

SOUTH CAROLINA LAW REVIEW



**THE ROAD TO SUBPRIME "HEL" WAS PAVED WITH GOOD
CONGRESSIONAL INTENTIONS: USURY DEREGULATION
AND THE SUBPRIME HOME EQUITY MARKET**

Cathy Lesser Mansfield

VOLUME 51

SPRING 2000

NUMBER 3

THE ROAD TO SUBPRIME “HEL”^{*} WAS PAVED WITH GOOD CONGRESSIONAL INTENTIONS: USURY DEREGULATION AND THE SUBPRIME HOME EQUITY MARKET

CATHY LESSER MANSFIELD^{**}

I.	INTRODUCTION	475
II.	A HISTORICAL PERSPECTIVE: EARLY FEDERAL INTEREST RATE AND MORTGAGE RATE REGULATION	476
	A. <i>The National Bank Act</i>	476
	B. <i>The Federal Home Loan Bank Act</i>	477
	C. <i>The Home Owners' Loan Act of 1933</i>	478
	D. <i>Federal Housing Administration Insured Loans (FHA Loans) and Veterans' Administration Insured Loans (VA Loans)</i>	480
III.	FEDERAL PREEMPTION OF STATE INTEREST RATE REGULATION	484
	A. <i>Federal Preemption of FHA Loans and VA Loans</i>	484
	1. <i>State Usury Law and FHA/VA Loans</i>	484
	2. <i>The 1976 California Preemption</i>	484
	3. <i>The 1979 "Arkansas" Preemption</i>	486
	B. <i>Federal Preemption of Non-FHA and VA Home-Secured Loans: DIDMCA</i>	492

^{*} Home Equity Lending. The author wishes to recognize that an unknown clever person at Moody's Investors Service came up with the "HEL" play on words. *1998 Year in Review and 1999 Outlook, Home Equity Asset-Backed Securities: To HEL in a Handbasket*, MOODY'S STRUCTURED FIN. SPECIAL REPORT (Moody's Investors Serv., New York, N.Y.), Jan. 8, 1999, at 2.

^{**} Associate Professor of Law, Drake University Law School. I would like to thank Heather Campbell for her many hours of research, supervision of other researchers, and general good humor during the long hours required to prepare this Article. I also want to thank Alan White of Philadelphia's Community Legal Services, Inc. for sharing material from his litigation files, as well as his experiences, ideas, insights, and editing skills; Larry James, Sr., whom I hope has learned as much from me as I have from him; Kathleen Keest for her indefatigable advice and counsel; and Ed Mansfield for doing an inordinate amount of child rearing during the preparation of this Article. I would like to thank the following students for their research assistance: Chengfei Ding, Constance Grignon, Kami Henke, Amy Hoffman, Chad Hutchings, Weldon MacDougall, Heather Mowery, William Smith, Holly Streeter, and Andrew Teigen. I would also like to thank Lisa Stock, Sherry VonBehren, and Carol Smith—the Drake Librarians—for their invaluable assistance. Finally, thanks to Karla Westberg for her ability to read my chicken scratch.

1. <i>Scope of DIDMCA Mortgage Rate Preemption</i>	492
2. <i>The Legislative History of DIDMCA</i>	495
C. <i>Federal Preemption of Alternative Mortgage Transactions</i>	510
IV. EARLY DEVELOPMENTS AFTER THE ADOPTION OF DIDMCA	511
A. <i>Early Uses of DIDMCA To Make Non-Housing Related Loans At Interest Rates Higher Than State Usury Limits</i>	511
B. <i>Early Court Decisions Interpreting DIDMCA</i>	514
1. <i>Was the DIDMCA Usury Preemption within Congress's Power to Regulate Commerce?</i>	514
2. <i>Was DIDMCA Meant to Preempt State Usury Laws in Nonpurchase Money Loans?</i>	515
V. MARKET DEVELOPMENTS SINCE THE ADOPTION OF DIDMCA: THE RISE OF FIRST LIEN HOME EQUITY LENDING AND THE SUBPRIME MARKET	520
A. <i>The Rise of Home Equity Lending As an Accepted and Encouraged Method of Consumer Lending</i>	521
B. <i>The Explosion of Mortgage Brokers and Nondepository Lenders</i>	526
C. <i>The Rise of Subprime Lending as a Distinct Industry and the Subprime Home Equity Industry</i>	527
D. <i>The Increased Use of Securitization to Fund Loans</i>	531
VI. CHARACTERISTICS OF MODERN SUBPRIME NONPURCHASE MONEY HOME-SECURED LENDING	532
A. <i>What is a Subprime Home Equity Loan?</i>	532
B. <i>Subprime Home Equity Loan Price Terms: Rates, Points, and Other Charges</i>	535
1. <i>Interest Rates</i>	535
2. <i>Points, Fees, and Loan Flipping</i>	545
3. <i>Other Charges: "Packing"</i>	551
C. <i>Ability to Repay, Risk of Defaults, and Foreclosures</i>	552
1. <i>Ability to Pay / Debt-To-Income Ratio</i>	552
2. <i>Subprime Loan Delinquency, Default, and Foreclosure Rates</i>	553
D. <i>Other Abusive Terms and Practices</i>	556
1. <i>Balloon Payments and Prepayment Penalties</i>	556
2. <i>Loan Solicitation Techniques</i>	556
3. <i>Borrower Understanding of Loan Terms, Knowledge of Pricing Information and Inability to Negotiate Terms</i>	558
4. <i>Disparate Impact on Minorities</i>	559
VII. LEGISLATIVE AND OTHER GOVERNMENTAL ACTION	561
A. <i>The Home Ownership and Equity Protection Act</i>	

	(HOEPA)	562
	B. <i>North Carolina 1999 Senate Bill 1149</i>	566
	C. <i>New York 1999 Senate Bill 5046, Assembly Bill 4744</i>	567
	D. <i>Other Legislative Proposals</i>	569
VIII.	SOLUTIONS AND RECOMMENDATIONS	570
	A. <i>Better Data Collection and the Home Mortgage Disclosure Act (HMDA)</i>	570
	B. <i>Increased Information in the Market</i>	572
	C. <i>Rate and Fee Regulation</i>	573
IX.	CONCLUSION	575
	APPENDICES 1-3	576

I. INTRODUCTION

Subprime home equity lending is probably one of the most important public policy issues that America will have to address during the coming years, as evidenced by the number of studies devoted to this issue in 1999 alone.¹ The number of high-rate, high-cost home-secured loans has exploded over the past seven or eight years, and the consequences of some subprime lending are now starting to be felt through record numbers of home foreclosures, victimization of some borrowers through inappropriate lending and lending practices,² and concerns over lender liquidity and investor security.

The challenge in the coming years will be to find a balance between the need to make reasonable amounts of credit available to borrowers with varying credit backgrounds and the need to protect borrowers from credit that is unjustifiably expensive, inappropriate for certain borrowers, or tainted by fraud and other misconduct. One of the most difficult questions that must be answered is whether and what kind of government regulation might be required to assure progress in addressing these issues.

1. See, e.g., NATIONAL TRAINING AND INFO. CTR., *PREYING ON NEIGHBORHOODS: SUBPRIME MORTGAGE LENDERS AND CHICAGOLAND FORECLOSURE* (1999) [hereinafter *PREYING ON NEIGHBORHOODS*] (studying the subprime market in the Chicago area); DANIEL IMMERGLUCK & MARTI WILES, WOODSTOCK INST., *TWO STEPS BACK: THE DUAL MORTGAGE MARKET, PREDATORY LENDING, AND THE UNDOING OF COMMUNITY DEVELOPMENT* (1999) [hereinafter *TWO STEPS BACK*] (studying the exploitation of homeowners by subprime lenders in the Chicago area); Deborah Goldstein, *Understanding Predatory Lending: Moving Toward a Common Definition and Workable Solutions* (Joint Center for Housing Studies at Harvard University, Neighborhood Reinvestment Corporation, October 1999).

2. Federal Trade Commission (FTC) Chairman Robert Pitofsky has been quoted as saying that the subprime home equity market demonstrates "some of the most abusive practices" he has ever seen. Christine B. Whelan, *FTC Is Targeting Abuses In Subprime Home Loans*, WALL ST. J., July 30, 1999, at C10.

One of the key historical developments, without which the high-rate first-mortgage lending that pervades the subprime home-secured lending industry would not be possible, was the adoption by Congress in 1979 and 1980 of the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA).³ DIDMCA, which was adopted in an era of high market rates for conventional mortgages, preempted state usury ceilings in most loans secured by a first lien on the borrower's home.⁴ Case law interpreting DIDMCA later held that DIDMCA preempted such state regulations even with regard to nonpurchase loans, as long as the lender secured a first lien on the home.⁵

This Article examines the history of federal regulation and deregulation of home-secured lending rates, the market and political environment in which DIDMCA was adopted, the deregulation of interest caps on Federal Housing Administration and Veterans' Administration insured loans, and the almost inadvertent deregulation of usury laws as they relate to nonpurchase home-secured loans. This Article further describes the subprime mortgage lending industry that developed in DIDMCA's wake, including the predatory lending practices that have emerged in the market and recent regulatory efforts at addressing these problems.

Finally, this Article discusses the need for better information about the subprime home equity industry, argues that policy makers rethink usury deregulation of the subprime home equity market, and suggests possible regulatory curbs on predatory subprime lending that might be appropriate and necessary.

II. A HISTORICAL PERSPECTIVE: EARLY FEDERAL INTEREST RATE AND MORTGAGE RATE REGULATION

A. *The National Bank Act*

Interest rates are generally regulated by the states, not the federal government. Indeed, until the late 1970s, Congress made only a few forays into the area of rate regulation. The first of these ventures occurred in 1864, when Congress adopted the National Bank Act⁶ in order to "restore to the still young federal government control of the monetary system."⁷ The National Bank Act provided (and the current codification still provides) that national banks may

3. DIDMCA is discussed in full in Section III.B. of this Article. It was adopted twice, once in temporary form in late 1979, Act of Dec. 28, 1979, Pub. L. No. 96-161, 93 Stat. 1233 (originally codified as a note to 12 U.S.C. § 1735f-7), and again in 1980, Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 501(a), 94 Stat. 132, 161 (originally codified as a note to 12 U.S.C. § 1735f-7, now codified as 12 U.S.C. § 1735f-7a).

4. See *infra* Section III.B.

5. See *infra* Section IV.B.

6. National Bank Act of June 3, 1864, § 30, 13 Stat. 99, 108 (current version codified at 12 U.S.C. § 85 (1994)).

7. KATHLEEN E. KEEST, NATIONAL CONSUMER LAW CTR., *THE COST OF CREDIT: REGULATION AND LEGAL CHALLENGES*, § 3.4.1 (1995).

charge the interest rate allowed by the state in which the bank is located, or a rate of one percent above "the discount rate on ninety-day commercial paper in effect at the Federal reserve bank in the Federal reserve district where the bank is located," whichever is greater, for loans originated by the bank.⁸

From this enactment in the 1860s until the Great Depression of the early 1930s, the federal government stayed out of matters involving interest rates.⁹ The federal government also did not get involved in regulating matters of home ownership. However, when the Great Depression of the 1930s hit, homeowners began defaulting on their loans in record numbers,¹⁰ and savings institutions found themselves unable to operate.¹¹ In response to this crisis, Congress enacted several statutes in order to preserve and encourage home ownership and to provide relief to homeowners who found it difficult or impossible to make their mortgage payments. With the adoption of these statutes, the federal government entered the arena of mortgage rate regulation.

B. The Federal Home Loan Bank Act

The first of the three major Depression-era congressional enactments relating to home-secured lending was the Federal Home Loan Bank Act of 1932.¹² That statute created the Federal Home Loan Bank Board¹³ and a system of regional Federal Home Loan Banks¹⁴ that were authorized to make secured advances to member and nonmember banks for a percentage of unpaid

8. 12 U.S.C. § 85 (1994). The discount rate is set by each Federal Reserve District and can be obtained from a number of sources, including the web page of each of the Federal Reserve Districts. See, e.g., Federal Reserve Bank of Atlanta website (visited Mar. 10, 2000) <<http://www.frbatlanta.org/>>; Federal Reserve Bank of New York website (visited Mar. 10, 2000) <<http://www.ny.frb.org/>>.

9. THOMAS B. MARVELL, *THE FEDERAL HOME LOAN BANK BOARD* 18 (1969); see also 126 CONG. REC. 7069 (1980) (statement of Sen. Morgan of North Carolina that usury laws historically were the province of state governments).

10. At the start of the Depression, there were approximately 11 million nonfarm homeowners. Of those, 60% had mortgages on their homes, and the average mortgage was for "well over half the value of the property." MARVELL, *supra* note 9, at 18. During the Depression between one-fifth and one-half of all homeowners could not meet their mortgage payments. *Id.*

11. Savings and loans, which made home mortgage loans, were hurt by the inability of borrowers to make payments on their loans, the rapid decline in property values (which made foreclosure an ineffective way to collect on defaulted mortgages), and customer demand for their cash deposits. *Id.* "In the 1930's, some 1,700 savings and loan associations failed, with losses to their savers estimated at about \$200 million, or about one-third the value of the savings in these associations." *Id.*

12. Federal Home Loan Bank Act, Pub. L. No. 72-304, 47 Stat. 725 (1932) (codified as amended at 12 U.S.C. §§ 1421-1449 (1994)).

13. § 17, 47 Stat. at 736. The Federal Home Loan Bank Board was dissolved and its responsibilities were taken over by the Office of Thrift Supervision (OTS) in 1989. Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, §§ 401(a)(2), 101(6), 201(b), 103 Stat. 183, 354, 187, 188. The Board's regulations and determinations were to remain in effect until OTS modified or repealed them. § 401(h), 103 Stat. at 357.

14. § 3, 47 Stat. at 726.

principal on loans secured by home first mortgages and first liens.¹⁵ The statute also authorized any bank organized under the act to be a home equity lender of last resort for borrowers "unable to obtain mortgage money from any other source."¹⁶ The first federal mortgage rate regulation was also contained in this statute, although the regulatory scheme deferred to state law usury limits, setting a federal rate only if there was no applicable state law.¹⁷

C. *The Home Owners' Loan Act of 1933*

In 1933 Congress adopted the Home Owner's Loan Act,¹⁸ which authorized the Federal Home Loan Bank Board to charter federal savings and loan institutions that were required to participate in the Federal Home Loan Bank System.¹⁹ The statute also directed the Federal Home Loan Bank Board to create the Home Owners' Loan Corporation,²⁰ which was authorized from June 13, 1933 until June 13, 1936 to issue bonds and exchange them for "home mortgages and other obligations and liens secured by real estate . . . recorded . . . or executed prior to the date of the enactment of this Act,"²¹ to provide cash advances to homeowners whose mortgage holders

15. §§ 10(a), 2(6), 47 Stat. at 731, 725.

16. § 4(d), 47 Stat. at 727.

17. § 5, 47 Stat. at 727. The statute provided that:

No institution shall be admitted to or retained in membership, or granted the privileges of nonmember borrowers, if the combined total of the amounts paid to it for interest, commission, bonus, discount, premium, and other similar charges, less a proper deduction for all dividends, refunds, and cash credits of all kinds, creates an actual net cost to the home owner in excess of the maximum legal rate of interest or, in case there is a lawful contract rate of interest applicable to such transactions, in excess of such rate (regardless of any exemption from usury laws), or, in case there is no legal rate of interest or lawful contract rate of interest applicable to such transactions, in excess of 8 per centum per annum in the State where such property is located.

Id.

18. Home Owners' Loan Act of 1933, Pub. L. No. 73-43, 48 Stat. 128 (formerly codified at 12 U.S.C. §§ 1461-1468 (1934)).

19. § 5(a), 48 Stat. at 132.

20. § 4(a), 48 Stat. at 129. The Corporation was created as "an instrumentality of the United States." *Id.*

21. § 4(d)(1), 48 Stat. at 130. In order to qualify for the exchange under subsection (d) or payments in lieu thereof under subsection (f), the home had to be used as a dwelling for not more than four families and have a value not exceeding \$20,000. § 4(d)(2), 48 Stat. at 131. In April 1934 Congress further restricted mortgage exchange and payments program to loans where the applicant was "in involuntary default on June 13, 1933" and "unable to carry or refund his present mortgage indebtedness" unless a default after that date was "due to unemployment or to economic conditions or misfortune beyond the control of the applicant, or in any case in

would not accept the Corporation's bonds in exchange for their mortgages and who could not find other lenders,²² to redeem property already foreclosed upon,²³ and to make mortgage loans for 50% of the value of unencumbered property.²⁴

Once the Corporation became the holder of a mortgage, the homeowner was entitled to many benefits not available in any other mortgage relationship. For example, homeowners whose mortgages were bought by the Corporation were relieved of their obligation to make principal payments for three years from the effective date of the Act.²⁵ Furthermore, the Corporation was permitted to allow home owners to make quarterly, semi-annual, or annual payments if the homeowner's situation so warranted and to grant an extension on any payment of principal or interest owed by the homeowner if "the circumstances of the home owner and the condition of the security justify such extension."²⁶ The Corporation was also directed to credit to the homeowner's outstanding balance the difference between the amount still owed by the homeowner on the mortgage and the face value of the bonds (plus any cash) given for the property, thereby reducing the homeowner's debt obligation.²⁷ Finally, the Corporation was authorized to advance taxes and assessments on the mortgaged property and to maintain and repair the property.²⁸

Unlike the 1932 statute, which deferred to state interest ceilings where appropriate, the Home Owners' Loan Act of 1933 set loan terms, including a maximum interest rate, for all mortgages that were to be held by the Corporation.²⁹ Loans held by the Corporation through the mortgage exchange program, or secured by previously unencumbered property, or made to redeem homes in foreclosure were required to be for a term of not more than 15 years, to be amortized over the term of the loan, and to carry an annual interest rate

which the home mortgage or other obligation or lien is held by an institution which is in liquidation." Act of April 27, 1934, Pub. L. No. 73-178, § 2, 48 Stat. 643, 644. Just one month later Congress eliminated from eligibility borrowers whose home mortgage or other obligations or liens were held by an institution in liquidation. Act of May 28, 1935, Pub. L. No. 74-76, § 14, 49 Stat. 293, 297.

22. § 4(f), 48 Stat. at 131. The cash advances were limited to 40% of the value of the property. *Id.*

23. § 4(g), 48 Stat. at 131. This section originally applied to mortgages that had been foreclosed upon subject to a trustee sale or were voluntarily surrendered within two years prior to the Corporation's exchange or advance. *Id.* This was later changed to cover any home which had been foreclosed upon subject to a trustee sale or was voluntarily surrendered after January 1, 1930. § 4, 48 Stat. at 645.

24. § 4(e), 48 Stat. at 131.

25. § 4(d)(2), 48 Stat. at 131.

26. § 4(d)(2), 48 Stat. at 130-31.

27. § 4(d)(2), 48 Stat. at 130. The Corporation could not exchange bonds and cash worth more than the smaller of \$14,000 or 80 percent of the value of the real estate, as determined by an appraisal performed by the corporation, for each mortgage. *Id.*

28. *Id.*

29. *Id.*

of not more than 5%.³⁰ Loans made to enable homeowners to pay their own mortgage holders were to "bear interest at a rate of interest which shall be uniform throughout the United States, but which in no event shall exceed a rate of 6 per centum per annum."³¹ These interest rate ceilings were not changed during the life of the Home Owners' Loan Corporation, which in 1953 was authorized to dissolve and transfer to the United States Government its property interests.³² The Home Owners' Loan Act of 1933 was repealed in 1966.³³

D. Federal Housing Administration Insured Loans (FHA Loans) and Veterans' Administration Insured Loans (VA Loans)

The third mortgage-related Depression-era statute adopted by Congress, the National Housing Act of 1934,³⁴ has had the most lasting impact on federal mortgage interest rates of all the Depression-era statutes. The National Housing Act provided for establishment of the Federal Housing Administration³⁵ and for the insurance by that agency of first mortgages³⁶ made by lenders approved by the Federal Housing Administrator.³⁷ Among the qualifications for a mortgage to be eligible for insurance was a requirement that the mortgage "[b]ear interest

30. *Id.* The amortization requirement was changed from 15 to 25 years in 1939. Act of Aug. 11, 1939, Pub. L. No. 76-381, § (a), 53 Stat. 1403, 1403. The Corporation was also given the ability to revise the terms of a mortgage to reflect a 25-year amortization, in addition to granting an extension on payments of principal and interest, if the circumstances of the homeowner and condition of the security so warranted. § (b), 53 Stat. at 1403.

31. § 4(f), 48 Stat. at 131.

32. Act of June 30, 1953, Pub. L. No. 83-94, § 21, 67 Stat. 121, 126-27.

33. Act of Sept. 6, 1966, Pub. L. No. 89-554, § 8, 80 Stat. 378, 632, 648.

34. National Housing Act, Pub. L. No. 73-479, 48 Stat. 1246 (1934).

35. § 1, 48 Stat. at 1246.

36. § 201(a), 48 Stat. at 1247 (codified at 12 U.S.C. § 1707(a) (1994) (defining the term "mortgages" to mean first mortgages)).

37. § 203(b)(1), 48 Stat. at 1248 (codified at 12 U.S.C. § 1709 (b)(1) (1994)). In 1968 HUD was also authorized to insure mortgages made to residential property lessees for the purpose of purchasing the property they were leasing. Housing and Urban Development Act of 1968, Pub. L. No. 90-448, § 304(a), 82 Stat. 476, 507 (codified as amended at 12 U.S.C. § 1715z-5 (1994)). The FHA also insures various other types of mortgage loans, some of which were provided for in the 1934 Act, and some of which became insurable at later times. *See, e.g.*, 12 U.S.C. § 1703 (1994) (providing for insurance of financial institutions); 12 U.S.C. § 1713 (1994) (insuring mortgages for rental housing); 12 U.S.C. § 1715e (1994) (insuring mortgages for cooperative housing); 12 U.S.C. § 1715k (1994) (insuring mortgages for rehabilitated housing); 12 U.S.C. § 1715l (1994) (insuring mortgages for housing for moderate income and displaced families); 12 U.S.C. § 1715n (1994) (insuring miscellaneous mortgages); 12 U.S.C. § 1715v (1994) (insuring mortgages for housing for the elderly); 12 U.S.C. § 1715w (1994) (insuring mortgages for nursing homes); 12 U.S.C. § 1715y (1994) (providing mortgage insurance for condominiums); 12 U.S.C. § 1715z (1994) (insuring mortgages for low income cooperative membership); 12 U.S.C. § 1715z-1 (1994) (insuring mortgages for rental and cooperative housing for low income families); 12 U.S.C. § 1715z-1a (1994) (insuring mortgages for troubled multi-family housing projects); 12 U.S.C. § 1715z-6 (1994) (insuring supplement loans for multi-family projects); 12 U.S.C. § 1715z-7 (1994) (insuring mortgage loans for hospitals).

(exclusive of premium charges for insurance) at not to exceed 5 per centum per annum on the amount of the principal obligation outstanding at any time, or not to exceed 6 per centum per annum if the Administrator finds that in certain areas or under special circumstances the mortgage market demands it."³⁸

In 1944 the Veterans' Administration began a similar mortgage insurance program with the adoption of the Servicemen's Readjustment Act of 1944.³⁹ The Act allowed the Veterans' Administration to guarantee \$2,000 of home mortgage debt owed by an individual who had served in the armed forces.⁴⁰ Only loans that bore an interest rate of 4% or less were eligible for a VA guarantee.⁴¹

Between 1958 and 1983 the methodology for setting maximum interest rates for VA and FHA loans varied, sometimes setting maximum permissible rates by statute, sometimes tying the VA loan rates to the maximum permissible FHA rates, and sometimes giving the agencies the ability to set rates for their respective loan programs.⁴² This last methodology—allowing the agencies to set maximum rates that could be readily changed through publication in the Federal Register—was a product of the first "credit crunch" of the sort that ultimately lead to deregulation of FHA and VA loan rates, as well as other

38. § 203(b)(5), 48 Stat. at 1248.

39. Servicemen's Readjustment Act of 1944, Pub. L. No. 78-346, §§ 500, 501, 58 Stat. 284, 291-92.

40. *Id.*

41. § 500(c), 58 Stat. at 291. This 4% cap was retained in the 1945 amendments to the Servicemen's Readjustment Act. Act of Dec. 28, 1945, Pub. L. No. 79-268, § 8, 59 Stat. 623, 626-27. In 1958 the VA was also authorized to make direct loans to veterans in some instances at an interest rate to be set by the Administrator of the VA, but not to exceed the rate for VA guaranteed loans. Act of Sept. 2, 1958, Pub. L. No. 85-857, § 1811, 72 Stat. 1105, 1208 (now codified at 38 U.S.C. § 3711 (1994); formerly codified at 38 U.S.C. § 1811 (1958)). Rates under this section are set in 38 C.F.R. § 36.4503 (1999). In 1970 the VA was authorized to guarantee loans to enable veterans to buy manufactured homes and lots. Veterans' Housing Act of 1970, Pub. L. No. 91-506, § 5, 84 Stat. 1108, 1110 (now codified at 38 U.S.C. § 3712 (1994); formerly codified at 38 U.S.C. § 1819 (1970)). The Administrator of the VA was given the power to set maximum rates for loans to be eligible for guarantee under this program. Sec. 5, § 1819(f), 84 Stat. at 1112 (now codified at 38 U.S.C. § 3712(f) (1994); formerly codified at 38 U.S.C. § 1819(f) (1970)). Rates under this section are set in 38 C.F.R. § 36.4212 (1999).

