisionmaking. Due to widespread misperceptions about risks and the lack of any forces

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128 Other policy measures apart from risk limits could help the functioning of the subprime home loan market. Increasing the efficiency of foreclosure markets would increase the amount of equity a borrower would receive back at foreclosure. Public policies that managed to increase the salience of alternatives to risky loans, including smaller loans, loans with fewer risky features, and forgoing the loan (and possibly facing bankruptcy with a homestead exemption as a result), might also help borrowers make better risk decisions. “Just say No to risky loans” campaigns would be useless however, as consumers are not able to determine whether the loan offered to them is risky.

129 Colin Camerer, Samuel Issacharoff, George Loewenstein, Ted O’Donoghue & Matthew Rabin, Regulation for Conservatives: Behavioral Economics and the Case for “Asymmetric Paternalism,” 151 U. PA. L. REV. 1211 (2003); Christine Jolls & Cass R. Sunstein, Debiasing Through Law, Working Paper at 59 (April 2004) (positing that by requiring lenders to disclose the total interest payments over the life of a loan, the law “counteracts errors that reduce welfare, but … does not significantly affect people who did not previously err.”).

130 Camerer et al, supra n. 129.
presenting alternatives to the loan to consumers, even more vivid disclosures are unlikely to help many consumers make a loan decision based on a true comparison of the risk posed by the loan and the amount of risk they should reasonably undertake in exchange for the benefits of the loan they are receiving. Finally, the costs of disclosures include more than administrative costs to the lender; the disclosures themselves may create an information overload and may cause the borrower to focus on less important dimensions of the decision. The disclosures give the veneer of legality to the transaction, falsely assuring some borrowers that they are more protected in the transaction than they are.\(^{131}\) Lenders, courts, and the borrowers themselves are more likely to blame the borrower for obtaining an overpriced or overly risky loan, and to exonerate the seller of the loan, because the borrower received the disclosures.\(^{132}\) Even Federal Reserve Board Governor Edward M. Gramlich has been quoted as saying: “‘When you hear these predatory lending stories, my initial reaction is ‘Gee, why couldn't the borrower get someone to review the papers before they signed them?'”\(^{133}\) The HUD-Treasury Report is uncharacteristically blunt on this point: “The fact is that written disclosure requirements, without other protections, can have the unintended effect of insulating predatory lenders where fraud or deception may have occurred.”\(^{134}\)

The lesson here is that only by examining the evidence on the ground closely can we know whether procedural “framing” or substantive “choice narrowing” regulation or some combination is preferable for addressing a social problem. Although the insights of behavioral science in one realm can help us form working hypotheses about how people are making

\(^{131}\) By seeing the many government-required disclosures, some borrowers may be led to believe that the government regulates the home loan process to a greater degree than it does. This “lulling effect” of the disclosures can result in borrowers failing to be as self-protective during the process as they should be, much like the lulling effect of an aspirin bottle safety cap. As one borrower stated in describing the settlement of his home loan, at which he signed the papers quickly, without taking the time to read any of them: “I was under the impression that the settlement officer is a neutral party and the D.C. government had some oversight over all settlements.” Quarles Declaration ¶ 17, Federal Trade Commission vs. Capital City Mortgage (on file with author).

\(^{132}\) Predatory lenders have an added reason to be meticulous in giving the required disclosures, as borrowers who receive over-priced and overly-risky loans are more likely to challenge the loans in litigation or foreclosure proceedings. Borrowers who claim that they did not understand the cost and terms of their loans when they agreed to them will face a lender brandishing the disclosures as a shield from any liability. The U.S. Court of Appeals for the District of Columbia Circuit, for example, recently agreed with the District Court that no reasonable jury could find that a borrower did not understand that credit insurance was optional when the borrower had signed a form disclosing that “Credit related life insurance is not required to obtain credit and will not be provided unless you sign and agree to pay the additional cost.” Williams v. First Gov't Mortg. & Investors Corp., 225 F.3d 738, 750-51 (D.C. Cir. 2000). This finding was upheld despite the Court’s description of the borrower as follows:

  Williams testified that he had only a sixth-grade education from the segregated schools of Savannah, Georgia, that he could read no more than 40 percent of a newspaper, … that he thought an interest rate of 13.90 percent exceeded 13.9 percent, and that when he bought his house in 1970, he “depended on [his wife] basically to do most of [his] reading [at the closing] ‘cause she had an 11th grade education.” Williams also testified that during his 20-minute meeting with [the lender] to settle the loan, the loan officers neither explained the papers he signed nor gave him time to review the papers or any papers to take home.

\(^{133}\) See Paul D. Davies, Fighting the Predators, PHILADELPHIA DAILY NEWS (Feb. 7, 2001).

\(^{134}\) HUD-Treasury Report, supra n. 7 at 67.
decisions in other realms, we must carefully check those hypotheses against real world data. Solutions depend crucially upon a detailed contextualized analysis, including the experiences of all affected population segments, rather than abstract theorizing. Just as parsimonious models of monolithic rational actor decisionmakers must give way to heterogeneous models of consumer decisionmaking behavior, so too a parsimonious model of monolithic paternalism lite must give way to an admission that one size will not fit all. In a market of individualized and opportunistic pricing and multifarious products faced by heterogeneous decisionmakers, no one solution will perfectly respond to the needs of all. But by understanding the heterogeneity, we can make conscious tradeoffs against a backdrop of the shared values of avoiding regressive and racially-skewed income redistribution and neighborhood instability, and promoting competitive pricing and homeownership.