42. In 1958 the VA Administrator was given the power to set the maximum interest rate as high as 4.75% as long as the rate set did not exceed the rate allowed to be charged on FHA loans, less one-half of 1%. Act of Sept. 2, 1958, Pub. L. No. 85-857, § 1803, 72 Stat. 1105, 1205. In 1959 Congress eliminated the requirement tying the maximum interest rate for VA loans to the maximum rate set by the FHA and raised the maximum rate that the VA Administrator could set to 5.25%. Act of June 30, 1959, Pub. L. No. 86-73, § 2, 73 Stat. 156. In 1966 Congress removed the 5.25% cap on VA loans and authorized the Administrator to set the maximum interest rate on VA loans based on market demands. Veterans' Readjustment Benefits Act of 1966, Pub. L. No. 89-358, § 5(b), 80 Stat. 12, 26. However, rates set for VA loans were once again tied to FHA rates, and could not exceed the maximum rate set for FHA loans. *Id.* FHA loans were still capped at "5 per centum per annum . . . or not to exceed 6 per centum per annum if the Administrator finds that in certain areas or under special circumstances the mortgage market demands it." National Housing Act, Pub. L. No. 73-479, § 203(b)(5), 48 Stat. 1246, 1248 (1934).

mortgage loan rates. By 1966 interest rates had risen, and Congress was concerned about the effect prevailing market rates were having on VA and FHA loan availability. When market rates rose above the maximum rate permitted to be charged by the National Housing Act of 1934 (5% or 6%), participating lenders were charging higher points to originate VA and FHA mortgages to increase their yield to market levels.⁴³ By October of 1966 points had risen from a typical charge of 2 points up to 7.5 points.⁴⁴ In 1966 FHA applications had declined from 1965 application rates by 36.5% for existing homes and by 18.4% for new homes.⁴⁵

The congressional response came in 1968, when Congress authorized the Secretary of Housing and Urban Development (HUD) to set maximum interest rates on FHA loans at any rate that the Secretary found necessary to meet the mortgage market.⁴⁶ Implicitly this meant that VA permissible rates would also rise, because VA rates were, at the time, tied to FHA rates.⁴⁷ This right was to expire on October 1, 1969.⁴⁸ However, the right was extended 24 times, meaning the Secretary actually possessed it until 1983.⁴⁹ In 1973 the Secretary of the VA was given similar authority to set VA rates based on the market that

43. S. REP. NO. 1090 (1968), *reprinted in* 1968 U.S.C.C.A.N. 1923, 1926.

44. *Id.*

45. *Id.*

46. Act of May 7, 1968, Pub. L. No. 90-301, §3, 82 Stat. 113, 113 (formerly codified at 12 U.S.C. § 1709-1 (1970)).

47. S. REP. NO. 1090 (1968), *reprinted in* 1968 U.S.C.C.A.N. 1923, 1928.

48. *Id.* In the interim a commission was established to "study mortgage interest rates and to make recommendations to assure the availability of an adequate supply of mortgage credit at a reasonable cost to the consumer." § 4(b), 82 Stat. at 114.

49. § 3(a), 82 Stat. at 113; Housing and Urban Development Act of 1968, Pub. L. No. 90-448, § 315, 82 Stat. 476, 512; Act of Sept. 30, 1969, Pub. L. No. 91-78, § 3, 83 Stat. 125, 125; Housing and Urban Development Act of 1969, Pub. L. No. 91-152, § 401, 83 Stat. 379, 394; Emergency Home Finance Act of 1970, Pub. L. No. 91-351, § 601, 84 Stat. 450, 461; Act of Dec. 22, 1971, Pub. L. No. 92-213, § 1, 85 Stat. 775, 775; Act of July 1, 1972, Pub. L. No. 92-335, § 1, 86 Stat. 405, 405; Act of Aug. 10, 1973, Pub. L. No. 93-85, § 2, 87 Stat. 220, 220; Act of Oct. 2, 1973, Pub. L. No. 93-117, § 3, 87 Stat. 421, 422; Flood Disaster Protection Act of 1973, Pub. L. No. 93-234, § 208, 87 Stat. 975, 984; Housing and Community Development Act of 1974, Pub. L. No. 93-383, § 309(e), 317, 88 Stat. 633, 682, 685; Act of June 30, 1977, Pub. L. No. 95-60, § 2, 91 Stat. 257, 257; Act of July 31, 1977, Pub. L. No. 95-80, § 2, 91 Stat. 339, 339; Housing and Community Development Act of 1977, Pub. L. No. 95-128, § 302, 91 Stat. 1111, 1131; Act of Sept. 30, 1978, Pub. L. No. 95-406, § 2, 92 Stat. 879, 880; Housing and Community Development Amendments of 1978, Pub. L. No. 95-557, § 302, 92 Stat. 2080, 2096; Act of Sept. 28, 1979, Pub. L. No. 96-71, § 2, 93 Stat. 501, 501; Act of Nov. 8, 1979, Pub. L. No. 96-105, § 2, 93 Stat. 794, 794; Housing and Community Development Amendments of 1979, Pub. L. No. 96-153, § 302, 93 Stat. 1101, 1112; Act of Oct. 3, 1980, Pub. L. No. 96-372, § 3, 94 Stat. 1363, 1364; Housing and Community Development Act of 1980, Pub. L. No. 96-399, §§ 302, 332, 94 Stat. 1614, 1638-39, 1652-53; Omnibus Budget Reconciliation Act of 1981, Pub. L. No. 97-35, § 332, 95 Stat. 357, 413; Act of Oct. 6, 1982, Pub. L. No. 97-289, § 2, 96 Stat. 1230, 1231; Act of May 26, 1983, Pub. L. No. 98-35, § 2, 97 Stat. 197, 197; Act of Oct. 1, 1983, Pub. L. No. 98-109, § 2, 97 Stat. 745, 746.

were not capped at the FHA maximum,⁵⁰ although the VA was instructed to “consult with the Secretary of Housing and Urban Development regarding the rate of interest the Secretary considers necessary to meet the mortgage market” for FHA loans, and to “carry out a coordinated policy on interest rates” on VA and FHA loans.⁵¹ By giving the Secretary of HUD, and ultimately the Secretary of the VA, the right to move rates in conformity with the market, Congress hoped to increase participation in the VA and FHA programs and to eliminate the high points being charged for FHA and VA loans.

Thus, after 1973, maximum rates for FHA loans were set by the Secretary of HUD pursuant to 12 U.S.C. § 1709-1,⁵² and maximum rates for VA loans were set by the Administrator of the VA pursuant to 38 U.S.C. § 1803(c)(1).⁵³ This policy stayed in effect until 1983 for FHA loans and until 1992 for VA loans, when all effective interest rate caps on these loans were eliminated.

In 1983 Congress eliminated the FHA’s regulation of interest rates charged on FHA loans, changing the interest rate ceiling from any rate that the Secretary found necessary to meet the mortgage market⁵⁴ to a maximum rate as agreed upon by the mortgagor and mortgagee.⁵⁵

Similarly, in 1992 Congress gave the VA Secretary the power either to set maximum interest rates after merely consulting with HUD regarding interest rate caps for FHA loans, or to cap rates at the amount “agreed upon by the veteran and the mortgagee.”⁵⁶ This change was made because Congress perceived that an administered rate hurt veterans trying to purchase a home.⁵⁷

50. Act of July 26, 1973, Pub. L. No. 93-75, 87 Stat. 176, 176. For an example of the VA changing the maximum rate, see Increase in Maximum Permissible Interest Rate, Final Regulations, 45 Fed. Reg. 56,343 (1980) (to be codified at 38 C.F.R. pt. 36).

51. 87 Stat. at 176.

52. Act of May 7, 1968, Pub. L. No. 90-301, §3, 82 Stat. 113, 113 (formerly codified at 12 U.S.C. § 1709-1 (1970)).

53. 87 Stat. at 176. This section was recodified to 38 U.S.C. § 3703(c)(1) (1994), its current placement, in 1991. Department of Veterans’ Affairs Codification Act, Pub. L. No. 102-83, § 5(b)(1), 105 Stat. 378, 406 (1991).

54. § 3, 82 Stat. at 113.

55. Act of Nov. 30, 1983, Pub. L. No. 98-181, § 404(b)(3), 97 Stat. 1153, 1209 (codified at 12 U.S.C. § 1709(b)(5) (1994)).

56. Veterans’ Home Loan Program Amendments of 1992, Pub. L. No. 102-547, §10(a), 106 Stat. 3633, 3643 (codified at 38 U.S.C. § 3703(c)(4)(A)(i) (1994)). This statute was originally set to expire on December 31, 1995. §10(a)(2), 106 Stat. at 3643. However, in February 1996 Congress repealed the expiration provision. Act of Feb. 13, 1996, Pub. L. No. 104-110, § 101(d), 110 Stat. 768, 768. The Secretary of the VA has continued to set rates for direct loans pursuant to 38 U.S.C. § 3711 (1994). See, e.g., 38 C.F.R. § 36.4503 (1999) (setting the rate at 9% for home improvement loans from the VA and at 7.5% for direct VA loans).

57. S. REP. NO. 102-405, at 14 (1992), reprinted in 1992 U.S.C.C.A.N. 3220, 3229. Congress perceived that when the market rate rose higher than the maximum VA rate, lenders were charging substantial points, which the VA rules required the seller to pay. Thus, sellers were raising the price of homes when they sold to buyers using VA loans. *Id.* Likewise, when the market rate fell below the maximum VA rate allowed, a contract for sale was signed, and the VA then adjusted its rates downward to below market rates, points were also required to be paid on loans. Some sellers with the option to do so canceled contracts because the points, which the

It was believed that a market rate standard would assure that sellers would continue to sell to veterans using VA loans, and would "ultimately reduce veterans' costs for housing."⁵⁸ Congress also sought to protect against predatory interest rates by allowing the VA to adopt a maximum rate rather than using the agreed-to rate rule if it became necessary,⁵⁹ and the Committee report expressed the Committee's belief that the highly competitive mortgage market would serve to control interest rates.⁶⁰

The VA regulation allowing VA loans to bear interest at a rate agreed upon by the veteran and the mortgagee was made final on July 26, 1995, and the rate rule has not changed since that time.⁶¹

III. FEDERAL PREEMPTION OF STATE INTEREST RATE REGULATION

A. Federal Preemption of FHA Loans and VA Loans

1. State Usury Law and FHA/VA Loans

In addition to being controlled by agency-dictated rate ceilings, FHA and VA loans were also subject to state interest rate caps between 1958 and 1979, unless a state's usury provision specifically exempted such mortgages from the state's usury laws. Thus, from the inception of these two loan programs until 1979, the interest rate that lenders could charge for FHA and VA loans was effectively capped at whichever was the lowest rate, the VA/FHA rate or the state usury rate.

2. The 1976 California Preemption

In 1975 the maximum rate that could be charged on a VA loan was between 8% and 9%, and during the first half of 1976 the maximum rate was between 8.5% and 9%.⁶² At the same time, contract mortgage rates on conventional 30-year fixed-rate mortgages varied between 8.82% and 9.43% in 1975 and between 8.73% and 9.02% in 1976.⁶³

At this time mortgage bankers in California were subject to a 10%

seller was obligated to pay, decreased the value to the seller. *Id.*

58. S. REP. NO. 102-405, at 15 (1992) *reprinted in* 1992 U.S.C.C.A.N. 3220, 3230.

59. *Id.*

60. *Id.*

61. Loan Guaranty: Implementation of Public Law 102-547, Final Rule, 60 Fed. Reg. 38,256 (1995). This, too, applied to both regularly guaranteed loans under 38 C.F.R. § 36.4311 (1999) and guaranteed loans for manufactured homes under 38 C.F.R. § 36.4212 (1999).

62. S. REP. NO. 94-806, at 7 (1976), *reprinted in* 1976 U.S.C.C.A.N. 1344, 1348. Maximum FHA rates would have been approximately the same because rates were set by the VA and FHA in consultation with each other. Act of July 26, 1973, Pub. L. No. 93-75, 87 Stat. 176.

63. Mortgage Bankers Association of America, *Contract Mortgage Rates, 30-Year Fixed-Rate Mortgage* (visited September 19, 1999) <http://www.mbaa.org/marketdata/data99/30frm_1.html>.

constitutional usury ceiling that had been in existence since 1934. However, commercial lenders such as banks and savings and loan associations were exempt from this restriction.⁶⁴ As interest rates rose close to the 10% usury ceiling in the 1970s, California mortgage bankers were forced out of the mortgage industry, unable to compete with lenders not subject to the 10% cap.⁶⁵ At the time, mortgage bankers were responsible for originating 80% of FHA and VA mortgages.⁶⁶ Thus, a reduction in the number of mortgage bankers making loans in California had the effect of drastically reducing the total number of FHA/VA loan originations in California.⁶⁷

For its part, the State of California seemed unable to raise its usury limit. Because the usury provision had been included in the constitution, rather than in the state code, amending the usury provision required a statewide vote.⁶⁸ Furthermore, simply getting the matter on a ballot required a two-thirds vote of the legislature or a referendum requested by a petition of at least 500,000 registered voters.⁶⁹ Unable to get the matter on the ballot in the prescribed ways,⁷⁰ the California Legislature adopted a resolution on April 16, 1975 essentially asking for Congress's help in extracting California from its constitutional shackles.⁷¹

Congress's response to California's request was Public Law 94-324, which preempted the provisions of any state constitution or law limiting the amount of interest that could be charged for an FHA or VA loan by certain classes of lenders.⁷² The statute specifically targeted the situation in California.⁷³

64. CAL. CONST. of 1879, art. XX, § 22 (1934), *now codified at* CAL. CONST. of 1879, art. XV, § 1 (1976); *Committee Against Unfair Interest Limitations v. State*, 157 Cal. Rptr. 543, 548 (Ct. App. 1979); S. REP. NO. 94-806, at 17-18. The lenders exempt from the 10% constitutional cap were nevertheless regulated by the legislature. *Committee Against Unfair Interest Limitations*, 157 Cal. Rptr. at 549. In 1979 the people of California exempted real estate brokers from the 10% rate cap in a statewide election held on November 6, 1979. CAL. CONST. of 1879, art. XV § 1 (1976) (historical note).

65. S. REP. NO. 94-806, at 18.

66. *Id.*

67. *Id.* (indicating that "mortgage activity is reduced by 70 percent when the FHA/VA interest rate reaches 9.5% in California").

68. *Id.* at 19.

69. *Id.*

70. Three attempts were made to amend the constitution, one in 1970 and two in 1976. All three failed. *Committee Against Unfair Interest Limitations v. State*, 157 Cal. Rptr. 543, 549 (Ct. App. 1979).

71. See S. REP. NO. 94-806, at 19. The resolution specifically asked for preemption of California's usury limit for all mortgages or deeds of trust that were insured by the FHA or VA, or which were intended for delivery to a governmental secondary market support institution such as the Federal National Mortgage Association (FNMA). *Id.*

72. Act of June 30, 1976, Pub. L. No. 94-324, § 8, 90 Stat. 720, 722 (codified at 12 U.S.C. § 1709-1a (1994) (effective June 30, 1976)).

73. S. REP. NO. 94-806, at 17. Indeed, the Chairman and Ranking Minority members of the Subcommittee on Housing and the Chairman and Ranking Minority members of the full Banking, Housing, and Urban Affairs Committee all assented to the bill being considered solely by the Veterans' Affairs Committee based on their understanding that the bill affected only

Interestingly, the statute gave states the ability to override the preemption by adopting a new state statute limiting the amount of interest that could be charged in VA and FHA loans.⁷⁴ This, of course, had the effect of putting the California legislature back in the driver's seat and allowing any other state unexpectedly affected to escape the federal preemption.

3. *The 1979 "Arkansas" Preemption*

By the late 1970s interest rates had risen quite significantly.⁷⁵ In response to this rise in interest rates, the VA and FHA continually raised their rate ceilings.⁷⁶ By January of 1979 the maximum VA rate was 9.5%.⁷⁷ Lenders were still requiring an average of five discount points on 9.5% VA and FHA contracts, which translated into higher prices being paid by buyers.⁷⁸ At the same time, several states had either constitutional or statutory rate ceilings near 10%.⁷⁹ As explained above, these state rate limits were also applicable to FHA and VA mortgages, unless such mortgages were specifically excluded from the state's usury laws. At the time, the State of Arkansas had a 10% constitutional cap on all loans.⁸⁰ It was this 10% cap in Arkansas that once again led Congress down the road of state usury rate preemption.⁸¹

California. *Id.* at 32.

74. 12 U.S.C. § 1709-1a(b) (1994).

75. For example, the Federal Reserve discount rate at which depository institutions borrowed from the Federal Reserve Bank of New York for 1975 was 6.25%. The rate was 5.5% in 1976, 5.46% in 1977, and 7.46% in 1978. By 1979 it had shot up to 10.29%, in 1980 it was 11.77%, in 1981 it was 13.42%, and in 1982 it was 11.01%. Federal Reserve Board, *Discount Rate* (visited Jan. 4, 2000) <<http://www.federalreserve.gov/releases/H15/data/a/dwb.txt>>. Mortgage contract interest rates on thirty year conventional fixed mortgages averaged 9.04% in 1975, 8.86% in 1976, 8.84% in 1977, 9.63% in 1978, 11.19% in 1979, and 13.77% in 1980. Federal Reserve Board, *30-Year Conventional Mortgages, Fixed-Rate* (visited Jan. 4, 2000) <<http://www.federalreserve.gov/releases/H15/data/a/cm.txt>>.

76. For changes to the VA rate, see 41 Fed. Reg. 47,049 (Oct. 27, 1976) (lowering the rate to 8%); 42 Fed. Reg. 28883 (June 6, 1977) (raising the rate to 8.5%); 43 Fed. Reg. 9274 (Mar. 7, 1978) (raising the rate to 8.75%); 43 Fed. Reg. 22717 (May 26, 1978) (raising the rate to 9%); 43 Fed. Reg. 29,001 (July 5, 1978) (raising the rate to 9.5%); 44 Fed. Reg. 24,555 (Apr. 26, 1979) (raising the rate to 10%); 44 Fed. Reg. 56,330 (Oct. 1, 1979) (raising the rate to 10.5%); 44 Fed. Reg. 62,510 (Oct. 31, 1979) (raising the rate to 11.5%).

77. 43 Fed. Reg. 29,001 (changing the rate to 9.5% on July 5, 1978). The FHA rate at the time would have been approximately the same since it was set after consultation with the Administrator of the VA. See Act of July 26, 1973, Pub. L. No. 93-75, 87 Stat. 176.

78. David F. Seiders, *Recent Developments in Mortgage and Housing Markets*, 65 FED. RES. BULL. 173, 180 (1979) [hereinafter Seiders, *Recent Developments*].

79. For a chart setting forth mortgage interest rate limits in 1979, see *Usury Lending Limits: Hearings on S. 1988 Before the Comm. on Banking, Hous., and Urban Affairs*, 96th Cong. 164-70 (1979).

80. ARK. CONST. of 1874, art. XIX, § 13.

81. H. R. REP. NO. 96-137, at 2 (1979).

In January of 1979, with conventional mortgage rates at 10.39%,⁸² VA rates at 9.5%,⁸³ and a home-state constitutional usury cap of 10%, Congressman John Paul Hammerschmidt (R-Ark.) introduced H.R. 411 in the United States House of Representatives.⁸⁴ The bill provided that constitutional—and only constitutional—state usury limits, and corresponding statutes in those states with constitutional limits, would not apply to loans guaranteed or made by the VA.⁸⁵ The bill also provided that the preemption contained in the bill would remain effective until an affected state adopted a new statute specifically limiting the amount of interest that could be charged on VA loans.⁸⁶ Once again, as with the 1976 preemption directed at California, the effect of this bill's passage would have been to put the power to determine usury limits in the hands of the state legislature, without state constitutional restraints.⁸⁷

When H.R. 411 emerged from the House Committee on Veterans' Affairs on May 10, 1979,⁸⁸ VA rates had just been increased to 10%.⁸⁹ The Committee issued a report clarifying that the bill was intended to specifically address the constitutional restriction in Arkansas. The report also emphasized that Arkansas would be the only state affected by the bill.⁹⁰ On June 25, 1979, the bill passed the House after very little debate and with virtually no opposition. The lone dissenter was Congressman Henry B. Gonzalez (D-Tex.), who worried that Congress was "authorizing exorbitant and usurious interest rates." After adoption, H.R. 411 was referred to the House Committee on Veterans' Affairs.

Also in May of 1979, several Representatives introduced in the House a bill providing that state usury laws, whether statutory or constitutional, would not apply to FHA loans.⁹¹ An identical measure was introduced in the Senate.⁹² Both bills permitted states to override the federal preemption by adopting a statute regulating FHA rates.⁹³ In its report to the Senate, the Senate Committee on Banking, Housing, and Urban Affairs indicated that the preemption was necessary because state usury laws were limiting access to FHA programs for

82. Mortgage Bankers Association Contract Mortgage Rates, *30-Year Fixed-Rate Mortgage Contract Rates* (visited Sept. 19, 1999) <http://www.mbaa.org/marketdata/data99/30frm_1.html>. The rates in November and December of 1978 were also above 10%, with a conventional thirty-year mortgage rate of 10.11% in November of 1978 and a rate of 10.35% in December of that year. *Id.*

83. 43 Fed. Reg. 29,001 (1978).

84. 125 CONG. REC. 443 (1979).

85. H.R. 411, 96th Cong. § 1 (1979).

86. H.R. 411 § 2.

87. H.R. REP. NO. 96-137, at 2 (1979).

88. 125 CONG. REC. 10742 (1979).

89. 44 Fed. Reg. 24,554, 24,555 (1979).

90. H.R. REP. NO. 96-137, at 2. Interestingly, the Veterans' Administration opposed the bill: "We do not believe it is appropriate for the Congress to enact Federal legislation to remedy this problem which is caused by a State constitution, and for which corrective procedures exist within the State." *Id.* at 4.

91. H.R. 3875, 96th Cong. § 311 (1979).

92. S. 1149, 96th Cong. § 319 (1979).

93. H.R. 3875 § 311; S. 1149 § 319 (1979).

low and moderate income families.⁹⁴ Regarding the effect preempting state usury laws would have on protecting consumers, the Senate report states:

The primary purpose of these statutes, which is to protect consumers from usury, is served by having the Secretary administer the FHA interest rate, which is intended to assure a rate that is fair to both lenders and consumers. As further protection, the section would allow States to reenact a usury limit applicable to FHA mortgages⁹⁵

The House bill containing the FHA usury preemption (H.R. 3875) passed the House on June 7, 1979⁹⁶ after four days of debate and no mention of the usury provision.⁹⁷

The Senate FHA preemption bill (S. 1149) passed the Senate as part of the Senate's amendments to the House FHA bill on July 13, 1979.⁹⁸ During debate on the Senate bill, Senator Robert Morgan (D-NC) introduced an amendment to strike the usury preemption provision.⁹⁹ Senator Morgan's opposition to the bill was based primarily on federalism, rather than consumer protection concerns.¹⁰⁰ But other Senators disagreed, believing that because state usury limits had paralyzed mortgage lending and affected the FHA program, this was an appropriate issue for the federal government.¹⁰¹ Senator Pryor advocated the need to act immediately because states such as Arkansas did not have time,

94. S. REP. NO. 96-164, at 22 (1979).

95. *Id.* Senator Cranston made a similar assurance of rate regulation by the VA on Nov. 15, 1979. 125 CONG. REC. 32,592 (1979). The House conference committee made another reference to FHA rate regulation at H.R. CONF. REP. NO. 96-706, at 61 (1979), reprinted in 1979 U.S.C.C.A.N. 2402, 2420. However, the FHA stopped setting FHA rate limits in 1983. Act of Nov. 30, 1983, Pub. L. No. 98-181, § 404, 97 Stat. 1153. The VA likewise stopped setting VA rate limits in 1992. Veterans' Home Loan Program Amendments of 1992, Pub. L. No. 102-547, § 10, 106 Stat. 3633, 3643.

96. 125 CONG. REC. 13,951 (1979).

97. *Id.* 13,166-73, 13,331-62, 13,616-48, 13,924-52.

98. The Senate preemption provision was originally contained in S. 1149, 96th Cong. § 319 (1979). However, on July 13, 1979 the Senate took up the House FHA preemption bill (H.R. 3875), struck the text as adopted by the House, and replaced it with several Senate bills, including S. 1149. The FHA usury preemption provision thus emerged from the Senate on July 13, 1979 as § 320 of H.R. 3875, 96th Cong. (1979). *Id.* at 18,552-57 (1979). The Senate then indefinitely postponed S. 1149. *Id.* at 18,560. Debate on the bill took place on July 12-13, 1979. *Id.* at 18,211-20, 18,497-561.

99. *Id.* 125 CONG. REC. 18,542 (introducing amendment 348).

100. *Id.* (statement of Sen. Morgan). Senator Morgan felt that if state usury laws were impeding access to FHA programs, the proper remedy was to "let the Secretary of HUD go to the Governors—most of ceilings are statutory enactments not constitutional matters—go and persuade the people of the States to see that we need to remove these usury limitations." *Id.* at 18,543.

101. *Id.* at 18,544 (statement of Sen. Proxmire); *id.* at 18,548 (statement of Sen. Pryor) (referring to Arkansas as a place in which mortgage lending had stopped because of a 10% usury cap and comparable VA and FHA rate limits).

given the cumbersome constitutional amendment process, to remedy the interest rate situation quickly enough.¹⁰² Some Senators believed that if Congress did not act there would be a financial crisis in states with a 10% usury ceiling.¹⁰³ Federalism concerns did not bother other Senators because states had the right to reenact their own usury limits after adoption of the bill.¹⁰⁴ Ultimately, the amendment to strike the preemption provision was defeated by a vote of 62 to 20.¹⁰⁵ A few days later the House disagreed with the Senate amendments and the bill, with the preemption provision, was sent to a conference committee.¹⁰⁶

In the meantime, on June 14, 1979 the Senate Committee on Veterans' Affairs began considering H.R. 411, the bill that had been introduced in response to Arkansas' constitutional usury ceiling.¹⁰⁷ The Senate Committee issued its report on H.R. 411 on July 27, 1979.¹⁰⁸ Ultimately, the Senate Committee expanded the constitutional VA preemption contained in H.R. 411 so that it preempted both constitutional and statutory usury provisions.¹⁰⁹ The new, expanded version was included as part of another bill, S. 689, which previously had no preemption provision. Senate bill 689 made preemption of state rates for VA loans dependent on preemption of state rates for FHA loans.¹¹⁰ Thus, S. 689 provided that state usury limits would not apply to VA loans if they did not apply to FHA loans.¹¹¹ The Committee explained that it tied VA preemption to FHA preemption to promote "a coordinated Federal policy with regard to the application of State anti-usury provisions to FHA and VA home loans."¹¹² The full Senate adopted this provision on August 3, 1979.¹¹³ Oddly enough, during debate on this bill—which now preempted usury provisions that were both statutory and constitutional—several references were made to the constitutional situation in Arkansas as if only that state would be

102. *Id.* at 18,543 (statement of Sen. Pryor). Senator Pryor indicated that, at the earliest, Arkansas would have its constitutional usury limit fixed by November of 1980 and that the citizens of Arkansas needed relief before that time. *Id.*

103. *Id.* at 18,544 (statement of Sen. Pryor) (stating that if the usury provision is stricken "we will see a financial crisis in States that have a 10 percent usury ceiling, because we will see mortgage money totally stopped. It is just about stopped right now, and in days or weeks it will be cut off from some very deserving people.").

104. *Id.* at 18,543-44 (statements of Sens. Garn, Pryor, and Proxmire).

105. *Id.* at 18,545.

106. *Id.* at 19,072.

107. S. REP. NO. 96-260, at 9 (1979), *reprinted in* 1979 U.S.C.C.A.N. 1894, 1895.

108. *Id.* at 1.

109. 125 CONG. REC. 21,114 (1979); S. REP. NO. 96-260, at 9-11 (1979), *reprinted in* 1979 U.S.C.C.A.N. 1894, 1895.

110. *Id.*

111. S. REP. NO. 96-260, at 11.

112. *Id.* at 31; *accord*, 125 CONG. REC. 22,603 (1979) (statement of Sen. Simpson).

113. 125 CONG. REC. 22,606 (1979). The text of S. 689 was adopted by the Senate as replacement text for another House Bill, H.R. 2282, that had no preemption provision. *Id.* The preemption provision ended up as Section 401 of H.R. 2282, as adopted by the Senate, and S. 689 was indefinitely postponed. *Id.*

affected by the bill.¹¹⁴ Ultimately, the VA preemption provision, preempting both statutory and constitutional usury limits and tying VA preemption to FHA preemption, was adopted by Congress in mid-November,¹¹⁵ after slight changes by both the House and the Senate.¹¹⁶

114. *Id.* at 22,603. Senator Simpson stated:

The enactment of this provision together with enactment of H.R. 3875 . . . would permit veterans of the State of Arkansas and other States to make use of their loan-guaranty entitlement in fiscal year 1980. The need for this legislation has evolved at this time because of the anti-usury prohibition in the State of Arkansas, where the State constitutional bar, which can be removed only through cumbersome amendatory procedures, has brought VA loan activity in that State to a halt.

Id. A similar statement is contained in the Congressional Budget Office's estimate of costs of the bill:

According to VA information, only the State of Arkansas would be significantly affected by this amendment. Other States either have State laws that exempt Federal home loan programs from the restrictions of their usury laws or have interest ceilings high enough to avoid conflict with current interest rates. Although enactment of the provision would increase loan activity in Arkansas, the increase should not significantly raise total program costs.

Id. at 22,595.

115. Veterans' Disability Compensation and Survivors' Benefits Amendments of 1979, Pub. L. No. 96-128, § 401(a), 93 Stat. 982, 986-87 (originally codified at 38 U.S.C. § 1828, now codified as amended at 38 U.S.C. § 3728 (1994)). The preemption portion of the statute, as adopted, reads as follows:

If, under any law of the United States, loans and mortgages insured under title I or title II of the National Housing Act are exempt from the application of the provisions of any State constitution or law limiting the rate or amount of interest, discount points, or other charges which may be charged, taken, received, or reserved by lenders . . . then loans guaranteed or insured under this chapter are also exempt from the application of such provisions.

38 U.S.C. § 3728. This statute has been amended twice since 1979. The first amendment, the Veterans' Disability Compensation, Housing, and Memorial Benefits Amendments of 1981, Pub. L. No. 97-66, § 501(b), 95 Stat. 1026, 1032, was adopted "to extend the exemption [of VA guaranteed loans from state anti-usury laws] to include exemptions from state laws that restrict the manner of calculating interest (including prohibition of the charging of interest on interest) and require a minimum amortization of principal." S. REP. No. 97-153, at 55 (1981), *reprinted in* 1981 U.S.C.C.A.N. 1595, 1640. The second amendment merely recodified the section. Department of Veterans' Affairs Codification Act, Pub. L. No. 102-83, 105 Stat. 378 (1991).

116. On October 30, 1979 the House considered H.R. 2282 as passed by the Senate and amended it slightly. 125 CONG. REC. 30,154-67 (1979). On November 15, 1979 the Senate made its own slight changes to H.R. 2282. See *id.* at 32,589-99, a portion of which is reprinted at 1979 U.S.C.C.A.N. 1966-67. On November 16, 1979 the House agreed to the Senate

The FHA preemption provision, on which the VA preemption provision as passed by Congress depended, was still in conference committee at the time that the VA preemption provision passed. Finally, in mid-December of 1979 the bill containing the FHA preemption provision (H.R. 3875) was reported out of the conference committee and passed both Houses of Congress.¹¹⁷ The only mention of the usury provision in either House was a short statement by Senator Williams that “[t]he conference report also overrides State usury limitations for FHA programs. This is necessary to prevent the shutdown of FHA in a number of States in which the FHA rate currently exceeds the State usury ceiling.”¹¹⁸ Only the House Conference Report on the bill contained any mention of consumer protection concerns following the preemption of state usury laws, and this only addressed concerns about inclusion of installment credit sales contracts for mobile homes in the preemption:

[T]he conferees note that with respect to . . . contracts used to finance mobile homes under Title I of the National Housing Act, FHA regulations already provide significant protections by prohibiting both the Rule of 78 and balloon payments, and by limiting late charges. FHA also provides an interest rate ceiling.¹¹⁹

amendments and the bill was sent to the President for signature. 125 CONG. REC. 32,837 (1979).

117. Housing and Community Development Amendments of 1979, Pub. L. No. 96-153, § 308, 93 Stat. 1101, 1113. The preemption portion of the statute as adopted reads as follows:

(a) The provisions of the constitution of any State expressly limiting the rate or amount of interest, discount points, or other charges which may be charged, taken, received, or reserved by lenders and the provisions of any State law expressly limiting the rate or amount of interest, discount points, or other charges which may be charged, taken, received, or reserved shall not apply to any loan, mortgage, or advance which is insured under title I or II of this Act.

(b) The provisions of subsection (a) shall apply to loans, mortgages, or advances made or executed in any State until the effective date (after the date of enactment of this section) of a provision of law of that State limiting the rate or amount of interest, discount points, or other charges on any such loan, mortgage, or advance.

Id. See H.R. 3875, as reported out of the conference committee, was debated by and passed the Senate on December 18, 1979. *Id.*; 125 CONG. REC. 36,608-12 (1979). H.R. 3875, as reported out of the conference committee, passed the House on December 19, 1979. § 308, 93 Stat. at 1113; 125 CONG. REC. 37,128 (1979).

118. 125 CONG. REC. 36,609 (1979) (statement of Sen. Williams).

119. H.R. CONF. REP. NO. 96-706, at 61 (1979), reprinted in 1979 U.S.C.C.A.N. 2402,

Thus, by the end of 1979 state usury ceilings were preempted for both VA and FHA loans. Nevertheless, as indicated earlier, from 1979 until 1983 the Secretary of HUD set FHA maximum loan interest rates,¹²⁰ and from 1979 until 1992 the Administrator of the VA set VA maximum loan interest rates after consultation with the HUD Secretary.¹²¹ Therefore, even though state rate regulation was preempted, federal agencies still regulated FHA and VA rates during this period.

The combined effect of the 1979 preemption of state usury ceilings and the 1983 and 1992 deregulation of FHA and VA interest rates was to remove any cap on interest rates for FHA and VA loan interest rates. Such rates are now set without regulation, except in states that adopted usury limits applicable to VA and FHA mortgages after the 1976 or 1979 enactments.¹²²

B. Federal Preemption of Non-FHA and VA Home-Secured Loans: DIDMCA

1. Scope of DIDMCA Mortgage Rate Preemption

The third and final mortgage rate preemption adopted by Congress in 1979 was the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA).¹²³ This statute was much more far-reaching than the FHA and VA preemptions in scope, and is the statute that ultimately set the stage for the subprime home equity lending industry of today.¹²⁴ DIDMCA provided for the following:

The provisions of the constitution or the laws of any State expressly limiting the rate or amount of interest, discount points, finance charges, or other charges which may be charged, taken, received, or reserved shall not apply to any

120. Act of May 7, 1968, Pub. L. No. 90-301, § 3, 82 Stat. 113 (formerly codified at 12 U.S.C. § 1709-1).

121. Act of July 26, 1973, Pub. L. No. 93-75, 87 Stat. 176. This section was re-codified to 38 U.S.C. § 3703, its current placement, in 1991. Department of Veterans' Affairs Codification Act, Pub. L. No. 102-83, § 5(b)(1), 105 Stat. 406 (1991).

122. Determining if a particular state has opted out of VA and FHA preemption is sometimes a difficult matter. *See generally* KATHLEEN E. KEEST & ELIZABETH RENUART, NATIONAL CONSUMER LAW CTR., *THE COST OF CREDIT: REGULATION AND LEGAL CHALLENGES*, § 3.6 (1995 & Supp. 1999).

123. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 501(a), 94 Stat. 132, 161-62 (codified as amended at 12 U.S.C. § 1735f-7a (1994)). A temporary and almost identical version of this provision was adopted in 1979. Act of Dec. 28, 1979, Pub. L. No. 96-161, § 105(a)(1), 93 Stat. 1233, 1234. This temporary provision expired on March 31, 1980. § 105(d), 93 Stat. at 1235.

124. For a discussion of which preemption applies in VA/FHA/DIDMCA overlap loans, *see* *Burris v. First Fin. Corp.*, 928 F.2d 797 (8th Cir. 1991); *Doyle v. Southern Guar. Corp.*, 795 F.2d 907 (11th Cir. 1986), *certifying questions to* Georgia Supreme Court, *Southern Guar. Corp. v. Doyle*, 353 S.E.2d 510 (Ga. 1987).

loan, mortgage, credit sale, or advance which is—

- (A) secured by a first lien on residential real property, by a first lien on stock in a residential cooperative housing corporation where the loan, mortgage, or advance is used to finance the acquisition of such stock, or by a first lien on a residential manufactured home;
- (B) made after March 31, 1980; and
- (C) described in section 527(b) of the National Housing Act (12 U.S.C. 1735f-5(b)) . . .¹²⁵

By its reference to section 527(b) of the National Housing Act,¹²⁶ the statute covers any mortgage, loan, or advance that:

- (b)(2)(A) is made in whole or in part by any lender the deposits or accounts of which are insured by any agency of the Federal Government, or is made in whole or in part by any lender which is itself regulated by any agency of the Federal Government; or
- (B) is made in whole or in part, or insured, guaranteed, supplemented, or assisted in any way, by the Secretary of Housing and Urban Development or any other officer or agency of the Federal Government or under or in connection with a housing or urban development program administered by the Secretary of Housing and Urban Development or a housing or related program administered by any other such officer or agency; or
- (C) is eligible for purchase by the Federal National Mortgage Association, the Government National Mortgage Association, or the Federal Home Loan Mortgage Corporation, or from any financial institution from which it could be purchased by the Federal Home Loan Mortgage Corporation; or
- (D) is made in whole or in part by any “creditor,” as defined in section 1602(f) of Title 15,¹²⁷ who makes or invests in residential real estate loans aggregating more than \$1,000,000 per year.¹²⁸

The statute also covers “any lender approved by the Secretary of Housing and Urban Development for participation in any mortgage insurance program under

125. § 501(a), 94 Stat. at 161. The final version clarified that the preemption also applied to loans or credit sales secured by a first lien on residential manufactured homes and to stock in coops. § 501(a)(1)(C)(ii)-(v), 94 Stat. at 161.

126. 12 U.S.C. § 1735f-5 (1994).

127. This refers to the definition of a “creditor” in the Truth in Lending Act. See 15 U.S.C. § 1602(f) (1994); 12 C.F.R. § 226.2(a)(17) (1999).

128. 12 U.S.C. § 1735f-5(b)(2) (1994).

the National Housing Act.¹²⁹

This bill and its temporary predecessor, enacted in November 1979,¹³⁰ were passed in an era of record-high interest rates.¹³¹ At the same time, mortgage interest rate ceilings, which were controlled by state law, were in some cases far below market interest rates, although this was not the case in many states.¹³² Thus, lenders were unable to make loans at prevailing interest rates because of usury ceilings that had been adopted before the advent of double-digit interest rates and had not yet been amended. In some cases these state usury limits were constitutional, but in most they were statutory.¹³³ The disparity between interest rate ceilings and market rates above those ceilings made lenders unable and unwilling to make mortgage loans in states with low ceilings. In some cases lenders invested in mortgages in states with higher ceilings.¹³⁴ This meant that mortgage money was unavailable in states with low usury ceilings.

Some states responded to this crunch by raising or eliminating their usury ceilings.¹³⁵ Nevertheless, not all states did so. It is this predicament that is most

129. § 501(a)(1)(C)(vi), 94 Stat. at 161.

130. Act of Dec. 28, 1979, Pub. L. No. 96-161, § 105(a)(1), 93 Stat. 1233, 1234 (codified as a note to 12 U.S.C. § 1235f-7 (1994)).

131. See *supra* note 75 and accompanying text.

132. Seiders, *Recent Developments*, *supra* note 78, at 180. One would think, based on the DIDMCA congressional debate, that such limits were in place in a majority of states. In fact, only about one-third of all states had rate ceilings "below national-average mortgage yields." *Id.* at 180. Additionally, by October 1979 sixteen states had a residential rate limit that floated above a designated market rate, eleven states had no rate limit on residential mortgages, one state had a 21% limit, and four states had an 18% limit. *Usury Lending Limits: Hearings on S. 1988*, *supra* note 79, at 164-70.

133. *Usury Lending Limits: Hearings on S. 1988*, *supra* note 79, at 164-70.

134. Seiders, *Recent Developments*, *supra* note 78, at 180-81.

135. S. REP. NO. 96-368, at 41 (1979), reprinted in 1980 U.S.C.C.A.N. 236, 272, 277 (Additional Views of Sen. Morgan). Senator Morgan explained:

Reflective of state concern in this area is the fact that during the period from December 1975 to June 1979 some 28 States liberalized their usury ceilings on individual or corporate loans in efforts to meet changing economic conditions. During this same period some 15 States exempted from their usury ceilings FHA and/or VA loans.

Id.; see also 125 CONG. REC. 29,111 (1979) (statement of Sen. Morgan) ("[D]uring the period from 1975 to 1979, 28 States liberalized their usury ceilings . . . in efforts to meet changing economic conditions."); 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 VA. L. REV. 1083, 1107-08 & n.82 (1984) (reporting that in the mid-1970s Kentucky, Maine, North Carolina, Oregon, Pennsylvania, and Virginia responded to rising interest rates by abolishing their usury ceilings and that Arizona, Hawaii, Illinois, Nebraska, South Carolina, South Dakota, Vermont, and Wisconsin did the same after 1979); *id.* at 1108 & n.83 (reporting that by 1978 Alaska, Minnesota, Ohio, and Pennsylvania had adopted interest rate ceilings that floated above an identified market index, and that in the next two years California, Delaware, Georgia, Kansas, Mississippi, Missouri, Montana, Nevada, New Jersey, New Mexico, New York, Tennessee, and West Virginia did the same); Charles Luckett, *Recent Financial Behavior of Households*, 66 FED. RES. BULL. 437, 439 (1980) [hereinafter Luckett,

often remembered as the impetus for the 1979 and 1980 first-lien preemption now codified at 12 U.S.C. § 1735f-7a, and most certainly this predicament played a role in Congress's decision to preempt state usury laws in mortgage loans.¹³⁶ However, the 1979 and 1980 preemptions were prompted primarily by congressional concerns about the solvency of the savings and loan industry.¹³⁷

2. *The Legislative History of DIDMCA*

The story of how the first-lien preemption provision became part of H.R. 4986, the bill that ultimately became DIDMCA, is fraught with political wrangling between the House and the Senate. When H.R. 4986 was introduced in the House of Representatives on July 27, 1979,¹³⁸ it was meant to address only those financial institution issues raised in the April 20, 1979 decision of the D.C. Circuit in *American Bankers Assoc. v. Connell*.¹³⁹ In that case, the D.C. Circuit held that in authorizing several types of customer deposit accounts at regulated financial institutions, federal regulators had exceeded their statutory authority.¹⁴⁰ Because many financial institutions had already set up

Recent Financial Behavior]. See, e.g., Act of Apr. 23, 1980, ch. 200, § 1, 1980 Ariz. Sess. Laws 567, 568 (repealing interest rate limitations); 1974 Pa. Laws 13, No. 6, §§ 301, 603 (repealing 41 PA. STAT. ANN. § 3 (1971), which set maximum rates for residential mortgages, and enacting 41 PA. CONS. STAT. ANN. § 301 (1999), which set a floating rate ceiling for residential mortgages).

136. See, e.g., 125 CONG. REC. 28,316 (1979) (statement of Sen. Proxmire) ("This legislation also preempts State home mortgage lending limits which are responsible for mortgage money drying up in many areas of the country.").

137. See *infra* notes 158-62 and accompanying text.

138. 125 CONG. REC. 21,052 (1979).

139. 686 F.2d 953 (D.C. Cir. 1979) (per curiam); see also 125 CONG. REC. 23,791 (1979) (statement of Rep. St. Germain) ("H.R. 4986, as reported by your Banking Committee, meets the court's instructions and assures that millions of consumer accounts will not be closed down at 12:01 a.m., January 1 [1980].").

140. *American Bankers*, 686 F.2d at 954. The deposit accounts affected by the opinion are described in the Senate Report to accompany H.R. 4986 as follows:

In order to provide the consumer with a more competitive and efficient service, the regulatory authorities by regulation permitted financial institutions to offer interest bearing checking account type services nationwide. The bank regulatory agencies permitted insured banks to offer the consumer automatic transfer service from savings accounts to checking accounts ("ATS"); the FHLBB permitted Federal savings and loan associations to allow consumers to make savings deposits and withdrawals from off-premises remote electronic service units in some cases located in various retail stores. The National Credit Union Administration authorized Federal credit unions the power to offer interest bearing checking accounts. These accounts

the accounts that were declared unauthorized by Congress, the D.C. Circuit gave Congress until December 31, 1979 to authorize the accounts before the effects of the opinion would become operative.¹⁴¹ If Congress failed to authorize the relevant accounts before December 31, "millions of consumers [would have had] their financial accounts abruptly terminated."¹⁴²

The House version of H.R. 4986 addressed only the issues raised by the court's opinion in *American Bankers*.¹⁴³ It did not contain any provisions relating to home mortgage loans. This bill was debated and passed by the House on September 10-11, 1979.¹⁴⁴

When the Senate Committee on Banking, Housing, and Urban Affairs reported H.R. 4986 out of committee on October 15, 1979¹⁴⁵ it had attached to it a host of other provisions, including the first-lien preemption.¹⁴⁶ As detailed below, these other provisions explain in large part why the bill contained a first-lien preemption provision.¹⁴⁷

The bill as reported out of the Senate Committee contained several

are called share draft accounts and are equivalent to
the NOW [negotiable order-of-withdrawal] accounts
offered by banks and thrifts.

S. REP. NO. 96-368, at 5.

141. 686 F.2d at 955. The court found the regulations outside of statutory authority, but stayed the effectiveness of the judgment until January 1, 1980 "in the expectation that Congress will declare its will upon these matters." *Id.*

142. S. REP. NO. 96-368, at 6. The depositors affected included "900,000 individuals with share draft accounts at nearly 1,000 federal credit unions; 750,000 individuals with \$6 billion in automatic transfer accounts at commercial banks; and 700,000 individuals with accounts accessible by savings and loan remote service units." *Id.* The urgent action required by Congress is discussed at times during the floor debate on the various bills that are discussed in this part of this article (H.R. 4986, S. 1347, H.R. 4998). *See, e.g.*, 125 CONG. REC. 30,288 (1979) (statement of Sen. Morgan).

143. *American Bankers*, 686 F.2d 953.

144. 125 CONG. REC. 23,790-801 (1979); *id.* at 24,026-27.

145. S. REP. NO. 96-368 (1979). H.R. 4986 had been referred to that Committee from the House on September 13, 1979. 125 CONG. REC. 24,391-92 (1979).

146. The first-lien preemption provision was reported out of committee as section 305 of H.R. 4986. S. REP. NO. 96-368, at 23. The provision had originally been included as section 303 of S. 1347, which was introduced in the Senate on June 14, 1979 by Senator Cranston and referred to the Senate Committee on Banking, Housing, and Urban Affairs. 125 CONG. REC. 14,866-67. Rather than report this bill out of committee, the Senate Committee attached the provisions of S. 1347 to H.R. 4986. S. REP. NO. 96-368, at 1, 4.

147. The House did not react well to the Senate's placement of the preemption and other provisions with H.R. 4986. On October 17, 1979, Congressman St. Germain sent a letter to Senators Proxmire and Cranston complaining that the Senate Committee had in essence taken unfair advantage of the urgent need to address the D.C. Circuit's opinion by including in its version of the bill a far-reaching restructuring of financial institutions that the House had not adequately studied. He urged the Senate to only address the issues raised by the *American Banker* opinion, stating, "I have repeatedly assured my Colleagues in the Subcommittee, the full Committee and on the House floor that we were dealing with the share draft-NOW account issue and not using this as a stalking horse for other issues." Letter from Rep. St. Germain to Sens. Proxmire and Cranston (October 17, 1979), *reprinted in* 125 CONG. REC. 29,106 (1979) (statement of Sen. Morgan).

provisions relating to savings and loan institutions which would significantly increase their operating costs. First, the legislation as passed by the Senate eliminated then-existing Regulation Q. Regulation Q limited the amount of interest that banks and savings and loans could pay on deposit accounts, and allowed savings and loans to compete for deposit funds by paying one-fourth of 1% more than banks.¹⁴⁸ At the time the bill was introduced, the rate cap for savings and loans was 5.5 % and the rate cap for banks was 5.25%,¹⁴⁹ while other depository and investment options were paying much more. This provision would have increased costs to savings and loans, because after elimination of Regulation Q they would have to pay higher interest on deposits and would lose their one-fourth of 1% competitive edge over banks.

Additionally, the bill allowed deposit institutions to offer money market certificates for \$1,000.¹⁵⁰ Previously, the minimum investment required for a money market certificate was \$10,000.¹⁵¹ This provision, too, would increase costs to savings and loans because more depositors would invest in higher interest money market certificates, requiring even more interest to be paid out by savings and loans. Finally, the bill provided that savings and loans could offer interest-bearing checking accounts.¹⁵²

The stated reason for adopting these three measures was that with interest rates so high, depositors were moving their funds into money market funds, which paid higher interest than deposit accounts could.¹⁵³ This had the effect

148. H.R. 4986, 96th Cong. § 107, as reported out of the Senate Committee on Banking, Housing and Urban Affairs, S. REP. NO. 96-368, at 21-22; 125 CONG. REC. 28,316 (1979) (statement of Sen. Proxmire).

149. 125 CONG. REC. 29,108 (1979).

150. H.R. 4986, 96th Cong. § 107(e) (1979), as reported out of the Senate Committee on Banking, Housing, and Urban Affairs, S. REP. NO. 96-368, at 22.

151. S. REP. NO. 96-368 at 2.

152. H.R. 4986, 96th Cong. §§ 101-106, as reported out of the Senate Committee on Banking, Housing, and Urban Affairs; S. REP. NO. 96-368, at 21; 125 CONG. REC. 28,316 (1979) (statement of Sen. Proxmire). During debate, Senator Morgan offered an amendment that would have allowed federal savings and loans to offer NOW accounts only if state chartered banks in the state were allowed to offer such accounts, thereby giving the decision-making power in regard to such accounts to the states. The amendment was defeated. *See id.* at 30,654-55.

153. *See* S. REP. NO. 96-368, at 3-4:

It is thus clear that regulation Q and its mandate of below market rates to small savers is driving money out of the financial system, out of housing, and into noninsured intermediaries As market interest rates have risen above the regulation Q ceilings, depositors have withdrawn funds out of the depository institutions and placed them in money market instruments offering market interest rates. . . . The committee believes that regulation Q must be phased out so that all savers may earn market rates on their savings.

Id.; *see also* 125 CONG. REC. 29,112 (1979) (statement of Sen. Proxmire) ("The economic reality is that Regulation Q is forcing thrifts to lose deposits because market innovators pay depositors

of decreasing the funds deposited in savings and loans, and had the residual effect of decreasing funds available for mortgage loans made by savings and loans.¹⁵⁴ Given that at this time savings and loan associations were making about 60% of all home mortgage loans, the diversion of deposit funds into other investments caused extreme alarm in Congress regarding the availability of mortgage funds.¹⁵⁵

Nevertheless, Congress realized that each of these measures meant that savings and loans would be required to have more funds available to pay

more than thrifts can pay.”); *id.* at 30,315 (statement of Sen. Heinz); *id.* at 30,660 (statement of Sen. Williams).

154. *See* 125 CONG. REC. 29,905 (1979) (statement of Sen. Proxmire) (“Regulation Q is driving money out of financial institutions and, therefore, out of the housing sector. Our thrift industry will not be able to survive in the regulation Q atmosphere in the long run.”); *see also id.* at 29,930 (statement of Sen. Morgan); *id.* at 29,933-34 (statement of Sen. Morgan, quoting from testimony of Henry Schecter in Senate hearings); *id.* at 30,311 (statement of Sen. Riegle); *id.* at 30,315 (statement of Sen. Heinz); *id.* at 30,660 (statement of Sen. Williams). An additional contributing factor to this problem was the fact that most of the mortgage loans held by savings and loans carried interest rates below 7.5%. This meant that the income to savings and loans was coming in at a lower rate than the rate at which the savings and loans would be required to pay out to depositors. *Id.* at 30,641 (statement of Sen. Javits). Senator Javits believed that one of the effects of this disparity in interest received and paid was that mortgage lenders would be more likely to foreclose sooner so they could relend the money at higher interest rates. *Id.* at 30,642 (statement of Sen. Javits).

Interestingly, a Federal Reserve Report issued in March 1979, just nine months before DIDMCA was enacted, suggests that sources for mortgage money were quite stable:

During previous periods with similar increases in market interest rates, residential mortgage lending contracted markedly and housing activity was sharply curtailed. While the mortgage and housing markets still are likely to be more responsive to changes in general credit conditions than are other major sectors of the economy, the effect now appears to be related more to the interest rate sensitivity of borrowers and less to shifts in the availability of funds at depository institutions. . . .

At the nonbank thrift institutions, net deposit flows have become less sensitive to changes in market interest rates, and thus the predominant source of residential mortgage credit has been less volatile than in the past.

Seiders, *Recent Developments*, *supra* note 78, at 173. On the other hand, the report does discuss a decrease in deposits at thrift institutions and limits on lending in states with usury ceilings lower than market rates. *Id.* at 174. In contrast, however, a 1980 report states: “With funds more readily available to mortgage lenders than in past periods of high and rising interest rates, and with ceilings on lending rates relaxed in some cases, mortgage flows remained near the large 1978 volume throughout most of last year [1979].” Lockett, *Recent Financial Behavior*, *supra* note 135, at 439. The 1980 report does go on to indicate that mortgage funds tightened by the end of 1979. *Id.*

155. Up to 1979 savings and loan institutions had made “about 60 percent of all of the home loans in America.” 125 CONG. REC. 29,930 (1979) (statement of Sen. Morgan); *see also* Seiders, *Recent Developments*, *supra* note 78, at 178 (finding that savings and loans made half of the total net acquisitions of home mortgages in 1978).

interest (1) to depositors, because interest rates would no longer be regulated; (2) to money market investors, a group that would be made larger because more individuals would be able to invest in higher-interest money market certificates; and (3) to holders of interest bearing checking accounts. The income to pay these moneys to consumers had to come to the savings and loans from somewhere. The bill fixed this side of the balance sheet by allowing savings and loans to diversify their investments beyond mortgage investments and offer trust services.¹⁵⁶ The bill also provided for more income to savings and loans by preempting state limits on mortgage loan interest rates and allowing them to charge whatever interest they could on first-lien home mortgages.¹⁵⁷

The need to increase savings and loan income was the primary motivation behind the state usury preemption provision.¹⁵⁸ The other reason for preemption

156. The bill as reported out of committee allowed 10% of a savings and loan's assets to be in consumer loans, commercial paper, corporate debt securities or bankers' acceptances and to offer personal trust services. See H.R. 4986, 96th Cong. §§ 301, 303, 304 (1979) as reported out of the Senate Committee on Banking, Housing, and Urban Affairs, S. REP. NO. 96-368, at 23; 125 CONG. REC. 28,316, 29100 (1979) (statement of Sen. Proxmire). However, during debate Senator Tsongas proposed an amendment that would have permitted federally chartered mutual savings banks to take deposits from anywhere and to invest up to 20% in nonmortgage investments. *Id.* at 30,644-45. This amendment would have had only exemplary impact, as there were at the time no federally chartered mutual savings banks, and the stated purpose for the provision was to encourage states to adopt similar provisions. See *id.* at 30,648. However, during debate Senator Morgan proposed an amendment to the amendment extending its coverage to all federally chartered savings and loans institutions. *Id.* at 30,648-49. This amendment was adopted, thereby adding a provision that all federally chartered mutual savings banks and savings and loans could diversify 20% of their investments. *Id.* at 30,650.

157. H.R. 4986, 96th Cong. § 305 (1979), as reported out of the Senate Committee on Banking, Housing, and Urban Affairs, S. REP. NO. 96-368, at 23; see also 125 CONG. REC. 30,315 (1979) (statement of Sen. Heinz) (citing the provision that would help savings and loans "offset the elimination of the interest rate ceiling [that could be paid on deposits] and the differential [between what banks and savings and loans could pay on deposits]" as one of three important provisions of the bill). An amendment offered during debate also provided that the savings and loans would, under some circumstances, be able to sell their low-interest mortgages to GNMA, giving them more money with which to make mortgage loans. *Id.* at 30,640-43. The rates on these new loans would have been limited by the FHA rate. *Id.* at 30,641. The Senate instead adopted a provision requiring a study of whether the GNMA program would have a positive impact. *Id.* at 30,643. During debate on this provision Senator Proxmire indicated that the mortgage usury override would be enough to make savings and loans profitable again. *Id.* at 30,642 (statement of Sen. Proxmire).

158. See 125 CONG. REC. 29,099 (1979) (statement of Sen. Proxmire) ("The thrust of H.R. 4986 is on deregulation and enhanced competition between financial institutions."); *id.* at 29,112 (statement of Sen. Proxmire) ("The fact is that thrifts need to pay market rates to depositors and to be able to earn returns so that they will remain viable. This legislation does just that and meets the needs of thrifts."); 126 CONG. REC. 6912 (1980) (statement of Sen. Cranston); S. REP. NO. 96-368, at 18-20. Indeed, the section of the report on the usury preemption cites as one of the two justifications for the preemption the ability of savings and loans to "offer higher interest rates on savings deposits." *Id.* at 18. The report goes on to say:

In addition to the adverse effects of usury ceilings on credit availability, mortgage rate ceilings must be

of state mortgage interest usury limits was that market rates had risen above the usury limitations in some states, making it difficult or impossible to obtain a mortgage loan in those states,¹⁵⁹ and causing an outflow of funds from states

removed if savings and loan institutions, as directed by other provisions of H.R. 4986 as amended by the committee, are to begin to pay market rates of interest on savings deposits. Without enhancing the ability of institutions to achieve market rates on both sides of their balance sheets, the stability and continued viability of our nation's financial system would not be assured. Thus, Federal preemption of State usury ceilings would not only promote national home financing objectives but would provide the resources with which savers could be paid more interest on their savings accounts.

Id. at 19; *see also* 125 CONG. REC. 29,905 (1979) (statement of Sen. Proxmire). Senator Proxmire stated:

H.R. 4986 provides for a 10-year phase-out of interest rate controls (regulation Q) along with augmented asset powers for thrift institutions (interest-bearing checking accounts, consumer loan powers, trust powers and enhanced home mortgage lending authority) all designed to maintain the viability of thrift institutions and their commitment to home mortgage lending while enabling depository institutions to pay the depositor a market rate of return on savings.

Id. In introducing the compromise bill to the full Senate, Senator Proxmire indicated that the "three major and interrelated themes embodied in H.R. 4986" were deregulation and reliance on market forces, equality among types of financial institutions, and fairness to small savers. 126 CONG. REC. 6893 (1980) (statement of Sen. Proxmire). He also indicated that the usury preemption was tied primarily to relieving institutions from "unreasonable restrictions on their earning capacity." *Id.* at 6900 (statement of Sen. Proxmire).

159. 125 CONG. REC. 28,316 (1979) (statement of Sen. Proxmire) ("This legislation also preempts State home mortgage lending limits which are responsible for mortgage money drying up in many areas of the country"); *see also* S. REP. NO. 96-368, at 18 (stating that the preemption provision is intended, in part, "in order to ease the severity of the mortgage credit crunches of recent years."). The Senate report continues:

The committee finds that where state usury laws require mortgage rates below market levels of interest, mortgage funds in those states will not be readily available and those funds will flow to other states where market yields are available. This artificial disruption of funds availability not only is harmful to potential homebuyers in states with such usury laws, it also frustrates national housing policies and programs.

Id. at 19. Senator Proxmire asserted:

We have a situation now where the rate is getting so high that many banks and savings and loans simply cannot offer mortgages or they violate the statute. In some cases, it is embedded in the Constitution; in other, it is very difficult for the legislature to meet

with low usury limits.¹⁶⁰ Even though this is seemingly the more often remembered reason for the 1979 preemption of state limits on mortgage interest rates, it received surprisingly little attention during congressional debate. Indeed, the most significant mention of the effect state usury laws were having on mortgage fund availability occurred after debate on the bill was virtually completed, but before the final vote on the bill. Two of these statements were in the context of the Arkansas Senators thanking the bill managers for their consideration.¹⁶¹ Another of these statements was in connection with a late amendment offered by Senator Proxmire allowing states to regulate discount points on mortgages by enacting a state law any time after adoption of the bill.¹⁶²

Two other extremely important aspects of the DIDMCA usury preemption

and act on it. This gives them a chance to start again.

125 CONG. REC. 29,100 (1979); *see also id.* at 30,299 (statement of Sen. Proxmire) (“With respect to mortgage loans, we find there are a number of States in which the usury laws are going to be just very quickly made so restraining it will be virtually impossible to get a mortgage loan.”). There is even a suggestion that the entire mortgage preemption provision was, as with the FHA and VA preemptions, the result of the constitutional 10% usury limit in Arkansas.

At the present time we have a provision in the bill that permits the usury rates applying to home mortgage loans to be overridden. It provides, of course, that that override by this legislation, however, can be, in turn, reversed or modified in any way by the State legislature. They can act any time before 1981 to provide that their usury law will stay on the books. *We do this because we found in the State of Arkansas an absolute disaster, as far as the financial institutions were concerned, and particularly as far as the borrowers were concerned.* Small businessmen, farmers, and other mortgage borrowers who wanted to borrow money simply could not get the funds. At least, if interest rates are too high you can decide whether to borrow at the high rate or not borrow at all, but in the case of Arkansas they could not borrow at all. In many States, as the Senator has pointed out, that is the position in which borrowers have found themselves.

Id. at 29,908 (statement of Sen. Proxmire) (emphasis added).

160. 126 CONG. REC. 7071 (1980) (statement of Sen. Proxmire); *id.* at 6965 (statement of Rep. Reuss).

161. 125 CONG. REC. 30,656 (1979) (statement of Sen. Pryor) (thanking the bill managers for their consideration and stating “in the last 2 months, to the best of his knowledge, the savings and loan institutions in Arkansas have made fewer than 25 residential mortgage loans to the citizens of our State.”); *see also* 125 CONG. REC. 30,656 (1979) (statement of Sen. Bumpers) (asking that a chart indicating which states would be affected by the usury preemption and an article on mortgage fund unavailability be reprinted in the Congressional Record).

162. 125 CONG. REC. 30,659 (1979) (statement of Sen. Proxmire) (“I support this mortgage usury [sic] override in the bill because I believe the facts clearly demonstrate that State laws which limit the rate of interest that can be charged on mortgage loans, although well intended, have often had the unfortunate effect of shutting off or disrupting the flow of credit.”).

also received little attention in the congressional debates. First, even though congressional attention was focused on the income needs of savings and loans, the benefit of the usury preemption was extended to any mortgage lender making more than \$1 million worth of loans per year, whether the lender was a deposit institution or not.¹⁶³ In some places in the debate it seems as if certain members of Congress were unaware of this fact.¹⁶⁴ In other places, only brief references are made to the impact this legislation would have on loans made by nondepository mortgage lenders.¹⁶⁵

163. DIDMCA extends the preemption to any lender who meets the other requirements and is "described in section 527(b) of the National Housing Act." 12 U.S.C. § 1735f-7a(a)(1)(C) (1994). By this reference, DIDMCA applies to any lender who is a creditor under the Truth in Lending Act and "who makes or invests in residential real estate loans aggregating more than \$1,000,000 per year." *Id.* § 1735f-5(b)(2)(D).

164. For example, in asking questions about how the first-lien interest rate preemption provision of the bill would impact lenders in Arkansas, Senator Bumpers completely ignored the fact that non-depository mortgage lenders would be exempt from state usury laws as well:

It is my understanding that section 305(a) (1) preempts a constitutional or statutory usury limit on any loan, mortgage, or advance on residential real property made after the date of enactment of this act if the loan or advance is described in section 527(b) of the National Housing Act.

This preemption shall apply to loans, mortgages, or advances on residential real property made by State banks and State savings and loan institutions, as well as national banks and Federal savings and loan institutions provided they are federally insured.

125 CONG. REC. 30,316 (1979) (statement of Sen. Bumpers). Senator Proxmire responded that this was the correct understanding of the legislation. *Id.* at 30,316 (statement of Sen. Proxmire). *But see id.* at 29,932 (statement of Sen. Morgan) (recognizing that the DIDMCA preemption would apply to mortgage bankers).

165. Nondepository mortgage lenders such as mortgage bankers were only mentioned in a few places during the debate. *See, e.g.*, 125 CONG. REC. 29,932 (1979) (statement of Sen. Morgan) ("I do not believe we should preempt State authority simply to make life easier for the mortgage bankers."). The dissent in *McInnis v. Cooper Communities, Inc.*, 611 S.W.2d 767, 772-73 (Ark. 1981), recognized that Congress was focused on the banking and savings and loan industries, not on non-depository lenders, when it adopted DIDMCA.

The Senate may not have focused on nondepository mortgage lenders because they were not a big a part of the market in 1979. David F. Seiders & Charles A. Luckett, *Household Borrowing in the Recovery*, 64 FED. RES. BULL. 155 (1978) [hereinafter Seiders & Luckett, *Household Borrowing*] (explaining that finance and mortgage companies lent only 1% of all home mortgage funds in 1977); Luckett, *Recent Financial Behavior*, *supra* note 135, at 437 (finding that finance and mortgage companies lent less than .5% of all home mortgage funds in 1979). Indeed, the possibility of such nondepository lenders was hardly considered by active opponents of the bill such as Senator Morgan. *See, e.g.*, 125 CONG. REC. 29,110 (1979) (statement of Sen. Morgan) ("This bill exempts all banks from State usury limitations on residential mortgage loans for specific lenders unless the state reenacts the ceilings within 2 years."). It is likely that because he was not considering nondepository mortgage lenders, Senator Morgan feared that if thrifts went out of business the federal government, not private companies, would become the mortgage lender of last resort. *Id.* at 29,930 (statement of Sen. Morgan); *See also id.* at 30,661 (statement of Sen. Williams) (indicating his hope, as chair of the Senate

Second, although the debate focused entirely on purchase money home mortgages, the preemption apparently extended to any mortgage secured by a first lien on residential real property.¹⁶⁶ Thus, Congress failed to make any distinction between purchase money loans and other home-secured loans.¹⁶⁷

Supporters of the bill believed that the bill's net effect would be to make more mortgage funds available by increasing deposits at savings and loans, improving their viability, and allowing for market-related mortgage interest rates.¹⁶⁸ The usury provision was perceived as both relatively uninvasive and essential to the whole package.¹⁶⁹ Supporters of the bill also heralded it as an aid to the "small investor," who would now receive interest on small deposits

Subcommittee on Housing and Urban Affairs, that new mortgage funding market participants might be found in the future); 126 CONG. REC. 6972 (1980) (statement of Rep. St. Germain) (indicating his belief that the usury preemption should be extended to all home financiers).

166. For a discussion of cases interpreting the "first-lien" provision of DIDMCA, see *infra* Part IV.A.

167. A purchase money loan may be thought of as one used to purchase residential property. U.C.C. § 9-203(g) (1999). A more helpful definition can be found in the structure of the Truth in Lending Act, which provides a right of rescission to a borrower who obtains a nonpurchase money loan secured by the borrower's principal dwelling. 15 U.S.C. § 1635(a) (1994). Under that scheme, a *purchase money* loan is either:

- 1) "a residential mortgage transaction," 15 U.S.C. § 1635(e)(1) (1994); 12 C.F.R. § 226.23(f)(1), in which the loan on a dwelling "is created or retained against the consumer's dwelling to finance the acquisition or initial construction of such dwelling," 15 U.S.C. § 1602(w) (1994); 12 C.F.R. § 226.2(a)(24) (1999); or
- 2) a loan that merely refinances the original purchase money loan. 15 U.S.C. § 1635(e)(2) (1994); 12 C.F.R. § 226.23(f)(2) (1999).

All other loans are nonpurchase money loans, giving the borrower the right to rescind under some circumstances. 15 U.S.C. § 1635 (1994); 12 C.F.R. § 226.23 (1999).

168. See, e.g., 125 CONG. REC. 29,925 (1979) (statement of Sen. Cranston) ("The bill . . . contains many new beneficial powers for thrifts that we hope will permit them to innovate and compete without impairing the potential for achievement of national housing policy objectives.").

169. S. REP. NO. 96-368, at 19 (1979), *reprinted in* 1980 U.S.C.C.A.N. 236, 255 ("The committee believes that this limited modification in state usury laws will enhance the stability and viability of our nation's financial system and is needed to facilitate a national housing policy and the functioning of a national secondary market in mortgage lending."); 125 CONG. REC. 29,103 (1979) (statement of Sen. Proxmire). Senator Proxmire asserted:

This legislation also contains provisions which will alleviate the situations in many States whereby low usury mortgage lending limits are inhibiting the flow of funds into home mortgagee lending. H.R. 4986 as reported preempts State usury limits on home mortgage loans but allows the States to reimpose such limits within a 2-year time period. This is not a preemption by fiat but makes a reasonable accommodation consistent with our Federal system.

Id.

and be entitled to higher interest through the availability of money market certificates in \$1,000 denominations.¹⁷⁰

However, opponents of the bill, led by Senator Morgan, warned that adoption of the bill would cause a net economic loss for small investors, who would have to pay for any interest they received on small deposits with higher mortgage interest rates, higher costs for products and services, and bank service fees.¹⁷¹ Opponents also argued that the bill would only serve to harm

170. See, e.g., 125 CONG. REC. 30,312-13 (1979) (statement of Sen. Proxmire); 126 CONG. REC. 6967 (1980) (statement of Rep. LaFalce); *id.* at 6968 (statement of Rep. Stanton); *id.* at 6984 (statement of Rep. Biaggi).

171. S. REP. NO. 96-368, at 39-40 (Additional Views of Sen. Morgan). Senator Morgan stated:

I believe that this bill inadequately addresses the question of earnings by financial institutions. It seems clear that if institutions are going to pay higher interest rates, and if market rate money market certificates are going to be available in \$1,000 denominations, that institutions are going to have to charge more for the services they offer and the money they lend. I believe this works against the interest of the average citizen generally, and will be especially damaging to housing finance.

Id. at 37 (Additional Views of Sen. Morgan) (asserting that H.R. 4986 "could seriously impair the availability of mortgage credit and indeed other consumer borrowing at affordable rates, and would be of dubious benefit to the average consumer.") (emphasis added); 125 CONG. REC. 29,109 (1979) (statement of Sen. Morgan) (quoting from a statement of Rep. Annunzio: "The interest paid on [negotiable order-of-withdrawal] NOW accounts will have to come from somewhere, and it will most likely be from higher interest paid on loans and other bank services. Those charges will be borne by the small depositor while the rich guys happily collect interest on their consumer-oriented NOW accounts."); *id.* at 29,112 (statement of Sen. Morgan); *id.* at 29,923 (statement of Sen. Proxmire) (admitting that increasing costs to savings and loans would be likely to increase mortgage interest rates); *id.* at 29,923-24 (statement of Sen. Ford); *id.* at 29,934 (statement of Sen. Morgan) (quoting from testimony of Henry Schecter in Senate hearings: "In absence of ceilings on savings interest rates, when money became tighter, thrift institutions could compete more aggressively for funds by paying higher rates to attract savings. The result would, of necessity, be higher mortgage interest rates."); *id.* at 30,285 (statement of Sen. Morgan); *id.* at 30,285-86 (statement of Sen. Morgan) (quoting letter from the presidents of the National Association of Home Builders and the National Association of Realtors that expressed their fear that the bill would increase mortgage interest rates); *id.* at 30,286 (statement of Sen. Morgan) (quoting from testimony of Henry Schecter in Senate hearings); *id.* at 30,298 (statement of Sen. Ford) ("So as we pound our fists and raise our voices in defense of the little depositor, the small fellow out there, we find in the record that we are increasing his interest rates . . ."); *id.* at 30,311 (statement of Sen. Morgan); *id.* at 30,312 (statement of Sen. Riegle) (supporting the amendment eliminating the reduction of money market minimums to \$1,000: "To price mortgage money out of reach with the notion that, somehow or other, we are doing something that actually helps the little person, I think, is really not fair. I do not think it is honest in the sense that it really portrays an inaccurate picture of what the effect would be."); *id.* at 30,312 (statement of Sen. Tower) (supporting the amendment eliminating the reduction of money market minimums to \$1,000). *But see id.* at 29,906 (statement of Sen. Garn) ("Attracting deposits back to savings institutions, coupled with other provisions in H.R. 4986 regarding the earnings potential of such institutions, would also insure the increased availability of mortgage credit at a more reasonable price than is now charged."). One estimate given on the floor of the

individuals with no savings.¹⁷² Senator Morgan pointed out that the individuals who would be most adversely affected by the bill were senior citizens and those with very low incomes.¹⁷³ In short, opponents of the bill in the Senate and House of Representatives preferred a measure that simply addressed the D.C. Circuit opinion in *American Bankers Ass'n v. Connell*.¹⁷⁴

The bill, with all of the Senate amendments just discussed, passed the Senate on November 1, 1979.¹⁷⁵ By now, the December 31, 1979 deadline for action on the D.C. Circuit's opinion in *American Bankers* was fast approaching. When the bill as passed out of the Senate was returned to the House of Representatives for action, the House replaced the text with its own version of the bill, which now contained some of the provisions in the Senate version, including the mortgage preemption provision.¹⁷⁶ The House approved the measure immediately without explanation or debate and voted to send the bill to conference committee, hoping that something could be worked out by

Senate was that 75% of all checking accounts had average monthly balances of below \$1,000, and that these depositors would make about \$50 per year in interest and would pay about \$65 in service fees. 126 CONG. REC. 7073 (1980) (statement of Sen. Heflin).

172. 125 CONG. REC. 30,287 (1979) (statement of Sen. Morgan) Senator Morgan explained that

[O]bviously the 37 percent of all families with no savings accounts would have no benefits of increased interest income from savings. However, they would have to absorb the costs of higher loan interest rates, directly in credit obligations assumed and indirectly in the prices of purchased goods and services whose production or marketing had been at least in part credit-financed.

Id.

173. *Id.* at 30,287 (statement of Sen. Morgan) ("The nonsavers, as might be expected, are a relatively high proportion of families with incomes of less than \$10,000. It is interesting to note also that among families with age of head 65 years or older, 50 percent were found to have no savings."); *Accord id.* at 30, (statement of Sen. Morgan) (describing costs to families with various levels of savings); *id.* at 30,311 (statement of Sen. Morgan) (noting that "[o]ver half of the people over 65 in America have no savings accounts.").

174. 686 F.2d 953 (D.C. Cir. 1979); S. REP. NO. 96-368, at 37 (Additional Views of Sen. Morgan) ("[A] wiser course for the Congress to follow would be to authorize the various instruments declared illegal on April 20, 1979 by the U.S. Court of Appeals . . . while also addressing the question of incentives for savings by giving small savers a long needed tax break on interest income."); Letter from Rep. St. Germain to Sens. Proxmire and Cranston (October 17, 1979), reprinted in 125 CONG. REC. 29,106 (1979) (statement of Sen. Morgan); 125 CONG. REC. 29,107 (1979) (statement of Sen. Morgan). During debate Senator Morgan introduced, as a potential substitute, an amendment (amend. No. 699) that merely addressed the D.C. Circuit's opinion in *American Bankers*, incorporated the provisions of the Truth in Lending Simplification and Reform Act, Pub. L. No. 96-221, tit. VI, § 601, 94 Stat. 168 (1980), and preempted for eighteen months (later modified to six months) state usury restrictions on agricultural and business loans in the amount of \$25,000 or more. *Id.* at 30,289-301. However, the amendment was laid on the table by a vote of 57 to 38 and never voted on. *Id.* at 30,301.

175. 125 CONG. REC. 30,662 (1979).

176. H.R. 4986, 96th Cong. § 205 (1979), as amended by the House of Representatives on Nov. 7, 1979, 125 CONG. REC. 31,312 (1979).

the December 31 deadline.¹⁷⁷ The House seemed less than pleased that the bill had been augmented by the Senate to such a great extent, alluding to the Senate additions as "Christmas-tree" provisions.¹⁷⁸ In response to this action by the House, the Senate disapproved of the House version of the bill, and agreed to the appointment of a conference committee.¹⁷⁹

By now it was November 28, 1979, just one month away from the date when the D.C. Circuit's opinion would become operative, and the bill was being consigned to conference committee with every expectation that coming to an agreement would be difficult. It was in this climate that Senators Cranston, Proxmire, and Garn offered an amendment to another, unrelated bill in hopes of temporarily resolving the issues raised by *American Bankers*.¹⁸⁰ The amendment authorized until March 31, 1980 those accounts declared as void by the D.C. Circuit Court.¹⁸¹ However, the Senators did not restrict their amendment to those issues that needed to be addressed by the *American Bankers* deadline. Instead they included several of the more contentious provisions from H.R. 4986, including the preemption of state usury laws in first-lien mortgage loans.¹⁸² This amendment was approved in the Senate with no debate.¹⁸³ In response to the Senate's action, Representative St. Germain introduced legislation meant to address only the *American Bankers* opinion,¹⁸⁴ which was adopted by the House in place of the amendment adopted by the Senate.¹⁸⁵ The House version omitted the preemption provision,¹⁸⁶ and House members criticized the Senate for taking advantage of an emergency situation to turn the bill "into a Christmas tree of unrelated financial measures."¹⁸⁷

The Senate volleyed back the next day with a replacement version that restored the preemption provision.¹⁸⁸ On December 19, 1979, the House concurred in the Senate amendments.¹⁸⁹ Representative St. Germain emphasized that the House had been forced into accepting the usury override

177. 125 CONG. REC. 31,309-27 (1979).

178. *Id.* at 31,325 (statement of Rep. Rousselot); *id.* at 31,326 (statement of Rep. Stanton); *id.* at 31,326-27 (statement of Rep. Reuss).

179. *Id.* at 33,846-50 (1979). In defense of the usury preemption, Senator Cranston talked about the ability of lenders to make higher interest mortgage loans to "those who can afford them." 126 CONG. REC. 6912 (1980) (statement of Sen. Cranston).

180. H.R. 4998, 96th Cong. (1979). This bill had passed the House on September 17, 1979. 125 CONG. REC. 24,882 (1979).

181. 125 CONG. REC. 35,267 (1979) (statement of Sen. Proxmire).

182. *Id.* at 35,265.

183. *Id.* at 35,264-68.

184. *Id.* at 35,481; H.R. 6100, 96th Cong. (1979).

185. 125 CONG. REC. 36,405 (1979) (adopting the text of H.R. 6100 as part of H.R. 4998).

186. *Id.* at 36,404 (statement of Rep. Reuss).

187. *Id.* at 36,392 (statement of Rep. St. Germain).

188. *Id.* at 36,613.

189. *Id.* 36,903-06. The House did make one slight change to the bill. Thus, the bill went back to the Senate and was finally approved by the Senate on December 19, 1979. *Id.* at 37,050-51.

by the D.C. Circuit's December 31, 1979 deadline.¹⁹⁰

Oddly enough, during the entire debate in the Senate no one apparently ever considered setting a national usury limit rather than simply preempting state limits.¹⁹¹ Furthermore, there was virtually no discussion of what might prevent a covered lender from charging predatory rates once state limits were preempted, except for one reference to rates being controlled by "the market,"¹⁹² and two references to the bill as relying on market forces rather than

190. *Id.* at 36,905 (1979) (statement of Rep. St. Germain) ("I am not very happy with the inclusion of the State usury ceiling provision, but we must have this bill. We are at the deadline time.").

191. For example, the Senate could have adopted a usury limit such as the one in effect for federal banks, which was 1% above the discount rate. 12 U.S.C. § 85 (1976); 126 CONG. REC. 6907 (1980) (statement of Sen. Bumpers). The Senate also could have adopted a mortgage preemption similar to the temporary business and agricultural loan preemption it adopted during debate on the bill, and upon which the Senate focused most of its preemption attention. DIDMCA Pub. L. No. 96-221, § 511, 94 Stat. 132, 164 (1980); Act of Nov. 5, 1979, Pub. L. No. 96-104, § 301, 93 Stat. 789 (intending application of a similar provision only to Arkansas); *see, e.g.*, 126 CONG. REC. 6906-07, 7071 (1980); 125 CONG. REC. 29,906-12, 29,944-45 (1979). Even the most active opponent of the bill, Senator Morgan, was not clear on this failure to substitute a fluctuating national usury limit. 125 CONG. REC. 29,111 (1979) (statement of Sen. Morgan) (speaking of "imposition of a national usury norm" with no mention of an adjustable rate). Of course, no federal usury structure was created to replace the existing state usury structure.

192. This mention of market limitations took place during the following colloquy between Senators Morgan, Cochran and Proxmire:

Mr. Morgan: If the Senator's amendment is adopted, would there be any limitation on interest for agricultural or business loans above \$25,000?

Mr. Cochran: Yes. The amendment provides for a 5 percent in excess of discount rate as a limitation on loans of the type described in the amendment. So there is an effective limitation.

It is not just *carte blanche*, that you could go out and rip off the public, or that kind of thing. It is a rate of interest which is not unlike that the banks around the country are now charging as their prime rate.

Mr. Morgan: In that connection, would the distinguished chairman be willing to tell me whether he knows this: If the bill passes with the preemption in the bill with regard to housing, would there be any limitation on usury for housing and items covered under the bill itself?

Mr. Proxmire: The Senator knows the answer to his question, of course. There is no limitation in the bill with respect to mortgage loans. Of course, there is a market limitation.

As the Senator knows, we always have had a situation in which the mortgage rate is lower than business rates, for a good reason, particularly when interest rates are rising. The reason is that the mortgage rate is for a long period of time. People are

regulation.¹⁹³ Although Congress did consider potential market abuses in the case of manufactured homes, it did not consider the same possibilities in the nonmanufactured home market.¹⁹⁴ Finally, not one Senator or Congressman seems to have recognized that what might have appeared necessary for purchase money mortgage loans might not be appropriate for nonpurchase, home-secured lending. Indeed, the distinctions between these two types of loans were never discussed.¹⁹⁵

On March 21, 1980 the permanent version of DIDMCA, H.R. 4986, finally emerged from the conference committee. In its final form, the act preempted "[s]tate usury ceilings on first mortgage loans made by banks, savings and loans, credit unions, mutual savings banks, mortgage bankers and HUD-approved lenders under the National Housing Act."¹⁹⁶

The conference report was submitted to the House and Senate on March 24, 1980.¹⁹⁷ The report passed the House on March 27, 1980¹⁹⁸ and the Senate on March 28, 1980.¹⁹⁹ Consequently, the permanent preemption became effective April 1, 1980.²⁰⁰

going to get that high interest rate for many years.
That is why the mortgage rate is well below prime.

We would rely on the market . . . I am
sure [Sen. Morgan] . . . agrees that the market should
work in this case.

125 CONG. REC. 29,911 (1979).

193. 126 CONG. REC. 6894 (statement of Sen. Proxmire). Senator Exon even complained that "State usury laws will be rendered completely meaningless unless a State legislature acts within 3 years to reestablish a usury ceiling. That is akin to Federal repeal of the States' laws against horse thieves, but being magnanimous by allowing the States to reenact them if they so desire." 126 CONG. REC. 7062 (1980) (statement of Sen. Exon).

194. 126 CONG. REC. 6900-01 (1980) (statement of Sen. Proxmire).

195. Congress may not have taken this distinction into account because when DIDMCA was adopted there was only a small market for nonpurchase money home equity loans. For example, a Federal Reserve Board study showed that in 1977 only 5.4% of all homeowners had a home equity loan. Glenn B. Canner & Charles A. Luckett, *Home Equity Lending*, 75 FED. RES. BULL. 333 (1989) [hereinafter Canner & Luckett, *Home Equity Lending*]. An earlier study by the Federal Reserve showed that in 1977 only 6% of households with first mortgage debt also had a junior mortgage, and only 7% of households had refinanced a first mortgage in order to raise new funds. Seiders & Luckett, *Household Borrowing*, *supra* note 165, at 156. There was an even smaller market for first-lien nonpurchase money loans, as most of these loans were written as second mortgages. For a discussion of the growth in home equity lending in the 1980s and 1990s see *infra* Part V.A.

196. H.R. CONF. REP. NO. 96-842, at 78.

197. 126 CONG. REC. 6231-54, 6300 (1980); *id.* at 6300.

198. 126 CONG. REC. 6984 (1980) (recording a vote of 380 yeas, 13 nays, 11 present, and 27 not voting).

199. 126 CONG. REC. 7073 (1980).

200. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 501(b) (1), 94 Stat. 132, 162. Section 501(a) of DIDMCA was originally codified as a note to 12 U.S.C. § 1735f-7 (1994). *Russell v. Fidelity Consumer Discount Co.*, 72 B.R. 855, 866 (E.D. Pa. 1987) ("Study of this Act [DIDMCA] is initially complicated by the fact that it is not codified as such in the United States Code . . . Rather, it appears only in the 'Historical Note' appearing in U.S.C. under 12 U.S.C. § 1735f-7."); *Bank of New York v. Hoyt*,

The statute gave states three years—until April 1, 1983—to opt out of the mortgage preemption provision of DIDMCA.²⁰¹ However, opting out required specific action by the state:

In order for a state to override a federal preemption of state usury laws provided for in this title the override proposal must explicitly and by its terms indicate that the state is overriding the preemption. Under this requirement the state law, constitutional provision, or other override proposal must specifically refer to this Act and indicate that the state intends to override the federal preemption this Act provides.²⁰²

The statute also allowed states to adopt “a provision of law placing limitations on discount points or such other charges on any loan, mortgage, credit sale, or advance described in subsection (a)(1) [the preemption section].”²⁰³ Because states have a continuing ability to enact limitations on discount points, “[a]ny [state] legislation, after March 31, 1980 which amends or institutes limitations on points or charges other than the stated interest rate,

617 F. Supp. 1304, 1308 (D.R.I. 1985) (“Section 501, for reasons not readily apparent to the court, has never been codified in the United States Code, but its text does appear in the historical note following 12 U.S.C. § 1735f-7”); *FirstSouth, F.A. v. Lawson Square, Inc. (In re Lawson Square, Inc.)*, 61 B.R. 145, 149 (W.D. Ark. 1986). Ultimately, Section 501 of DIDMCA was given its own section, and it is now codified at 12 U.S.C. § 1735f-7a (1994). *Smith v. Fidelity Consumer Discount Co.*, 898 F.2d 907, 908 (3rd Cir. 1990).

201. § 501(b)(2), 94 Stat. at 162.

202. H.R. CONF. REP. NO. 96-842, at 79 (1980), reprinted in 1980 U.S.C.A.N. 298, 309; S. CONF. REP. NO. 96-640, at 34 (1980); § 501(b)(2), 94 Stat. at 162. In order to effectively opt out of DIDMCA, a state had to adopt a statute or constitutional provision that “states explicitly and by its terms that such State does not want the provisions of subsection (a)(1) [the preemption section] to apply with respect to loans, mortgages, credit sales, and advances made in such State.” H.R. CONF. REP. NO. 96-842, at 79. Later cases recognized that the DIDMCA usury preemption could not be overridden by a state through simple readoption of, or amendment to, a state’s usury law after passage of DIDMCA. *Seiter v. Veytia*, 756 S.W.2d 303, 304-05 (Tex. 1988). Rather, to override DIDMCA a state had to explicitly state that it did not want DIDMCA to apply. *Id.* Fifteen states and Puerto Rico eventually opted out of DIDMCA. See KEEST & RENUART, *supra* note 122, at § 3.5.5.1 and n.258 (specifically, Colorado, Georgia, Hawaii, Idaho, Iowa, Kansas, Maine, Massachusetts, Minnesota, Nebraska, Nevada, North Carolina, Puerto Rico, South Carolina, South Dakota, and Wisconsin).

203. § 501(b)(4), 94 Stat. at 162; see also 125 CONG. REC. 30,659 (1979) (statement of Sen. Proxmire) (“States should have flexibility to enact new laws placing limitations on discount points or such other charges, without any time limitation.”); *Autrey v. United Cos. Lending Corp.*, 872 F. Supp. 925, 928 (S.D. Ala. 1995) (finding Alabama had overridden DIDMCA preemption of points limitation merely by adopting a points limitation statute after DIDMCA was adopted); *United Cos. Lending Corp. v. McGehee*, 686 So.2d 1171, 1178 (Ala. 1996) (agreeing that Alabama had overridden DIDMCA preemption of points limitation). Regarding whether preemption is a federal question, see *Hardy v. Equisouth Financial Services*, 1993 WL 764463 (M.D. Ala. Nov. 23, 1993) (finding that determination of whether a state overrode the DIDMCA points preemption is a question of state law); accord, *Autrey*, 872 F. Supp. at 928.

arguably constitutes opt-out legislation."²⁰⁴ However, re-adoption of a state's points limitations may not always serve to override the DIDMCA preemption.²⁰⁵

C. Federal Preemption of Alternative Mortgage Transactions

Two years after Congress adopted the DIDMCA preemption of state usury ceilings for first liens, it adopted the Alternative Mortgage Transaction Parity Act (AMTPA).²⁰⁶ AMTPA preempts state statutes restricting the use of alternative mortgage transactions²⁰⁷ such as variable interest rate loans,²⁰⁸ balloon payments,²⁰⁹ and negative amortizations²¹⁰ in any "loan or credit sale secured by an interest in residential real property"²¹¹ that is made, purchased or

204. KEEST & RENUART, *supra* note 122, at § 3.5.5.2.

205. *Reed v. World Wide Financial Services*, 1998 WL 852854 at *3 (N.D. Ill. Nov. 27, 1998) (finding that Illinois had not overridden the DIDMCA points preemption by merely repeating in an amendment to the Illinois Interest Act the sections dealing with points that had existed before DIDMCA). A contrary result appears to have been reached by an Ohio Court of Common Pleas in an unpublished, unwritten decision. The Ohio court reportedly found that Ohio had opted out of the DIDMCA discount preemption when the Ohio Legislature made a 1988 technical amendment to Ohio's usury statute, even though the point provision in the Ohio statute was unaffected by the 1988 amendment. Therese Franzen, *Recent Developments in Consumer Finance Law*, 52 CONSUMER FIN. L.Q. REP. 350, 351 (1998).

There have been several regulations adopted pursuant to DIDMCA. 12 C.F.R. §§ 590.1-590.4, 590.100-590.101 (1999). Except for a section setting out consumer protection rules covering mobile home loans, these regulations mostly restate the provisions of the statute. 12 C.F.R. § 590.4 (1999).

206. Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469 (codified as amended at 12 U.S.C. § 3801-3806).

207. 12 U.S.C. § 3803(c)(1994). The statute also overrides section 501(c)(1) of DIDMCA for mortgages covered by AMTPA. 12 U.S.C. § 3805 (1994).

208. 12 U.S.C. § 3802(1)(A) (1994). The maximum interest permitted to be charged on an adjustable rate mortgage must be included in the loan. *Id.* § 3806(a). The Federal Reserve is authorized to issue regulations in this regard. *Id.* § 3806(b). A violation of this section is treated as a violation of the Truth in Lending Act, 15 U.S.C. §§ 1601-1611 (1994).

209. 12 U.S.C. § 3801(1)(B)(1994).

210. 12 U.S.C. § 3801(1)(C). A negative amortization occurs when periodic payments made by the obligor on a loan are not large enough to cover the principal and interest due during that period. KEEST & RENUART, *supra* note 126, at § 4.3.1.2. The result is that the total amount owed by the obligor goes up rather than down at the end of the period, even though the obligor may have made a regular periodic payment. *Id.* If the lender uses the "actuarial rule," the unpaid interest is added to the principal, and in the following period interest is charged on both the outstanding principal and the unpaid interest. *Id.* at §§ 4.3.12, 4.6.1.1. In other words, any due and unpaid interest is added to the principal, and interest is charged thereon. If the lender uses the "U.S. rule," the borrower continues to owe the unpaid interest, but the interest is not added to principal. Both methods are methods of calculating simple interest. *Id.* at § 4.6.1.1; *Grunbeck v. Dime Sav. Bank of New York*, 74 F.3d 331, 344 (1st Cir. 1996) (holding that a state statute requiring interest to be calculated based on the simple interest method was not preempted by DIDMCA or AMTPA).

211. 12 U.S.C. § 3802(1). The act also covers loans secured by an interest in "a dwelling, all stock allocated to a dwelling unit in a residential cooperative housing corporation, or a residential manufactured home (as that term is defined in section 5402(6) of title 42)." *Id.*

enforced by a covered lender.²¹² The statute applies to depository institutions as defined in DIDMCA,²¹³ lenders approved by the Secretary of Housing and Urban Development for participation in any mortgage insurance program under the National Housing Act,²¹⁴ any person who regularly makes alternative mortgage transaction loans, credit sales, or advances secured by an interest in property,²¹⁵ and any transferee of any covered originator.²¹⁶

The statute lists the factors that motivated its enactment, including "increasingly volatile and dynamic changes in interest rates [that had] seriously [impaired] the ability of housing creditors to provide consumers with fixed-term, fixed-rate credit secured by interests in real property, cooperative housing, manufactured homes, and other dwellings."²¹⁷ Congress also articulated its belief that "alternative mortgage transactions are essential to the provision of an adequate supply of credit secured by residential property."²¹⁸ The statute gave states a three-year window in which to opt out, by legislative act or by popular vote, of the AMTPA preemption.²¹⁹

Although an extensive discussion of AMTPA is beyond the scope of this article, AMPTA plays a role in the subprime home equity industry because it allows lenders to make loans with terms that may obscure the total cost of a loan (for example, by reducing monthly payments through a large balloon payment at the end of the loan).²²⁰

IV. EARLY DEVELOPMENTS AFTER THE ADOPTION OF DIDMCA

A. Early Uses of DIDMCA To Make Non-Housing Related Loans At Interest Rates Higher Than State Usury Limits

It didn't take long after DIDMCA was adopted for some second mortgage lenders, and for other lenders who had been making high cost consumer loans, to notice that DIDMCA appeared to allow them to charge an unlimited amount of interest provided they took a first lien on the borrower's home. Thus a number of lenders who would not have otherwise made first-lien home equity

212. *Id.* § 3803(a).

213. *Id.* § 3802(2)(A).

214. *Id.*

215. *Id.* § 3802(2)(C).

216. *Id.* § 3802(2)(D).

217. *Id.* § 3801(a)(1).

218. *Id.* § 3801(a)(2). Congress also intended to put nonfederally chartered housing creditors on equal footing with federally chartered institutions, which were already permitted to make alternative mortgage transactions. *Id.* § 3801(b).

219. *Id.* § 3804(a). Under this provision a state could express explicitly in legislation or by certified vote that the state did not want the preemption provided in § 3803 to apply with respect to alternative mortgage transactions subject to the laws of that state. *Id.* This action had to be taken by a state between October 15, 1982—the effective date of AMTPA—and October 15, 1985. *Id.*

220. For a more complete discussion of this issue, see *infra* Parts VI.C.1 and V.D.1.

loans before DIDMCA began to cast car loans, small consumer loans, and second mortgage loans as very expensive home equity first-lien loans.

The case of *Laubach v. Fidelity Consumer Discount Co.* provides an example of this practice. In *Laubach* five customers of Fidelity Consumer Discount Company—Herbert and Annabelle Smith, John Coplin, Tito Manor, and Gloria Young—sued the nondepository Pennsylvania lender for violating Pennsylvania's usury law.²²¹ Mr. Smith's trouble began in December, 1983 while shopping for a used car.²²² In order to obtain a loan to pay for the car, Mr. Smith was referred by the car dealership to Fidelity. Fidelity informed the car dealership that it would not make the loan to Herbert unless his 80-year-old mother, Annabelle Smith, agreed to cosign the loan and secure it with a mortgage on her home.²²³ Mrs. Smith had owned her home since 1955, and it was clear of unpaid liens.²²⁴ Fidelity ultimately visited the Smiths at their home, made them a loan for the amount of the car (\$2,300), and took a mortgage in the home.²²⁵ The loan was then canceled after Herbert had trouble with the car.²²⁶ However, Fidelity continued to pursue a lender/borrower relationship with the Smiths by offering them a \$7,500 "line of credit" secured by the home.²²⁷ In January 1984 Fidelity made the Smiths another loan for \$5,500 (\$4,216.59 of which was received by the Smiths) that was also secured by the home.²²⁸ Along with this amount, Fidelity sold credit life insurance to the Smiths for \$154.80, and charged them for discharging liens that had been paid but were still recorded on the property.²²⁹

Fidelity charged the Smiths an annual percentage rate of 36.57%, claiming that Pennsylvania's usury statutes were preempted by DIDMCA because Fidelity had taken a first position lien on the Smiths' property.²³⁰ If Fidelity had written the Smiths' car loan as a standard consumer credit loan, taking a security interest in the car, the interest rate would have been capped at no more than 24% by Pennsylvania's usury law.²³¹ If Fidelity had written the second

221. *Laubach v. Fidelity Consumer Discount Co.*, 686 F. Supp. 504, 507 (E.D. Pa. 1988), *aff'd in part and rev'd in part sub nom*, *Smith v. Fidelity Consumer Discount Co.*, 898 F.2d 896 (3d Cir. 1990) *withdrawn and replaced*, 898 F.2d 907 (3d Cir. 1990).

222. *Id.*

223. *Laubach*, 686 F. Supp. at 507. At this time it was still quite unusual for a car lender to take a lien on real estate as security for a car purchase. *Canter & Luckett, Home Equity Lending*, *supra* note 204, at 337 tbl. 5 (finding that only 5% of traditional home equity loans in 1988 were used for car purchases).

224. *Laubach*, 686 F. Supp. at 505, 507.

225. *Id.*

226. *Id.*

227. *Id.* The "line of credit" offered was not a true line of credit because the Smiths could not draw on the money at will. *Id.*

228. *Id.*

229. *Id.*

230. *Id.*

231. *Smith v. Fidelity Consumer Discount Co.*, 898 F.2d 896, 909 (3d Cir. 1989) ("It is undisputed that, absent preemption, Fidelity will have violated these [usury] statutes, the most generous of which allows lenders to charge up to 24% interest per annum.").

consumer loan as a standard consumer loan without taking a mortgage on the Smiths' home, the interest rate would likewise have been capped at no more than 24%.²³² Additionally, because the loan was secured by Mrs. Smith's home, Mr. and Mrs. Smith were charged an origination fee—which one would not expect to see in a car loan or small consumer loan²³³—and other fees totaling \$275.08 associated with title to Mrs. Smith's house.²³⁴ These fees would not have been present if the loans had not been written as home-secured loans. Thus, the cost to the Smiths of having their loans made as mortgage loans was tremendous.

John Coplin's experience with Fidelity mirrored that of the Smiths'. In October 1984 Fidelity made a car loan to Mr. Coplin, a 75-year-old who could not read or write.²³⁵ As it did with the Smiths, Fidelity secured its car loan with a mortgage on Mr. Coplin's home.²³⁶ Mr. Coplin had owned his home since 1957.²³⁷ This transaction was similar to the Smith transaction in that Fidelity assumed that taking a first-lien mortgage brought the loan under the DIDMCA preemption of Pennsylvania's usury laws. Also like the Smith transaction, the Coplin loan cost the borrower more simply because it was cast as a home-secured loan. Mr. Coplin's loan bore an annual interest rate of 41.10%,²³⁸ and he was charged a \$1,072 origination fee (20.5% of the loan proceeds) and \$91.00 in fees for recording lien documents.²³⁹ Mr. Coplin's transaction also contained another post-DIDMCA financing technique—that of the lender paying off a less-expensive first lien as part of a new loan in order to take first-lien position on the home.²⁴⁰ By refinancing all of Mr. Coplin's debt secured by his home, Fidelity was able to take first-lien position and claim the right under DIDMCA to ignore Pennsylvania's usury laws.²⁴¹

Tito Manor's experience followed a similar pattern. In 1986 Mr. Manor and his mother and stepfather went shopping for a used car.²⁴² The car salesman

232. *Id.*

233. *Laubach*, 686 F. Supp. at 513. The origination fee was \$1,008.34 on an amount financed of \$5,500, which is a little more than 18% of the loan proceeds. *Id.* The Smiths also paid pre-paid finance charges of \$990, also about 18% of the proceeds. *Id.* This sort of cost is exorbitant even by today's standards.

234. *Smith v. Fidelity Consumer Discount Co.*, 58 U.S.L.W. 2055, 1989 WL 106695 at *2 (3d Cir. 1989), *withdrawn and replaced*, 898 F.2d 907 (3rd Cir. 1990).

235. *Id.* at *8.

236. *Id.*

237. *Laubach*, 686 F. Supp. at 506.

238. *Id.*

239. *Id.*

240. *Smith*, 898 F.2d at 909 (3d Cir. 1990); see also Julia Patterson Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing*, 69 TUL. L. REV. 373, 418 (1994) ("[A] lender can obtain a first lien simply by requiring the borrower to pay off existing liens with proceeds of a home equity loan."). In Mr. Coplin's case, the car loan part of his loan was only \$1,761.50. *Laubach*, 686 F. Supp. at 506. The majority of the loan proceeds (\$3,429.50) went to paying off various other lien holders, including three lenders and the tax authorities for delinquent real estate taxes. *Id.*

241. *Smith*, 1989 WL 106695, at *8.

242. *Laubach*, 686 F. Supp. at 508.

informed Mr. Manor that he would need a cosigner for his loan.²⁴³ Ultimately Mr. Manor's Aunt, Gloria Young, agreed to cosign the loan.²⁴⁴ The car salesman passed Ms. Young's loan application on to Fidelity.²⁴⁵ The car salesman later notified Mr. Manor and his aunt that the loan had gone through and instructed them to come to the car dealership, telling Ms. Young to bring the deed to her house to verify that she was a homeowner. Ms. Young was not informed that her home would be used as security for the loan.²⁴⁶

Once at the car dealership, Mr. Manor and his aunt were driven by an employee of the car dealership to the Fidelity offices to sign the loan documents.²⁴⁷ Fidelity took a first mortgage on Ms. Young's home at an interest rate of 36.617%, far in excess of the state usury limit.²⁴⁸ Fidelity also took an origination fee of \$544.44 on the \$3,613.87 loan (approximately 15% of the loan).²⁴⁹

None of the borrowers discussed in this case would have been permitted to take loans from Fidelity without giving a first-lien security interest in a home.²⁵⁰ Thus it seems clear that Fidelity was using DIDMCA as a device to get around Pennsylvania's usury limits.

B. *Early Court Decisions Interpreting DIDMCA*

1. *Was the DIDMCA Usury Preemption within Congress's Power to Regulate Commerce?*

Soon after DIDMCA was adopted, the Arkansas courts decided a case in which the borrower challenged Congress's authority to preempt state usury

243. *Id.*

244. *Id.*

245. *Id.*

246. *Id.*

247. *Id.*

248. *Id.*

249. *Id.*

250. The court found:

The evidence is undisputed that Fidelity customers do not have the option of keeping prior liens on their property if they want to obtain a loan from Fidelity. This is evidenced by the following deposition testimony:

Q: Ordinarily do you leave it up to the customer to decide between a consumer discount loan and the first mortgage loan?

A: There is no decision. It is our decision to make.

Q: It is basically a take it or leave it proposition; correct?

A: Yes.

Smith, 1989 WL 106695, at *16 n.11.

restrictions on first-lien mortgages.²⁵¹ The Arkansas Supreme Court initially held that the first-lien preemption contained in DIDMCA “was an invalid legislative exercise of congressional power pursuant to the Commerce Clause.”²⁵² The court reversed itself on rehearing, holding that Congress did have the authority to preempt Arkansas’s usury limit on first-lien mortgages. The court noted that the testimony during the congressional hearings was that state usury laws have a significant impact on the economy by diverting credit out-of-state and by stagnating the housing industry, all of which distorts and adversely affects local and national economies.²⁵³

One of the issues raised by the dissenting judges, *sua sponte*, was whether lenders making \$1 million in loans were making federally related loans simply by taking a first lien on land.²⁵⁴ In the dissenting judge’s opinion, if taking a lien on local land by a local lender who makes \$1 million in local mortgage loans was “‘federally-related’ then brushing your teeth is federally-related.”²⁵⁵

2. Was DIDMCA Meant to Preempt State Usury Laws in Nonpurchase Money Loans?

Laubach v. Consumer Fidelity Discount Co., introduced in the previous section,²⁵⁶ provided courts with the first opportunity to interpret DIDMCA’s first-lien preemption. At issue was whether any lender who took a first-lien position was entitled to the DIDMCA preemption, even if the loan was not a purchase money loan and was made by a lender who, but for the unlimited interest possibility under DIDMCA, would likely not have secured the loan with a first lien. On its face the statute appeared to clearly entitle all first liens made by covered lenders to the preemption, yet the legislative history strongly suggested that Congress was focused almost entirely on purchase money mortgages. Furthermore, in the parlance of the time, first mortgages were generally thought of as those used to purchase a home, while second mortgages were generally thought of as those taken out using equity accumulated in the home as security, whether the lender took first-lien position or not.²⁵⁷

If DIDMCA’s purpose was to promote home ownership through the

251. *McInnis v. Cooper Communities, Inc.*, 611 S.W.2d 767, 768 (Ark. 1981) (regarding a purchase money loan made by a developer to purchasers of a residential lot at 12% per year, during a time when the state constitutional limit was 10% per year.).

252. *Id.* at 770.

253. *Id.* at 772, cited with approval in *Troutt v. First Fed. Sav. & Loan Ass’n of Hot Springs*, 659 S.W.2d 183, 184 (Ark. 1983).

254. *McInnis*, 611 S.W.2d at 773 (Hickman, J., dissenting).

255. *Id.*

256. See *supra* Part IV.A.

257. See, e.g., *Canner & Luckett, Home Equity Lending*, *supra* note 195, at 344 n.2 (noting that “[t]raditional home equity loans are sometime called second mortgages, although legally they may involve a first lien”); see also 24 C.F.R. § 3500.5 (1979) (defining a “Federally Related Mortgage Loan” for purposes of the Real Estate Settlement Procedures Act as a loan secured by a first lien, including purchase money loans but excluding home improvement, refinance, or other nonpurchase money loans).

continued availability of mortgage funds in the face of high interest rates and low usury ceilings, this purpose certainly could have been accomplished by restricting DIDMCA's application to purchase money mortgages.

Counsel for the Fidelity borrowers argued that in deregulating home mortgage interest rates in DIDMCA "Congress never intended to preempt state interest rate limitations in used car financing—a traditional area of state regulation."²⁵⁸ The words "first lien" in DIDMCA, they argued, should be read to mean purchase money mortgages, not simply any loan where the lender, by whatever means and for whatever purpose, takes first-lien position.²⁵⁹ This interpretation, they argued, would be consistent with both congressional interest in facilitating national housing policy and the reference in the statute to the National Housing Act, a purpose of which was to enable every American family to have a "decent home."²⁶⁰ On the other hand, an interpretation that allowed car lenders to make loans at any interest rate they desired merely by taking a first mortgage would not "further . . . national housing goals." Indeed, such an interpretation would harm national housing goals by creating the risk that consumers taking out non-home-related consumer loans might lose their homes.²⁶¹ Plaintiffs' counsel thus maintained that Fidelity secured its car and small loans with first-lien home mortgages instead of traditional secured loans purely to avoid the state usury statute.²⁶²

On the other hand, Fidelity's counsel argued that the term "first lien," as used in DIDMCA, was not ambiguous, and thus it was inappropriate for the courts to interpret the term.²⁶³ They argued further that administrative agency interpretations contained in regulations, official staff interpretations, unofficial staff interpretations, and an Office of Thrift Supervision amicus brief supported their position.²⁶⁴

Initially the Third Circuit held that based on the legislative history and goals of DIDMCA, DIDMCA did not preempt the loans made by Fidelity:

258. Reply Brief for Appellants on Rehearing at 1, *Smith v. Fidelity Consumer Discount Co.*, 898 F.2d 896 (3d Cir. 1990) (No. 88-1444). Later commentators on DIDMCA have argued that although the articulated purpose of DIDMCA was to increase the available credit for home ownership, the failure to limit DIDMCA to purchase money and home improvement home equity loans has actually had the effect of channeling funds that would have been available to consumers for nonhome-secured transactions into the mortgage market, rather than an increase in home ownership. Forrester, *supra* note 240, at 436.

259. Reply Brief for Appellants on Rehearing at 4, *Smith v. Fidelity Consumer Discount Co.*, 898 F.2d 896 (3d Cir. 1989) (No. 88-1444). Appellants argued that the term "first lien" had already been interpreted in another context—the Real Estate Settlement Procedures Act, 12 U.S.C. § 2602 (1994)—as meaning only purchase money mortgages. *Id.*

260. *Id.* at 4-5 (quoting from 42 U.S.C. § 1441(1994)).

261. *Id.* at 6. They also argued that, "[b]ased on the clear expression in the legislative history, to permit a loan which lacks any nexus to our national housing policy to be preempted would pervert the goals Congress intended to achieve in DIDMCA." *Id.* at 5-6.

262. *Id.* at 6.

263. *Id.* at 4, 7.

264. *Id.* at 11.

Viewed with the congressional aims in mind, Congress cannot be said to have intended to preempt state usury laws where a creditor is able to obtain a first priority mortgage against a debtor's house in a transaction in which the debtor is seeking financing to purchase a used car, but is required by the lender to refinance all previous and prior liens against his or her residence. In the instant case, Fidelity wrote loans with disclosed annual percentage rates ranging from approximately 31% to 41%. At a time when market interest rates hover at 10-12%, the congressional purpose of promoting the stability and viability of financial institutions, by allowing them to charge realistic interest market interest rates [sic], cannot be said to be furthered.

More importantly, the omnipresent congressional goal of assisting homebuyers to secure homes is frustrated rather than implemented by applying DIDMCA to the instant case. Application of DIDMCA to used car financing, such as in the instant case, encourages lenders to obtain first priority security for their loans against the borrower's homes [sic] in order to avoid state usury restrictions. Thus, lenders are encouraged not only to take a mortgage against a borrower's residence but also to lend and require that the debtor borrow, sufficient funds to satisfy all the debtor's prior obligations against their home. The end result: a car buyer's home is at a significantly higher risk of foreclosure because the size of the lien against it is increased by the value of the car and the finance charges associated with its purchase, and the refinanced prior debt is at a rate not subject to usury limitations. Moreover, the lender is able to foreclose on the borrower's home for a default, rather than repossess the car for which the loan was sought. Indeed this is preferable for the lender. Witness the Young/Manor transaction. Uncontradicted deposition testimony reveals that when Manor was unable to continue making loan payments he suggested that Fidelity take the car, at which time a Fidelity representative responded: "we don't want your car, we want your aunt's house." Deposition of Tito Manor, App. at 241.

We cannot believe that this anomalous result was within the congressional intent when it enacted DIDMCA. It seems absurd to find that Congress intended lenders to be able to short circuit state usury limitations and increase the risk of foreclosure in order to enable the borrower to purchase a used car.²⁶⁵

265. *Smith v. Fidelity Consumer Discount Co.*, Nos. 88-1406, 88-1444, 1989 WL 106695, at *16-17 (3d Cir. Jun. 27, 1989), *withdrawn and superceded by* *Smith v. Fidelity Consumer Discount Co.*, 898 F.2d 896 (3d Cir. 1990).

The court went on to say that it was not interpreting DIDMCA to be limited to purchase money mortgages, but rather its interpretation was limited to the facts of the particular case.²⁶⁶ Thus the court held Fidelity had violated Pennsylvania's usury statute.²⁶⁷

However, in a subsequent opinion the court reversed itself by essentially adopting the opinion of the dissent in the original, withdrawn opinion.²⁶⁸ In this new opinion, the court found that the DIDMCA first-lien preemption applied to all first-lien loans, and that this was consistent with a literal reading of the statute—legislative history showing no intent to exclude car loans or other nonpurchase money loans from the preemption²⁶⁹—and FHLBB interpretations, opinions, and regulations.²⁷⁰ The court also found that this interpretation “advances one of Congress’s stated purposes for enacting § 501—increasing

266. *Id.*

267. *Id.* at *19. In making its decision the court was forced to address the impact of a Federal Home Loan Bank Board official interpretation, which provided that the DIDMCA preemption applied to a new first-lien loan which refinanced an old first-lien loan at a higher rate of interest. *Id.* The court found this interpretation to have “no force on the instant facts” because the debtors “were not seeking to refinance their homes but were seeking to purchase used cars.” *Id.* In a dissenting opinion, Judge Stapleton opined that DIDMCA clearly preempted state usury limits in the loans in question:

The court inexplicably concludes that Congress could not have intended to preempt the application of state usury laws to transactions involving a first lien on residential real estate if the consumer intends to apply the proceeds towards the purchase of a used car. This purportedly narrow exception to § 501 is unsupported by anything in the text of DIDMCA, its legislative history, or the interpretive rulings of the FHLBB.

Id. at *21. Judge Stapleton believed that the court’s decision made it impossible for lenders to know which loans might be covered by the DIDMCA preemption. *Id.*

268. *Smith*, 898 F.2d 907.

269. *Id.* at 912. Interestingly, the court seems to imply that Congress consciously rejected limiting the preemption to purchase money loans:

Congress could have provided for the preemption of state usury laws with respect to any loan “secured by a first lien on residential real property used to finance the acquisition of such property.” We think its failure to do so in this context can hardly have been inadvertent. In short, we believe that if Congress had intended to limit the preemptive effect of § 501 in this manner, it “would have so stated in the language of the provision.”

Id. (citations and emphasis omitted). This assessment probably gave Congress too much credit for considering the full effects of the preemption.

270. *Id.* at 913-14. The court referred to the Federal Home Loan Bank Board Interpretation No. 590-2, 45 Fed. Reg. 6165, 6166 (1980); Opinion of Office of General Counsel, Federal Home Loan Bank Board, No. S. 5 (Dec. 30, 1980); Opinion of Office of General Counsel, Federal Home Loan Bank Board, No. S. 6 (June 2, 1980); see also *FirstSouth F.A. v. Lawson Square, Inc.* (*In re Lawson Square, Inc.*), 61 B.R. 145, 150 (Bankr. W.D. Ark. 1986) (referring to federal statute and state constitutional amendment).

the ability of financial institutions to pay market rates of interest to depositors.²⁷¹

Most courts that have subsequently addressed the issue have agreed that nonpurchase money lenders who take a first-lien position are entitled to the DIDMCA preemption.²⁷² However, at least one early decision under DIDMCA avoided this issue, basing its decision on the lender's failure to produce strict proof that the lender was a covered lender under DIDMCA.²⁷³ Many other courts have similarly required lenders claiming entitlement to the DIDMCA preemption to prove that they are a covered lender under the statute,²⁷⁴ or that

271. *Smith*, 898 F.2d at 914. The court obviously ignored the fact that the lender in this case was not a depository lender. *Id.*

272. *See, e.g., Brown v. Investors Mortgage Co.*, 121 F.3d 472 (9th Cir. 1997); *Gora v. Banc One Fin. Servs., Inc.*, No. 95C2542, 1995 WL 613131 (N.D. Ill. Oct 17, 1995) (citing to the *Smith* decision extensively and criticizing the court's opinion in *Fidelity Financial Services, Inc. v. Hicks*, 574 N.E.2d 15, 21 (Ill. App. Ct. 1991)); *L.G.H. Enters., Inc. v. Kadilac Mortgage Bankers, Ltd. (In re L.G.H. Enters.)*, 146 B.R. 612, 616 (E.D.N.Y. 1992); *see also FirstSouth F.A. v. Lawson Square, Inc. (In re Lawson Square, Inc.)*, 61 B.R. 145, 150 (Bankr. W.D. Ark. 1986), (holding that the DIDMCA preemption applied to a business loan made to a commercial developer that was secured by a first lien on property being developed by the debtor for residential use); *Bank of N.Y. v. Hoyt*, 617 F. Supp. 1304, 1310 (D.R.I. 1985) (holding that the DIDMCA preemption applied to a residential condominium property construction loan secured by a first lien on the property).

273. *Russell v. Fidelity Consumer Discount Co. (In re Russell)*, 72 B.R. 855, 868-69 (Bankr. E.D. Pa. 1987). In that case the lender provided the debtor in bankruptcy with a home equity loan at an annual interest rate of 33.7%, and the borrower paid 17 points up front in origination fees. *Id.* at 859. The lender submitted an affidavit of its president that stated that the lender "makes or invests in real property loans that aggregate more than \$1,000,000.00 per year." *Id.* at 860. The court held that the lender was not entitled to the DIDMCA preemption because the lender failed to prove that it made more than the required \$1 million in mortgage loans, making its interest and points charges usurious under Pennsylvania law. *Id.* at 860-861, 868. The borrower in *Russell* paid over \$5,000 on her loan with a principal balance (after subtracting fees that went to the lender and others) of just over \$5,000. Nevertheless, when she filed for bankruptcy four years after taking the loan, her principal balance had gone up from the original principal balance. *Id.* at 860. *But see Brown v. Investors Mortgage Co.*, 121 F.3d 472, 477 (9th Cir. 1997) (finding that the lender's affidavit was enough to establish that it made \$1 million in loans).

274. *McInnis v. Cooper Communities, Inc.*, 611 S.W.2d 767, 769 (Ark. 1981) (finding that lender/developer had sufficiently demonstrated that it was a lender covered by the DIDMCA first-lien preemption.); *Fidelity Fin. Servs., Inc. v. Hicks*, 574 N.E.2d 15, 21 (Ill. App Ct., 1991); *Pacific Mortgage & Inv. Group, Ltd. v. Horn*, 641 A.2d 913, 922 (Md. Ct. Spec. App. 1994); *Mitchell v. Trustees of U.S. Mut. Real Estate Inv. Trust*, 375 N. W. 2d 424, 431 (Mich. Ct. App. 1985). For other cases in which the creditor was charged with the burden of proving that it was entitled to the DIDMCA preemption because of its loan activity, *see Grant v. General Elec. Credit Corp.*, 764 F.2d 1404, 1406 (11th Cir. 1985) (en banc); *Quiller v. Barclays American/Credit, Inc.*, 727 F.2d 1067, 1071-72 (11th Cir. 1984), *reinstated*, 764 F.2d 1400 (11th Cir. 1985) (en banc); *Overton Constr., Inc. v. First State Bank, Springdale*, 662 S.W.2d 470, 471 (Ark. 1984); *First Amer. Bank & Trust v. Windjammer Time Sharing Resort, Inc.*, 483 So.2d 732, 737-38 (Fla. Dist. Ct. App. 1986). In contrast, the court in *Moyer v. Citicorp Homeowners, Inc.*, 799 F.2d 1445 (11th Cir. 1986) held that the lender was entitled to the DIDMCA preemption on a mobile home purchase, where the lender had complied with the DIDMCA regulation (12 C.F.R. § 590.4(d) (1985)) requirement that right to prepay notice be in "type larger than that used for the body of the document" by printing the notice in boldface type—even

the loan was in fact a first lien.²⁷⁵ Other cases have stated in dicta that pursuant to congressional policy and legislative history, the first-lien language should be interpreted to apply only to purchase money mortgages.²⁷⁶ Nonetheless, there has been almost no recent litigation asserting that the DIDMCA preemption applies only to purchase money first liens; indeed, the opposite conclusion now seems to be taken as a given.²⁷⁷ It is this conclusion that has paved the way for the subprime home equity market that exists today.

V. MARKET DEVELOPMENTS SINCE THE ADOPTION OF DIDMCA: THE RISE OF FIRST LIEN HOME EQUITY LENDING AND THE SUBPRIME MARKET

Several market factors developed in the 1980s and 1990s that combined by the mid-1990s to create a large nonpurchase money subprime home equity lending industry. These factors included increased home equity lending, the growth of nondepository lenders, increased subprime lending, and the development of a market for pooled loan securities. The following Sections will describe these market forces and the subprime home equity industry that

though the typeface was not larger than the rest of the document—and where the notice did not clearly inform borrowers they would have 30 days notice before foreclosure or acceleration of the debt. *Id.* at 1448-49.

275. See, e.g., *Grigsby v. Thorp Consumer Discount Co.* (*In re Grigsby*), 119 B.R. 479, 490-91 (Bankr. E.D. Pa. 1990) (holding that the lender was not entitled to the DIDMCA preemption because the lender's miscalculation of the payoff on the first lien left it in second lien position, even though lender and borrower may have intended for the lender to have first-lien position); *Fidelity Fin. Servs., Inc.*, 574 N.E.2d at 21 (finding that the lender was not entitled to the DIDMCA preemption where in one filing by lender, lender claimed it had a first-lien position, and in other filing by lender, lender claimed it had second lien position).

276. *Mitchell*, 375 N.W.2d at 431. In addressing this issue, the court noted:

Section 501 of the act seems to reflect a congressional effort to stimulate the housing industry by assuring the availability of home loans, albeit at potentially high interest rates. It follows, then, that a construction of § 501's "first-lien" language should be limited to those mortgages which secure purchase money loans and not extended to nonpurchase-money wraparound transactions aimed at refinancing and debt consolidation. Refinancing transactions, such as that in the instant case, do nothing to further federal housing policies. In our opinion, it was not the intent of Congress in enacting § 501 to include junior mortgages executed for refinancing purposes among the loan transactions exempted from state usury laws.

Id. Regarding the main issue in that case, the court found that a "wraparound mortgage," a mortgage in which the first lender maintains a security in the property, was not a first-lien mortgage under DIDMCA. *Id.* at 431-32; see also *Fidelity Fin. Servs., Inc.*, 574 N.E.2d at 21. In *Fidelity Financial*, the court held that the evidence supported a finding that the loan was subordinate to the original purchase money loan, but also stated that the "'first lien on residential real property' language should be interpreted to apply only to purchase-money mortgages." *Id.*

277. *But see Brown v. Investors Mortgage Co.*, 121 F.3d 472, 475 (9th Cir. 1997) (discussing limiting the statute to purchase money mortgages).

developed from 1990 to 1999.

A. *The Rise of Home Equity Lending As an Accepted and Encouraged Method of Consumer Lending*

Several things happened during 1979 and 1980—around the time DIDMCA was passed—which led to massive increases in home equity lending. First, by the time DIDMCA was adopted the same inflation that had pushed interest rates up had also pushed up property values.²⁷⁸ This led to a large untapped security pool for lenders, and lending secured by home equity became more popular.²⁷⁹ However, as interest rates soared in the early 1980s and the country experienced a recession, consumer borrowing—including mortgage borrowing—dropped significantly.²⁸⁰ Perhaps as a result of this, home equity borrowing did not increase significantly between 1980 and 1986.²⁸¹

278. Seiders, *Recent Developments*, *supra* note 78, at 177 (“The capital gains associated with the rapid appreciation in home prices . . . have generated collateral for mortgage credit that may be used for other purposes.”). A Federal Reserve report in 1978 indicated that the median selling price of existing homes approximately doubled between 1970 and 1977. Seiders & Luckett, *Household Borrowing*, *supra* note 165, at 155. By late 1979 this “upward trend of average home prices slowed markedly.” Luckett, *Recent Financial Behavior*, *supra* note 135, at 439.

279. By 1978 the Federal Reserve estimated that there was over \$900 billion in available housing equity to serve as collateral for loans—double the amount available in 1970. Seiders & Luckett, *Household Borrowing*, *supra* note 165, at 155. By 1986 one article estimated that there was \$3 trillion dollars in untapped home equity. Bill Sing, *Tax Code Changes Spur Plans to Cope: Home Equity Loans Could Replace Consumer*, L.A. TIMES, Dec. 21, 1986, at 1; see also Walt Bogdanich, *Second Thoughts: Home-Equity Loans Grow in Popularity—And in Their Problems*, WALL ST. J., January 29, 1986, at A1 (stating that “second mortgage indebtedness has more than doubled since 1982 to a record high of \$150 billion.”); Glenn B. Canner & Charles A. Luckett, *Mortgage Refinancing*, 76 FED. RES. BULL. 604, 607 (1990) [hereinafter Canner & Luckett, *Mortgage Refinancing*] (discussing the increase in available home equity); Glenn B. Canner & Charles A. Luckett, *Home Equity Lending: Evidence From Recent Surveys*, 80 FED. RES. BULL. 571, 572 (1994) [hereinafter Canner & Luckett, *Recent Surveys*] (indicating that in the article’s references to second mortgages it is referring to traditional home equity loans, including those in which the lender technically has a first-lien position).

280. Charles Luckett, *Recent Developments in the Mortgage and Consumer Credit Markets*, 68 FED. RES. BULL. 281 (1982) [hereinafter Luckett, *Recent Developments*]; Robert B. Avery et al., *Changes in Consumer Installment Debt: Evidence from the 1983 and 1986 Surveys of Consumer Finance*, 73 FED. RES. BULL. 761 (1987) [hereinafter Avery, *Changes in Consumer Installment Debt*].

281. Avery, *Changes in Consumer Installment Debt*, *supra* note 280. For example, a Federal Reserve Board study showed that in 1977 only 5.4% of all homeowners had a home equity loan. Canner & Luckett, *Home Equity Lending*, *supra* note 195, at 333; Canner & Luckett, *Recent Surveys*, *supra* note 279, at 572. An earlier study by the Federal Reserve showed that only 6% of households in 1977 with first mortgage debt also had a junior mortgage, and only 7% of households had refinanced their first mortgage in order to raise new funds. Seiders & Luckett, *Household Borrowing*, *supra* note 165, at 156. By 1983 “this proportion had risen only slightly, to 6.8%.” Canner & Luckett, *Home Equity Lending*, *supra* note 195, at 333-34. One Federal Reserve Board Report concluded that between 1983 and 1986 borrowers had not yet begun substituting mortgage debt for consumer credit. Avery, *Changes in Consumer Installment Debt*,

In 1986 Congress adopted the Tax Reform Act of 1986,²⁸² which disallowed the deductibility of consumer interest²⁸³ but permitted taxpayers to deduct interest paid on loans secured by the taxpayer's principal and one other residence.²⁸⁴ This deductibility encouraged increased home equity lending as the preferred method of consumer borrowing.²⁸⁵

These tax changes, coupled with untapped equity that could be used to secure loans and aggressive promotion by home equity lenders, spurred a tremendous increase in consumer home equity borrowing in the mid-to-late 1980s.²⁸⁶ Thus by the second part of 1988, 11% of homeowners (about 6.5 million households) had a home equity loan, a percentage that was up from 6.8% in 1983.²⁸⁷ Of these home equity loans in 1988, 64% of traditional home equity loans had been made since 1986.²⁸⁸ In dollar amounts, this meant that home equity loans grew from "virtually nothing" in 1983 to "about \$40 billion" by the end of 1986.²⁸⁹ At around the same time, second mortgage indebtedness more than doubled to a record high of about \$150 billion in 1986.²⁹⁰ By the end

supra note 280, at 761.

282. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of the I.R.C.)

283. § 511(b), 100 Stat. at 2246 (codified at I.R.C. § 163(h)(1), (2) (1993)). Prior to the adoption of this act, most types of interest paid by individuals were deductible. Internal Revenue Code of 1954, Pub. L. No. 83-591, § 163, 68A Stat. 46, 46 (repealed 1986).

284. Tax Reform Act of 1986, Pub. L. No. 99-514, § 511(b), 100 Stat. 2085, 2247-49. This ability to deduct interest paid on a home equity loan was capped at \$100,000 one year later. Revenue Act of 1987, Pub. L. No. 100-203, tit. X, § 10102, 101 Stat. 1330-84 to 1330-87 (codified at I.R.C. § 163(h)(3) (1993)).

285. TWO STEPS BACK, *supra* note 1, at 15; Glenn B. Canner, et al., *Recent Developments in Home Equity Lending*, 84 FED. RES. BULL. 241, 242 (1998) [hereinafter Canner, *Recent Developments*]; Forrester, *supra* note 261, at 410-16; Sing, *supra* note 279; Thomas Watterson, *Con Artists Make the Home Equity Loan Even More Dangerous*, THE CHRISTIAN SCIENCE MONITOR, June 24, 1987, at 17.

286. Avery, *Changes in Consumer Installment Debt*, *supra* note 286, at 761; Canner & Luckett, *Home Equity Lending*, *supra* note 195, at 334 (also attributing the increase in home equity lending to aggressive promotions by financial institutions); Canner & Luckett, *Recent Surveys*, *supra* note 279, at 571-72.

287. Canner & Luckett, *Home Equity Lending*, *supra* note 195, at 333-34. The survey found that about half of these borrowers had a traditional home equity loan, while the other half had home equity lines of credit. *Id.* Home equity lines of credit are used mostly by "upscale" borrowers, whereas lower income borrowers continue to get mostly home equity loans. *Id.* at 336. This Article does not discuss home equity lines of credit because they have not been a part of the subprime home-secured lending problem.

288. *Id.* at 334.

289. Sing, *supra* note 279, at 15; Seiders & Luckett, *Household Borrowing*, *supra* note 165, at 156 (indicating that nonpurchase money home-secured borrowing was at \$40 billion by the fourth quarter of 1977).

290. Bogdanich, *supra* note 279, at A1; *see also* Sing, *supra* note 279, at 15 (estimating second mortgage indebtedness to be about \$160 billion in 1986). It is unclear whether this use of the term "second mortgage" refers to mortgages in which the lender has taken a second lien, or simply to nonpurchase mortgage loans. Canner & Luckett, *Home Equity Lending*, *supra* note 195, at 344 n.2 (noting that "[t]raditional home equity loans are sometime called second mortgages, although legally they may involve a first lien.").

of 1988 home equity loans were between \$135 billion and \$190 billion.²⁹¹

By 1989 one survey estimated that 15% of mortgage debt holders held a home equity loan.²⁹² That year also saw the beginning of a disturbing trend whereby homeowners began to pay off existing mortgages by borrowing additional funds. In some cases the additional loan carried a higher rate than the original mortgage.²⁹³ Generally, home equity loans in the 1980s, which were being made mostly to prime borrowers, were still cast mostly as second mortgages and tended to have lower balances, shorter maturities, and low combined loan to value ratios (that is, the combined loan-to-value ratio of both the first and second mortgages).²⁹⁴

By 1994, 12.9% of homeowners (about 8.2 million households) had home equity debt,²⁹⁵ totaling about \$255 billion in home equity debt by the end of 1993.²⁹⁶ Of these, 8.3% had a home equity line of credit, while 4.9% (worth about \$145 billion)²⁹⁷ had traditional home equity loans.²⁹⁸ Although this may give the impression that there was little increase in home equity lending between 1988 (when 11% of households had home equity debt)²⁹⁹ and 1994, Federal Reserve reports indicate that the 12.9% figure does not include home equity lending rolled into a refinancing of the borrower's first mortgage.³⁰⁰ The

291. Canner & Luckett, *Home Equity Lending*, *supra* note 195, at 339. The authors of the Federal Reserve study stated that it was difficult to isolate the amount of home mortgage debt attributable to home equity lending on the books of depository lenders because they were not required to report this separately. *Id.* at 340. Home equity lines of credit were at about \$75 billion by the end of 1988, putting the total home equity debt to between \$210 billion and \$265 billion, and making up between 10% and 12% of all home mortgage debt. *Id.*

292. Canner & Luckett, *Mortgage Refinancing*, *supra* note 279, at 607. Even with this growth in home equity lending, the purpose for which home equity loans were used in the 1980s remained fairly consistent with earlier loan uses, with 45% of traditional home equity loans being used for home improvement, 35% used for repayment of other debts, and 16% used for other real estate related charges in 1988. Canner & Luckett, *Home Equity Lending*, *supra* note 204, at 338. By contrast, only 5% of traditional home equity loans were used for car purchases. Canner & Luckett, *Mortgage Refinancing*, *supra* note 296. Canner & Luckett, *Recent Surveys*, *supra* note 279, at 577.

293. Canner & Luckett, *Mortgage Refinancing*, *supra* note 279, at 611 (finding that 60% of borrowers who refinanced home mortgage loans in 1989 also borrowed additional funds). This arrangement, of course, generally puts the lender in first-lien position. However, the study suggests that in 1989 home equity loans were still more prevalent than borrowing on home equity through refinancing, with 7% of all homeowners refinancing a mortgage for more than the original mortgage in order to liquidate equity, and 11 % of all homeowners taking out some kind of home equity loan. *Id.*

294. James D. August et al., *Survey of Finance Companies, 1996*, 83 FED. RES. BULL. 543, 549, n.15 (1997) [hereinafter August, *Survey*].

295. Canner & Luckett, *Recent Surveys*, *supra* note 279, at 572.

296. *Id.* at 579.

297. *Id.*

298. *Id.* This percentage of households having traditional home equity loans was actually a decrease from a rate of 5.4% in 1997. *Id.*

299. Canner & Luckett, *Home Equity Lending*, *supra* note 195, at 333-34.

300. Canner & Luckett, *Recent Surveys*, *supra* note 279, at 572, 582. In discussions of this phenomenon, the Federal Reserve reports focus not on subprime lending, but on the decrease in interest rates between 1991 and 1994 that motivated homeowners to refinance and

report also excludes data regarding loans securitized and removed from the balance sheet of loan originators.³⁰¹ Refinancing the first mortgage while making a home equity loan is a common feature in subprime home-secured lending, and is in fact necessary to enable the lender to take the first-lien position and avail itself of the DIDMCA preemption. Moreover, securitization and removal of loans from a company's balance sheet is a funding technique used by some subprime home equity lenders. Thus the 12.9% figure probably excludes a great deal of subprime lending. Additionally, the Federal Reserve reports are based on bank, savings and loan, and finance company data required to be reported by those entities that do not categorize commercial and residential information separately or designate lien position.³⁰² Thus the report indicates that although its home equity lending estimates by 1994 were more accurate than in the late 1980s, the estimates from 1990 forward "should still be viewed as subject to a fairly wide margin of error."³⁰³

Another notable market development by 1994 was an increase in the percentage of home equity loans being used to repay other debts, up significantly from 35% in 1988³⁰⁴ to 68% in 1993 and 1994.³⁰⁵ Concurrently, there was a decrease in the number of home equity loans being used for home improvements. In 1988, 45% of traditional home equity loans were used for home improvements.³⁰⁶ By contrast, in 1993 and 1994, only 38% of home

liquidate equity by borrowing more than necessary to refinance their outstanding balances. *Id.* at 582. A similar limitation was recognized by the Federal Reserve in its report of data from 1989 and 1992 surveys:

[T]he survey did not ask respondents about how the funds from a first mortgage were used: They are assumed to have been used to purchase a home. However, when mortgages are refinanced, people may extract funds from their accumulated equity beyond what is needed to finance the balance on their existing mortgage. The rise in refinancing noted earlier underscores the potential importance of such borrowing.

Arthur B. Kenmickell & Martha Starr-McCluer, *Changes in Family Finances from 1989 to 1992: Evidence From the Survey of Consumer Finances*, 80 FED. RES. BULL. 861, 875 (1994). A report by John C. Weicher, published by the Hudson Institute and funded by members of the subprime home equity industry, recognizes the same limitation of applicability of similar 1989 Federal Reserve reports. JOHN C. WEICHER, HUDSON INSTITUTE, *THE HOME EQUITY LENDING INDUSTRY: REFINANCING MORTGAGES FOR BORROWERS WITH IMPAIRED CREDIT* 99 n.20 (1997).

301. Canner & Luekett, *Recent Surveys*, *supra* note 279, at 579 n.1.

302. For example, finance company lending is reported to the Federal Reserve on a monthly basis in terms of total real estate credit, but the finance company reports do not distinguish between commercial and residential mortgage credit, or between first and second mortgages. *Id.* at 579 ("Estimating the amount of traditional home equity debt outstanding is somewhat more difficult, because fewer institutions provide specific data on this type of loan . . .").

303. *Id.*

304. Canner & Luekett, *Home Equity Lending*, *supra* note 195, at 338.

305. Canner & Luekett, *Recent Surveys*, *supra* note 279, at 577.

306. Canner & Luekett, *Home Equity Lending*, *supra* note 195, at 338.

equity loans were so used.³⁰⁷ This may have been caused by the 1986 tax change, but may also have been an indication that lenders were aggressively promoting debt consolidation loans secured by the borrower's residence.³⁰⁸

In 1995 home equity lending grew 11% from the previous year, and in 1996 it grew another 17% to a total of \$350 billion.³⁰⁹ By 1997 outstanding home equity debt was at \$420 billion,³¹⁰ and although the percentage of households with home equity debt stayed constant between 1993 to 1994 and 1997—at about 13%—the number of households with home equity debt grew about 10%, along with a growth in the number of households.³¹¹ Of those households with home equity debt, about 9 million (roughly 5% of households) had home equity loans, as opposed to home equity lines of credit.³¹² This \$420 billion represented a 60% increase from 1993 home equity loan totals.³¹³ However, these figures ignored home equity borrowing tied to refinancing³¹⁴ and were based on imprecise estimates.³¹⁵

In addition to a tremendous increase in home equity lending, during the 1990s the types of home equity loans being made also changed significantly. The 1980s trend of making prime loans as second mortgages gave way to an increase in First-lien subprime loans—loans with variable terms, such as adjustable rates, nonpurchase uses, and high loan-to-value ratios.³¹⁶ Thus the increase in home equity lending in general eventually led to an increase in subprime home equity lending.

307. Canner & Luckett, *Recent Surveys*, *supra* note 279, at 577.

308. For a discussion of subprime home equity loan solicitation techniques, see *infra* Part VI.D.2.

309. August, *Survey*, *supra* note 294, at 549; see also Arthur B. Kennickell, et al., *Family Finances in the U.S.: Recent Evidence from the Survey of Consumer Finances*, 83 FED. RES. BULL. 1, 16 (1997) [hereinafter Kennickell, *Recent Evidence*]. This report found:

The proportion of families borrowing through mortgage loans in 1995 was up slightly from the 1989 level, but the median amount outstanding rose about 30 percent over the six-year period. Over the same period, the median value of a primary residence rose only 4.8 percent; the much larger rise in the size of mortgage debt suggests that families were using more of their home equity for purchases or investments other than the purchase of their primary residence.

Id.

310. Canner, *Recent Developments*, *supra* note 285, at 242, 248.

311. *Id.* at 243.

312. *Id.*

313. *Id.* at 251.

314. *Id.* at 243. *But see id.* at 251.

315. *Id.* at 251 ("Estimating the amount of traditional home equity debt outstanding [as opposed to home equity lines of credit] is somewhat more difficult: Fewer institutions provide specific data on this type of credit, and much of the recent growth has been among holders for whom the data are the least precise.")

316. August, *Survey*, *supra* note 294, at 549 n.15.

B. The Explosion of Mortgage Brokers and Nondepository Lenders

In the mid and late 1980s the home equity loan and home mortgage loan market shifted away from traditional banks and thrift institutions, and new players emerged in the home-secured lending market. First, the number of home loan mortgage brokers increased significantly.³¹⁷ Second, nondepository mortgage lenders began to take a larger role in the market.³¹⁸

In 1977 nondepository mortgage lenders, such as finance and mortgage companies, lent only 1% of all home mortgage funds.³¹⁹ In 1979 finance and mortgage companies lent only .5% of all home mortgage funds.³²⁰ However, by 1989 nondepository lenders had a "significant market share," making 32% of all traditional home equity loans.³²¹ By 1990 real estate receivables at finance companies, which would include purchase money loans and nonpurchase money/home equity loans, amounted to \$61.2 billion dollars, and securitized receivables were up to \$24.9 billion.³²² This steady growth of finance company participation in real estate lending is significant because these lenders are now the most active group of subprime, nonpurchase money lenders.³²³

By 1994 finance companies held about \$40 billion of outstanding debt on traditional home equity loans.³²⁴ This made finance companies the second highest lender of traditional home equity loans.³²⁵ The character of mortgage lenders also changed in the early '90s as the savings and loan industry declined, and "the increase in the local presence of national mortgage lenders changed the types of institutions that families faced when obtaining loans."³²⁶

By 1995 finance companies held 21% of all outstanding family debt,

317. Bogdanich, *supra* note 279, at A2 (reporting that in New York the number of loan brokers had jumped from 54 in 1983 to 136 in 1985).

318. TWO STEPS BACK, *supra* note 1, at 40 (stating that "[the] shift of mortgage lending from depository institutions to mortgage companies has drastically reduced the proportion of home lending being examined by bank and thrift regulators").

319. Seiders & Luckett, *Household Borrowing*, *supra* note 165, at 153 tbl. 1.

320. Luckett, *Recent Financial Behavior*, *supra* note 132, at 437 tbl. 1.

321. Canner & Luckett, *Mortgage Refinancing*, *supra* note 279, at 608. The lenders included in this figure include not only finance companies, brokerage firms, and mortgage companies, but also previous owners, contractors or developers, employers, government agencies, and relatives. *Id.*

322. August, *Survey*, *supra* note 294, at 548.

323. WEICHER, *supra* note 300, at 12, 22. A 1994 Federal Reserve report noted that finance companies tend to make loans to lower income borrowers. Canner & Luckett, *Recent Surveys*, *supra* note 279, at 573; accord August, *Survey*, *supra* note 300, at 548 (finding that home equity loans extended by finance companies were generally to borrowers "below the top tier in credit quality.").

324. Canner and Luckett, *Recent Surveys*, *supra* note 279, at 579.

325. *Id.*

326. Kennickell and Star-McCluer, *supra* note 300, at 861. This study attributes growth in overall loan activity by finance companies to failures of savings and loans, and to a resulting decrease in loan origination market share by savings and loans (from 23.5% in 1989 to 18.9% in 1992). *Id.* at 879 tbl.12. At the same time, finance companies had a 12.9% loan origination market share in 1992, up from 9.4% in 1989. *Id.* at 879.

compared with 13.5% in 1992 and 9.6% in 1989.³²⁷ By 1996 there were approximately 1,250 nondepository financial institutions in the United States, although market share in the industry was concentrated in the top 20 firms.³²⁸ Real estate lending by finance companies, which would include purchase money loans and nonpurchase money/home equity loans, amounted to almost \$104 billion by mid-1996 (including \$23.5 billion in securitized real estate loans, compared to \$0 in 1990).³²⁹ Of this \$104 billion in real estate receivables, \$71 billion was to individual homeowners in one-to-four family properties, and nearly all were home equity, nonpurchase money loans.³³⁰ This rapid growth continued between mid-1996 and March 1997, with loans to individual homeowners growing at a 27.2% rate, from \$70.7 billion in receivables outstanding in mid-1996 to \$85.1 billion in receivables outstanding in March, 1997.³³¹ Because these figures do not include mortgage banking companies that finance their lending through securitization, which make many subprime home-secured loans,³³² the size of the nondepository mortgage loan industry was even larger than these numbers reflect. By 1997 finance companies had outstanding traditional home equity loan debt of \$48 billion, not including debt outstanding in securitized pools.³³³

C. *The Rise of Subprime Lending as a Distinct Industry and the Subprime Home Equity Industry*

Among the nondepository lenders taking a new role in the consumer financial services market in the 1980s and 1990s were lenders that specialized in lending to borrowers who were previously unable to get credit. These lenders became known as "subprime lenders," a term that referred to the supposed credit quality of the customers to whom they were making loans.

The subprime lending industry experienced tremendous growth in the 1980s and 1990s. In 1983, for example, subprime lending made up only 1.4% of all loans.³³⁴ By 1998 subprime loans made up 10.2 % of all loans.³³⁵ The industry experienced its most rapid and most significant growth in the home equity lending market.

While it is difficult to determine with precision just how big the subprime

327. Kennickell, *Recent Evidence*, *supra* note 309, at 20 tbl.13.

328. August, *Survey*, *supra* note 294, at 548 (finding that the top 20 firms owned 71% of total industry receivables in 1996).

329. *Id.* at 548, 547 tbl 1. This was a 9.2% increase between 1990 and 1996. *Id.*

330. *Id.* at 548. The report estimates that this made up about one-fifth of the entire home equity market. *Id.*

331. *Id.* at 550-51 tbl. 6.

332. *Id.* at 548 n.12.

333. Canner, *Recent Developments*, *supra* note 285, at 251.

334. Fred Faust, *Minorities Likely to Pay More for Loans, Report Says*, ST. LOUIS POST-DISPATCH, Oct. 22, 1999, at C8.

335. *Id.*

home equity market really is,³³⁶ the subprime home equity lending market clearly expanded rapidly during the early 1990s, with “over 90% of all subprime mortgage loans made in or after 1993.”³³⁷

This growth increased even more during the last half of the 1990s, with a tremendous increase in the number of subprime home equity loans being made.³³⁸ For example, in 1990 subprime home equity loan origination volume was at \$7 billion.³³⁹ By contrast, in 1996 subprime loan origination volume was between \$100 billion and \$150 billion—most of which was home equity lending.³⁴⁰ By 1997 home equity subprime origination generated around \$125 billion.³⁴¹ This made up about “11.5% of the total home equity lending market

336. Camner, *Recent Developments*, *supra* note 285, at 250. This report found:

The volume of subprime home equity credit cannot be estimated with much precision, in large part because definitional distinctions among different types of loans are not clear. With much of subprime home equity credit funded by securitization, an approximate measure of the volume of subprime credit can be derived from securitization volumes. But the loan pools designated as “home equity” pools frequently contain subprime purchase-money mortgages or refinanced loans as well; they may also mix some higher-quality home equity loans with the subprime paper. Conversely, not all subprime home equity loans are securitized.

Id. The same report found that “the rapid development of securitization of home equity loans and the expanding role of mortgage companies and specialized home equity lenders, for whom data reporting is fragmentary” had “introduced new sources of imprecision into the estimates” of home equity loans. *Id.* at 251; *see also* PREYING ON NEIGHBORHOODS, *supra* note 1, at 10 (explaining that because of reporting requirements and mixed prime and subprime lending by some lenders “determining the subprime market is not straightforward.”).

337. *Home Equity Lending Abuses in the Subprime Mortgage Industry: Hearings Before the Senate Special Comm. on Aging*, 105th Cong. at 63 (1998) (statement of Jodie Bernstein, Dir. of Consumer Protection of the FTC) [hereinafter *Home Equity Lending Abuses, Hearings*]; *see also* Matt Murray, *Ford’s Loan Unit Draws Criticism at a Hearing*, WALL ST. J., Mar. 17, 1998, at A4 (“Soaring profits fueled rapid growth in the business in the early 1990s, attracting numerous new players but leading to a credit glut.”).

338. The Weicher report estimated that ten years earlier the industry was “perhaps one-half to one-tenth its current size.” WEICHER, *supra* note 300, at 22.

339. Liz Pulliam, ‘Sub-Prime’ Lenders in Credit Crunch, L.A. TIMES, Oct. 12, 1998, at C1.

340. Jesus Sanchez, *Sub-Prime Time Finance: Faced With Thinning Profit Margins, Big Mortgage Lenders are Moving into High Risk Territory*, L.A. TIMES, Mar. 20, 1997, at D1. In the same year there was about \$800 billion in conventional mortgage origination. *Id.* Based on these figures, this meant that in 1996 the volume of subprime loans grew twice as fast as the volume of conventional loans. *Id.*

341. *Home Equity Lending Abuses, Hearings*, *supra* note 337. The Weicher report gave much lower numbers, showing subprime home equity lending at \$65 billion in 1995, \$43 billion in 1996, and \$60 billion in 1997. WEICHER, *supra* note 300, at 33, 97 n.1.

in 1996" and 15.5% of the market in 1997.³⁴² By another estimate, between 1995 and 1997 "subprime lenders more than tripled their market share of the total mortgage market . . . originat[ing] a full 15% of all mortgages, up from 4% in 1995."³⁴³ By a third estimate, the number of subprime nonpurchase loans increased by 890% between 1993 and 1998.³⁴⁴ In 1999 subprime loans are expected to make up more than 10% of the mortgage market and account for more than \$150 billion in loan originations.³⁴⁵

A recent study of subprime mortgage lending in Chicago also demonstrates the tremendous growth of subprime lending. In 1997 there were 50,953 subprime home equity loans made in the Chicago area, compared with 3,137 in 1991.³⁴⁶ This was a 1,524% increase.³⁴⁷ During the same time, nonsubprime loan origination volume grew by only 20,194 loans, a 14.6% increase.³⁴⁸ Subprime market share in the Chicago area rose from 2.6% of all loan originations in 1991 to 24.3% in 1997.³⁴⁹ According to the same study one subprime lender, The Money Store, made 584 subprime home equity loans in the Chicago area in 1994 and 2,906 of those loans in 1997—a 400% increase.³⁵⁰ Thus, as one 1998 Federal Reserve Report observed, "a new element has given a sharp boost to overall growth in home equity lending over the past couple of years, and that is the vigorous marketing by nonbank lenders to the 'subprime' segment of the market—homeowners with relatively low incomes, limited equity, or tarnished credit histories."³⁵¹

During the 1990s the number of lenders making subprime home equity loans also increased dramatically. This growth included some conventional mortgage lenders who ventured into the subprime market in the mid-1990s to find new customers and tap into market profits,³⁵² as well as other types of

342. *Home Equity Lending Abuses, Hearings, supra* note 337. The Weicher report estimated that subprime mortgage lending, including purchase money and nonpurchase money lending, grew at an annual rate of 25% between 1996 and 1997. WEICHER, *supra* note 300, at 37. The same report estimated that by 1997 subprime, nonpurchase money first-lien lending accounted for "5 to 10 percent of total mortgage originations in the U.S." *Id.* at 11, 22, 97 n.1.

343. PREYING ON NEIGHBORHOODS, *supra* note 1, at 6.

344. TWO STEPS BACK, *supra* note 1, at 5.

345. Christine B. Whelan, *FTC Cracks Down on Lending Abuses in Subprime Area*, WALL ST. J., July 30, 1999, at C10.

346. PREYING ON NEIGHBORHOODS, *supra* note 1, at 4; *Unregulated Subprime Loans Cause Chicago-Area Foreclosure Rates to Double, NTIC Study Finds*, PR NEWSWIRE, Sept. 20, 1999, at 1, available in LEXIS News Library, PR Newswire File [hereinafter *Unregulated Subprime Loans*].

347. PREYING ON NEIGHBORHOODS, *supra* note 1, at 4; *Unregulated Subprime Loans, supra* note 366, at 1.

348. PREYING ON NEIGHBORHOODS, *supra* note 1, at 17.

349. *Id.* at 16; *Unregulated Subprime Loans, supra* note 347, at 1.

350. PREYING ON NEIGHBORHOODS, *supra* note 1, at 6. The study also found that most of these loans were made in "lower-income neighborhoods." *Id.*

351. Canner, *Recent Developments, supra* note 285, at 249.

352. For example, Countrywide Home Loans, Inc., which had previously done only prime lending, moved into the subprime market in March 1997 with a division called Full Spectrum. Sanchez, *supra* note 340, at D1. Countrywide's reason for entering into the market

consumer companies that bought subprime mortgage companies.³⁵³ After a shortage of funds in late 1998, and after what some have described as a crash in subprime lender stocks during the first week of October 1998,³⁵⁴ the industry seemed to experience some consolidation, and some market participants filed for bankruptcy.³⁵⁵ Consumer lawsuits and government investigations may have also contributed to these business failures.³⁵⁶ Since that time, there seems to

was the size of the subprime borrower pool, and the fact that it could tap into this pool by directing to its new division the borrowers that were turned down by its prime division. *Id.*; see also 1998 Year in Review and 1999 Outlook, *Home Equity Asset-Backed Securities: To HEL in a Handbasket* 6, MOODY'S STRUCTURED FINANCE SPECIAL REPORT (Moody's Investors Service, New York, N.Y.), Jan. 8, 1999 [hereinafter 1998 Year in Review]; James S. Granelli, *California: Another Subprime Lender, New Century, Files for IPO*, L.A. TIMES, April 22, 1997, at D2 (stating that the "hot" subprime mortgage market had "spurred mergers and acquisitions" and pushed the traditional loan companies to join the subprime market). For an examination of bank movement into the subprime home equity market, see Evan M. Gilreath, Note, *The Entrance of Banks into Subprime Lending: First Union and The Money Store*, 3 N.C. BANKING INST. 149 (1999).

353. For example, in April 1997 H&R Block acquired Option One Mortgage Corp. for \$190 Million. Granelli, *supra* note 352, at D2. This sudden growth in the number and type of market participants caused one commentator to state that "[a] lot of new entrants are going to have their heads handed to them." Sanchez, *supra* note 340, at D1. In 1998 First Union Corp., the nation's then sixth largest bank, bought The Money Store, a company that started out as a subprime home equity loan lender and has since diversified into other financial services. 1998 Year in Review, *supra* note 352, at 6; Murray, *supra* note 337, at A4.

354. In the second week of October 1998 some stocks fell as much as 70%. Pulliam, *supra* note 339, at C1. This article indicated that "[t]he Wall Street funding that provided much of the capital for these loans is drying up, as recent severe losses in foreign financial markets and in the U.S. stock market have caused major banks and brokerages to shrink from risk-taking," and that investors instead invested in U.S. Treasury securities and other safer investments. *Id.*; see also Liz Pulliam, 'Sub-Prime' Lender Merger Deals Collapse, L.A. TIMES, Oct. 13, 1998, at C1 [hereinafter Pulliam, 'Sub-Prime' Lender Merger Deals] (giving as an example of the stock crash in October 1998 the value of stock in FirstPlus Financial Group, Inc., which made many 125% loan-to-value loans, and whose stock fell from about \$40 per share in March 1998 to \$2.56 in October 1998); 1998 Year in Review, *supra* note 352, at 4.

355. Bankruptcies have included Southern Pacific Funding Corp. (Oct. 1, 1998), Criimi Mae Inc. (Oct. 5, 1998), and Cityscape Financial Corp. (Oct. 7, 1998). Pulliam, *supra* note 339, at C1; Pulliam, *Sub-Prime Lender Merger Deals*, *supra* note 354, at C1. Other companies experienced financial problems. For example, in October 1998 Dylan Mortgage started to "go under" when it couldn't sell \$46 million in loans to other mortgage holding companies. Cory Reiss, *Bank in Court to Halt Lender's Building Sale*, MORNING STAR (Wilmington, N.C.), Aug. 24, 1999, at 2B. Between then and August 1999, Dylan laid off more than 250 employees—about 95% of its work force. *Id.*

356. For example, several consumer plaintiffs prevailed in lawsuits against United Companies Financial Corp. and/or its home equity loan subsidiary, United Companies Lending Corp. In one case, United unsuccessfully attempted to get declaratory relief invalidating the Massachusetts Attorney General's regulation prohibiting unconscionable points. *United Cos. Lending Corp. v. Sargeant*, 20 F. Supp. 2d 192, 209-10 (D. Mass. 1998). The regulation was upheld, and United ultimately settled with an agreement to pay substantial refunds of points to Massachusetts borrowers. *Id.*; see also *Newton v. United Cos. Fin. Corp.*, 24 F. Supp.2d 444 (E.D. Pa. 1998) (finding that United withheld required disclosures from plaintiffs and overcharged in loan origination fees and finance charges); *Autrey v. United Cos. Lending Corp.*, 872 F. Supp. 925 (S.D. Ala. 1995); *Autrey v. United Cos. Lending Corp.*, 723 So.2d 617, 624

have been a concentration of market share in a smaller number of stronger market participants.³⁵⁷ However, analysts do not expect the business to go away. "Instead, it is likely to shift to larger, better-financed companies that can provide their own funding," such as Associates and Household International.³⁵⁸

There are several reasons why the subprime home equity market grew so rapidly in the 1990s.³⁵⁹ First, subprime lending has been viewed as risky but quite profitable.³⁶⁰ Second, success in expanding the number of lower income individuals who own their own homes has provided a new market for subprime lenders to target.³⁶¹ Third, the easy availability of unsecured credit, such as credit cards, and the lack of health insurance have caused some families to resort to tapping into their home equity to pay their bills.³⁶² Finally, securitization and an increased number of mortgage brokers have played a large role in the growth of the subprime market.

D. *The Increased Use of Securitization to Fund Loans*

Yet another market development that now plays a large role in subprime home-secured lending is the increased reliance on securitization of loan pools

(Ala. 1998)(holding that United was prohibited from charging points in excess of that amount set forth under Alabama law); *United Cos. Lending Corp. v. McGehee*, 686 So. 2d 1171, 1173-74 (Ala. 1996) (alleging that United made false representations to plaintiffs in connection with a loan transaction); *Arnold v. United Cos. Lending Corp.*, 511 S.E.2d 854, 862 (W. Va. 1998) (finding that arbitration clauses contained in loan documents were unconscionable and invalidating them). In March 1999, United filed for bankruptcy. *Troubled Lender Files Chapter 11*, AP Online, March 1, 1999, available in WESTLAW 1999 WL12934492 (1999) (mentioning United's plans to file for bankruptcy).

Dylan Mortgage in North Carolina, which had serious financial problems in October 1998, had been the target of an investigation by North Carolina's Attorney General. Reiss, *supra* note 355, at 2B. After the Attorney General began its investigation, Dylan changed its name to Chase Mortgage and began brokering rather than funding mortgages. *Id.* In another example, shares of First Alliance Corp. fell 83% in 1998. Pulliam, *supra* note 339, at C1. At the time, they were under investigation by state and federal regulators in regard to their lending practices. *Id.*

357. Some larger market participants have acquired other market participants. For example, Aames Financial Corp. acquired One Stop Mortgage. Sanchez, *supra* note 352, at D1. Other companies have indicated that they were open to takeovers. See, e.g., Murray, *supra* note 337, at A4 (explaining that in March 1998 Beneficial Corporation had put itself "on the block" looking for a purchaser).

358. Pulliam, *supra* note 339, at C1. Indeed, the FTC cites the growth of subprime lending by large nationwide corporations as a "dramatic change" in the subprime market. *Home Equity Lending Abuses, Hearings*, *supra* note 337, at 63. Some people believe that if, as expected, banks and other large firms take over the subprime market, this will lower the costs of making and servicing subprime loans. Karen Thomas, *Regulators Say RESPA and HOEPA Need Better Enforcement*, 9 ORIGINATION NEWS, Oct. 1, 1999, at 43. Some, though not all, also think that this decrease in cost will be passed on to consumers. *Id.*; see generally *1998 Year in Review*, *supra* note 352, at 9 (discussing the outlook for subprime loans in 1999).

359. For a flow chart entitled "The Causes of Increased Predatory Lending in Minority and Lower-Income Communities", see TWO STEPS BACK, *supra* note 1, at 13.

360. *Home Equity Lending Abuses, Hearings*, *supra* note 337.

361. TWO STEPS BACK, *supra* note 1, at 12.

362. *Id.* at 12, 14.

to provide funds to lenders. Securitization involves grouping loans into loan pools. Securities are sold in the pools by various investment banking firms.³⁶³ Any given securities offering in a pool of subprime loans will have several classes of investments available for purchase by investors.³⁶⁴ Investors are compensated through interest paid based on the class of securities purchased by the investor. There is always a spread between the interest paid to investors and the interest charged to borrowers on loans in the pool. The difference between the amount paid by the borrowers and the amounts paid to investors is meant to cover the lender's risk of loss and any servicing costs. After such costs, any money left from this difference in interest is usually paid to the lender.³⁶⁵ The pools of loans are sometimes insured or credit-enhanced, and they are rated by the various major bond rating agencies.³⁶⁶

Subprime lenders began to securitize pools of loans in earnest by the mid 1990's. In 1994 subprime lenders securitized approximately \$10 billion worth of home equity loans.³⁶⁷ By the end of 1997 "the amount of home equity credit in securitized pools was about \$90 billion . . . much of it believed to be subprime in quality."³⁶⁸ This was about one-fifth of all the outstanding home equity credit at the end of 1997.³⁶⁹ In 1998 there was a 30% increase in securitization of subprime home equity loans, with a total 1998 volume of around \$85 billion, despite a slight drop in securitizations during the end of 1998.³⁷⁰ This led the Federal Reserve to comment, "[m]ost subprime lenders place heavy reliance on securitization of their loans to fund their operations."³⁷¹

VI. CHARACTERISTICS OF MODERN SUBPRIME NONPURCHASE MONEY HOME-SECURED LENDING

A. *What is a Subprime Home Equity Loan?*

A subprime home equity loan is a loan made to a borrower who, according to a particular lender's underwriting standards and the lender's assessment and categorization of the borrower, does not qualify for a loan at a conventional

363. August, *Survey*, *supra* note 294, at 543-44.

364. WEICHER, *supra* note 300, at 33.

365. When loans in a securitized pool go into default, the lender may repurchase the loan out of the pool, thereby decreasing the loss to investors and decreasing the spread paid to the lender. *1998 Year in Review*, *supra* note 352, at 8.

366. WEICHER, *supra* note 300, at 33.

367. TWO STEPS BACK, *supra* note 1, at 12.

368. Canner, *Recent Developments*, *supra* note 285, at 250.

369. *Id.*

370. *1998 Year in Review*, *supra* note 352, at 1-2; *see also* TWO STEPS BACK, *supra* note 1, at 12 (stating that in 1998, "the issuance of asset-backed securities (ABS) for home equity loans . . . [was approximately] \$80 billion").

371. Canner, *Recent Developments*, *supra* note 285, at 249.

mortgage rate.³⁷² Each subprime lender sets its own underwriting standards through funding matrices. These matrices set certain criteria that define a borrower as subprime, and further grade the borrower into a subprime category (A, B, C, or D).³⁷³ Within the funding matrices, the minimum costs of the loan go up with each credit downgrade.³⁷⁴ Thus if a lender designates a particular borrower as a "C borrower" the minimum interest rate that borrower will get is higher than if the same borrower were categorized as a "B borrower." These funding matrices purportedly categorize borrowers based on their credit history, property loan-to-value ratios and, sometimes, on the borrowers' credit scores—a number assigned to borrowers based on a credit scoring system developed by the lender itself or by the Fair, Isaacs & Company (FICO) credit scoring system. The matrices then set a loan rate based on the lender's categorization of the borrower.³⁷⁵

Because each subprime lender maintains its own underwriting standards, there is tremendous diversity in funding standards across the subprime industry.³⁷⁶ Furthermore, any given company's funding standards change periodically.³⁷⁷

Despite the appearance from the matrices of uniform application of funding standards, it is well known in the industry that subprime lenders do not strictly follow their underwriting guidelines. As the Weicher report found, "[subprime home equity lender funding] matrices are themselves only general guidelines 'Underwriting to the matrix is an art, not a science.'"³⁷⁸ Thus,

372. As explained by the Federal Reserve, "Subprime loans include those with more lenient underwriting standards (such as high loan-to-value ratios), those made to borrowers with blemished credit histories, and those with both characteristics." August, *Survey*, *supra* note 294, at 549; see generally WEICHER, *supra* note 300, at 34, 56-57 (noting that subprime borrowers are further categorized by lenders in funding subcategories usually designated as A-, B, C, or D, with A- being the best of these categorizations and D being the worst).

373. WEICHER, *supra* note 300, at 34-35.

374. *Id.* at 57 tbl.4-1.

375. For a description of the Fair, Isaacs Credit Scoring system see WEICHER, *supra* note 300, at 36-37. For example, the Weicher report, published by the Hudson Institute and funded by members of the subprime home equity industry, found that the range of credit histories that put a borrower in a B-rated category ranged from two to four thirty-day delinquencies, or three thirty-and one sixty-day delinquency. *Id.* at 34; August, *Survey*, *supra* note 294, at 549. For some companies, the funding matrix sets the rate that can be charged to borrowers placed in that category, but then allows the rate to be increased by an undesignated amount in a number of circumstances. See, e.g., United Companies Lending Corporation, Fixed and ARM Loan Programs and Underwriting Parameters, January 1, 1996, Trial Exhibit U1-33, 16-17, *Newton v. United Cos. Fin. Corp.*, 24 F. Supp. 2d 444 (E.D. Pa. 1998).

376. WEICHER, *supra* note 300, at 13, 34-37 (finding that "[t]here is general agreement in the industry that [funding and credit] standards vary across firms."). For an example of subprime grades, see Sanchez, *supra* note 340, at D1.

377. WEICHER, *supra* note 300, at 35.

378. WEICHER, *supra* note 300, at 35 (quoting Rudy Orman, Originating and Marketing Techniques for B/C Mortgages Through Wholesale & Correspondent Channels, Presentation at the Non-Conforming Credit Lending Conference of the Mortgage Bankers Association of America (Jan. 13, 1997); see also *Newton*, 24 F. Supp. 2d at 453 (recognizing that United set its underwriting standards based on "what it was already doing in terms of evaluating

in many cases, rates and points may be assigned to an individual borrower with no reference to the funding matrix at all. This tendency toward nonuniform application of underwriting standards is probably exacerbated by the various types of agents that originate subprime home equity loans on behalf of subprime lenders. Some subprime lenders maintain retail offices, making loans directly to borrowers through these offices.³⁷⁹ Other loans are made by "correspondent lenders" with borrowed funds from another lender.³⁸⁰ However, other loans are made by mortgage brokers who then sell the loans to subprime companies after taking a fee out of the disbursed loan funds.³⁸¹ In this case the larger the loan, and the worse the credit categorization, the higher the broker's fee, thereby providing incentive for brokers to write larger loans and give borrowers poorer credit categorizations than they might deserve.³⁸² The same incentive may be present in retail and correspondent lending structures, with employee commissions serving as the impetus for overcharging borrowers.³⁸³

Whether the borrower deserves to be categorized as subprime or not, and whether the lender even attempts to categorize the borrower as subprime or within credit grades, one thing is certain: a subprime loan involves higher interest rates and fees than the borrower would pay if the borrower were made a conventional loan.³⁸⁴

the ability of low-income households to repay loans" and not based on "any research or study," and finding that United had not followed these underwriting standards in making the loans that were the subject of the case) (citations omitted); *1998 Year in Review*, *supra* note 352, at 6 (mentioning Freddie Mac's "A-minus" quality subprime loans).

379. WEICHER, *supra* note 300, at 13, 32. The Weicher report estimated that this makes up approximately one-sixth of the market. *Id.* It also found that in 1996 retail operations accounted for 17% of subprime loan originations. *Id.*

380. This practice sometimes is referred to as "table funding," and the line of credit issued by the backup lender to the initial lender is called a "warehouse line of credit." 24 C.F.R. § 3500.2 (1999) (defining table funding). The Weicher report found that in 1996 correspondents accounted for approximately 47% of subprime loan originations. WEICHER, *supra* note 300, at 32.

381. WEICHER, *supra* note 300, at 13, 32. The Weicher report found that in 1996 mortgage brokers accounted for 36% of subprime loan originations. *Id.* Recently, borrowers have sued mortgage brokers and others over broker fees and how such fees are disclosed. *See, e.g., Culpepper v. Inland Mortgage Corp.*, 132 F.3d 692, 694 (11th Cir. 1998). This yield spread premium issue is outside the scope of this Article.

382. The Woodstock Institute Study recognizes that lenders have an "incentive to refinance all outstanding debt even if the rate of the new loan is higher than the existing mortgage" because this brings the loan principal up and thus generates higher points and fees for the lender and/or broker. TWO STEPS BACK, *supra* note 1, at 19.

383. *See generally Newton*, 24 F. Supp. 2d at 449-50 (recognizing that the loan officer had acted dishonestly in order to protect his commission).

384. Canner, *Recent Developments*, *supra* note 302, at 249 ("Loans in this higher-risk segment carry interest rates several percentage points higher than those on 'A-quality' home equity loans . . ."); Pulliam, *supra* note 339, at C1 ("Subprime lenders make their money by charging higher rates and fees. While a traditional home equity loan to someone with good credit might carry a 9% rate, subprime lenders typically charge 11% to 14%, plus up to 10% of the loan amount in additional fees.").

B. *Subprime Home Equity Loan Price Terms: Rates, Points, and Other Charges*

The hallmark of a subprime loan is a high interest rate and high points or fees charged at the time the loan is closed.³⁸⁵ Although it is clear that subprime pricing is higher than conventional lending, it is impossible to determine or describe with accuracy the rates, points, and fees charged by the subprime home equity industry as a whole, because pricing information is neither collected by any public source nor advertised with specificity by the industry.³⁸⁶ Nevertheless, it is still possible to make some general conclusions about the subprime home lending industry and market from the information that is available.

1. *Interest Rates*

Because lenders do not set interest rates based on any common factors, even within their own company,³⁸⁷ it is impossible to determine average interest rates for subprime borrowers with any amount of certainty. Each loan made by a subprime company is made on an individual basis, and interest rates for each loan are disclosed in loan documents that are not recorded or reported anywhere. However, as described earlier, many subprime loans are grouped with other loans in loan pools, and securities are then sold in the pools—a process known as securitization.³⁸⁸ When a lender sells securities in the pool of loans, the lender must issue a prospectus that is filed with the Securities and Exchange Commission. Each prospectus describes the pool of loans in a given securities offering. These prospectuses taken together provide the only public source of rate information for subprime loans. Although not comprehensive, and not necessarily representative of loans that are not securitized, the information from these prospectuses provides a good picture of loan rates being

385. Points are fees to the lender that are paid up front and are usually a percentage of the principal amount of the loan. Because high interest rates and/or points and fees are the hallmarks of a subprime loan, the Home Ownership Equity Protection Act (HOEPA)—an act to protect homeowners in some high cost home equity loans—covers loans that have an annual percentage rate of more than 10% above the yield on comparable-length treasury securities, and loans in which the “total points and fees payable by the consumer at or before closing will exceed the greater of (i) 8 percent of the total loan amount; or (ii) \$400.” 15 U.S.C. § 1602(aa)(1) (1994). A full discussion of HOEPA can be found at *infra* Part VII.A. of this Article.

386. For expressions of frustration over the difficulty of analyzing the industry given the unavailability of pricing information, PREYING ON NEIGHBORHOODS, *supra* note 1, at 11 (concluding that “[u]nless and until all lenders directly report, in a timely and accurate fashion, such data as interest, Annual Percentage Rate[APR], fees, and the like, it will be impossible to get a more accurate picture of subprime lending practices than that provided here.”); *id.* at 37-38 (advocating that subprime lenders, mortgage brokers and home improvement contractors be required to report interest rates, fees, and APRs as well as the terms of loans made and the broker or home improvement contractor involved in the loan).

387. See *supra* Part VI.A.

388. See *supra* Part V.D.

charged in a large portion of the subprime home equity market.³⁸⁹

In order to get a sense of interest rates in the subprime home equity market, the author examined the Securities and Exchange Commission (SEC) Form 424(b)(5) Filings³⁹⁰ by the fourteen top subprime home equity lenders (chosen based on their ranking by the National Mortgage News Quarterly Data report in the fourth Quarter of 1998).³⁹¹ These fourteen lenders together originated just over 50% of the subprime home equity loans generated by the top 100 subprime lenders in the fourth quarter of 1998.³⁹²

Only six of these fourteen lenders³⁹³ had made regular filings with the SEC. Furthermore, it is likely that not all of these six lenders securitize all of the loans they originate. Nevertheless, the SEC filings allow a look at loan rates for 1,065,753 loans that were placed in securitized pools between 1995 and 1999.³⁹⁴ While this is most certainly not a statistical sampling, it is surely a significant one.

The rate range for these subprime loans increased between 1995 and 1999, ranging in 1995 between 5.00% and 17.99%, and between 3.00% and 19.99% in 1999.³⁹⁵ For Green Tree Financial, the range of rates in 1999 alone was between 4.00% and 19.99%.³⁹⁶ By contrast, the range of rates in the conventional market was never more than two percentage points.³⁹⁷

The median interest rate for the subprime loans was between 10% and 10.99% in 1996 and 1997, and between 11% and 11.99% in 1995, 1998, and

389. In this regard, the NTIC study found that subprime loans in the Chicago area frequently were adjustable rate mortgages in which the interest rate adjusted up every six months. PREYING ON NEIGHBORHOODS, *supra* note 1, at 6. Adjustable rate mortgages are permitted in these loans because of AMTPA.

390. These filings describe the loans in securitized loan pools.

391. National Mortgage News, *Top Subprime Lenders in Q498* (visited Oct. 10, 1999) <<http://www.mortgagstats.com/demos/qdr/BCOrig.htm>>. The list ranks subprime lenders based on loan origination volume. The lenders are Associates, Household Financial, ContiMortgage Corporation, Green Tree Financial, The Money Store, Commercial Credit/Travelers, Advanta Mortgage USA, Equicredit Corporation, Amresco, Option One Mortgage Corporation, New Century Financial, Impac, Long Beach Mortgage, and Residential Funding/GMAC. *Id.*

392. *Id.*

393. Green Tree Financial, Equicredit Corporation, Amresco, Option One Mortgage Corporation, Impac, and Residential Funding/GMAC. These six lenders originated just over 18% of the subprime home equity loans originated by the top 100 subprime lenders. *Id.*

394. Of these loans, 168,485 were in pools in 1995; 247,609 were in pools in 1996; 217,637 were in pools in 1997; 214,844 were in pools in 1998; and 216,178 were in pools in 1999.

395. The range during 1996, 1997, and 1998 was between 4.00-4.99% and 19.00-19.99%.

396. See *infra* Appendix 1 at tbl. 6.

397. 1995 rates on conventional thirty-year fixed rate mortgages ranged between 7.2% and 9.15%; 1996 rates on conventional thirty-year fixed rate mortgages ranged between 7.03% and 8.32%; 1997 rates on conventional thirty-year fixed rate mortgages ranged between 7.10% and 8.14%; 1998 rates on conventional thirty-year fixed rate mortgages ranged between 6.71% and 7.14%; 1999 rates on conventional thirty-year fixed rate mortgages ranged between 6.79% and 7.91%. Federal Reserve Board, *30-year Conventional Mortgages, fixed-rate* (visited Jan. 4, 2000) <<http://www.federalreserve.gov/releases/H15/data/m/cm.txt>>.

1999.³⁹⁸ During those same years, the annualized rate on conventional thirty-year mortgages was 7.95% (1995), 7.80% (1996), 7.60% (1997), 6.94% (1998), and 7.43% (1999).³⁹⁹ Therefore, the median interest rate for the subprime loans was at least 2.2 percentage points—and as much as 4.06 percentage points—higher than the conventional annualized rate.⁴⁰⁰

The full rate distribution on these loans is shown in Table 1, set forth below and reprinted in Appendix 1 to this Article.

Table 1: Rate Distribution for Subprime Loans

Rate	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>
3.00-3.99	-	-	-	-	1
4.00-4.99	-	2	20	16	23
5.00-5.99	3	597	1,332	1,876	2,009
6.00-6.99	33	1,860	2,681	5,218	9,544
7.00-7.99	2,432	12,527	14,339	11,138	8,024
8.00-8.99	12,032	38,226	30,312	17,739	17,367
9.00-9.99	13,715	39,602	36,192	31,193	29,361
10.00-10.99	40,114	62,220	41,763	34,796	29,004
11.00-11.99	50,144	47,866	36,692	30,517	26,132
12.00-12.99	29,716	27,588	23,758	26,856	28,274
13.00-13.99	12,217	8,564	16,202	22,499	31,116
14.00-14.99	3,890	4,519	8,515	16,331	18,104
15.00-15.99	4,365	3,517	4,212	10,184	7,139
16.00-16.99	789	441	1,349	4,464	6,846
17.00-17.99	35	71	245	1,995	2,765
18.00-18.99	-	8	22	16	425
19.00-19.99	-	1	3	6	44
# of Loans	169,485	247,609	217,637	214,844	216,178

398. See tbl. 1.

399. Federal Reserve Board, *30-year Conventional Mortgages, fixed-rate* (visited Jan. 4, 2000) <<http://www.federalreserve.gov/releases/H15/data/m/cm.txt>>.

400. These numbers were computed by taking the lowest of the median range for each year (e.g. 11% in 1995) and subtracting the annualized rate (e.g., 7.95% in 1995).

Appendix 1 shows the rate distribution for all of the examined loans by year in both tabular and graphical format. Graphs 2-6 show the rate distribution for each year between 1995 and 1999 in graphical format, while Tables 2-6 display the same data in tabular format (divided by lender).⁴⁰¹

Recent studies have also examined nonstatistical samplings of interest rates. For example, the Chicago study⁴⁰² looked at the records for 2,074 properties sold at a foreclosure sale in 1993, and for 3,964 properties sold at a foreclosure sale in 1998.⁴⁰³ Based on the rate information available in that group of loans⁴⁰⁴ the study determined that the average interest rate on foreclosed loans began to move up after the advent of subprime lending, rising higher and higher above the thirty-year Treasury rate. Before the emergence of subprime lending the average rate on foreclosed loans had stayed in relative step with thirty-year Treasury rates.⁴⁰⁵ The study also determined that of the loans foreclosed in 1993 and 1998, there was a 43.4% rise in loans with a rate of zero to two points above the thirty-year Treasury rate, an 8.7% rise in loans with a rate of two to four points above the thirty-year Treasury rate, a 521.1% rise in loans with a rate of four to six points above the thirty-year Treasury rate, a 316.3% rise in loans with a rate of six to eight points above the thirty-year Treasury rate, and a 56% rise in loans with a rate of more than eight points above the thirty-year Treasury rate.⁴⁰⁶ Loans with rates of four to eight points over the thirty-year Treasury rate made up 6.5% of foreclosures in 1993, and 22% of foreclosures in 1998.⁴⁰⁷ Based on unpublished data from the Mortgage Information Corporation, the Weicher report disclosed mean subprime interest

401. Individual company data for these companies may be obtained from the author.
402. PREYING ON NEIGHBORHOODS, *supra* note 1.

403. *Id.* at 10.

404. Interest rate information was available for 1,641 of the 1993 foreclosures and 2,579 of the 1998 foreclosures. *Id.* at 10.

405. *Id.* at 18. The study found that:

As can be seen in Figure 5, the interest rate on Chicago foreclosed properties ran steadily between one and two percentage points above the Treasury rate from 1977 to 1993 at their origination. In other words, interest rates on foreclosed properties mimicked the Treasury rate's peaks and descents until 1993. After 1994, in a new trend, interest rates on foreclosed properties began to diverge from the Treasury rate. The divergence that began in 1994 corresponds to the expansion of the subprime lending market in Chicagoland. The increase in interest rate on loans that went into foreclosure strongly suggests that the advent of subprime lending, which is responsible for most loans at higher interest rates, plays an important role in the foreclosure increase.

Id.

406. *Id.* at 20.

407. *Id.* at 21-22.

rates of 11.04%.⁴⁰⁸ The same study showed average mortgage rates for five subprime lenders at a range between 10.54% and 14.04%.⁴⁰⁹

It would appear, then, that rates at which subprime loans are made are on the rise.⁴¹⁰ By contrast, conventional thirty-year mortgage rates have stayed between 6.71% and 8.32% since the end of 1996 and did not go above 7.94% in 1998 or 1999.⁴¹¹

High rates have real consequences for borrowers. While the difference between a 12% subprime and an 8% prime mortgage rate may seem small, the cost to a low or moderate income homeowner is great. On a typical \$50,000 mortgage, for example, over thirty years the interest payments at 8% would be \$82,079.97, while at 12% they would be \$135,138.78—a difference of \$53,058.81. The monthly payment would be \$366.88 at 8% and \$514.31 at 12%. These payments would represent 31% of a \$1,200 monthly income at the conventional interest rate, but over 43% of the same income at the subprime rate. Thus, for the homeowner-borrower, the costs of being steered to a subprime loan are large (even without regard to the points and fees). Moreover, the higher rate increases the risk of default because it increases the burden on the homeowner's budget.

The high rates and fees charged by subprime lenders purportedly serve to cover the risk of default associated with making loans to borrowers with poor credit or limited income. Various industry-related materials and industry representatives broadcast this justification.⁴¹² With these statements and

408. See WEICHER, *supra* note 300, at 58-59.

409. *Id.* at 60 (showing average mortgage rates for GE at 10.54%, Conti at 11.66%, Equicredit at 12.30%, Advanta at 13.39%, and Alliance at 14.04%).

410. By contrast, the subprime home equity industry's Weicher report concluded that "[i]nvestors' willingness to buy the [securities backed by pools of subprime home mortgages] has in turn translated into lower interest rates on the underlying mortgages." *Id.* at 45. Similarly, one newspaper article reported that "[m]any lenders . . . have cut their fees and their fat profits as the competition for the most credit-worthy borrowers in the sub-prime field has intensified." Sanchez, *supra* note 340, at D1; see also *1998 Year in Review*, *supra* note 352, at 1, 3 (reporting a drop in whole loan prices at the end of 1998).

411. Federal Reserve Board, *30-year Conventional Mortgages, fixed-rate* (visited Jan. 4, 2000) <<http://www.federalreserve.gov/releases/H15/data/m/cm.txt>>.

412. For example, the Weicher report repeatedly asserts that subprime rates are justified and required by the risk involved in making subprime loans. WEICHER, *supra* note 300, at 15-16 (stating that "[i]nterest rates in the subprime home equity loan market are higher than the rates on prime loans, because subprime lenders face higher servicing costs and assume more risk"; that "lenders charge higher rates on loans expected to be riskier"; and that "rates are higher, and terms less generous, on riskier loans."). Various subprime lenders have also indicated that their rates relate to risk. See, e.g., Pulliam, *supra* note 339, at C1 (reporting that the Chief Operating Officer of IndyMac Mortgage Holdings, Inc. had announced a rate increase "to help cover its risks."); Carol Frey, *A Home Buyer Takes on His Lender*, RALEIGH NEWS & OBSERVER, Jan. 13, 1999, at D1 [hereinafter Frey, *Home Buyer*] (reporting that "United Companies and other mortgage lenders argue that high fees and low-cost complaint arbitration cover their risk of making loans to the poor and others with flawed credit records," and that United said it had to "charge higher rates and fees to offset the risk of making loans to someone who doesn't have stellar credit").

materials, subprime lenders seek to paint a picture of an industry that carefully places borrowers into well-researched categories based on their credit histories, risk of delinquency, default, and nonpayment. Under this model, high subprime rates are merely devices through which lenders cover their costs and make an acceptable profit. However, the reality of the subprime home equity market is quite different.

First, subprime home equity lending generally has been a very profitable business and continues to be so for most lenders.⁴¹³ For example, in testimony before Congress during consideration of the Home Ownership and Equity Protection Act (HOEPA), Fleet Funding testified that in 1992 it lost approximately \$8 million on foreclosures,⁴¹⁴ but nonetheless generally makes about \$30 million dollars annually.⁴¹⁵

Recent earnings figures also show that this type of lending has been very profitable for some lenders.⁴¹⁶ For example, Associates, Household, ContiMortgage, Green Tree/Conseco, The Money Store/First Union, Advanta, Amresco, and Impac each had positive earnings per share during the first three quarters of 1999.⁴¹⁷ This general profitability suggests that pricing is not tied to risk very tightly. If pricing were largely based on risk, one would not expect to see such profits.

Second, if pricing of individual loans were tied to risk one would expect to see fairly uniform underwriting standards, correlative pricing, and obedience to loan origination standards. Instead, the industry as a whole engages in ad hoc

413. Sanchez, *supra* note 340, at D1 (stating that "Wall Street has responded enthusiastically to the public stock offerings of several sub-prime lenders, such as Aames, which outperformed the shares of many traditional banks" and quoting an industry analyst as saying that subprime lending's growth and profitability outweighed the potential risks for newcomers); see also Murray, *supra* note 337, at A4 (referring to subprime profitability in the early 1990s as "soaring"); Pulliam, *supra* note 339, at C1 (quoting an industry analyst as saying that "[t]he subprime market is not going to go away It's too profitable."); Bernard Trujillo, *Bankruptcy Reform: Who Should Decide Creditworthiness*, CHI. TRIB., Sept. 13, 1999, § 1, at 21 (stating in regard to high risk lending in general that "lenders have been taking bigger risks with their money and demanding higher returns. This has translated into a relaxation of lending criteria, along with huge gains for lenders.").

414. *Id.*

415. *Id.*

416. Determining profitability in the subprime home equity loan market is difficult for many reasons. First, very few of the top subprime lenders are pure home equity lenders, so their earnings figures reflect profit and loss across other subprime consumer markets, and in some cases profits across prime and subprime markets. Second, not all subprime home equity companies are publicly traded. The earnings information for these companies is sometimes not available. Finally, it must be acknowledged here that subprime home equity lending has not been, in the long run, profitable for some companies, like United, which have ended up in bankruptcy. *Troubled Lender Files Chapter 11*, AP Online, Mar. 1, 1999, available in WESTLAW, 1999 WL12934492 (1999).

417. See *infra* Appendix 3. These lenders were ranked first, second, third, fourth, fifth, seventh, ninth, and twelfth, respectively, in subprime home equity loan origination volume in the fourth quarter of 1998. National Mortgage News Quarterly Data Report, *Top Subprime Lenders in Q4 98* (visited Oct. 10, 1999) <<http://www.mortgagestats.com/demos/qdr/BCOrig.htm>>.

underwriting and pricing,⁴¹⁸ undermining any claim that the price an individual borrower gets is somehow carefully tied to the risk affiliated with the borrower's credit history or credit score. Furthermore, one would expect to see lower rates for borrowers with loans that have risk averse features, such as loans that are fully secured and have low loan-to-value ratios.⁴¹⁹

Third, the risk of loss on individual loans is spread across loan pools for securitized loans, and across all loans held by a company in its portfolio. Thus, while the risk of loss on an individual loan may be high, the risk of loss for the lending company, or for investors in a pool of subprime loans, is determined by the performance of a whole group of loans. Furthermore, risk to investors on securitized loans is further diluted through third party insurance, guarantees, credit enhancements, and, on other loans, through sale in the secondary market.⁴²⁰

Fourth, the notion of risk is a complicated idea in itself. The industry treats risk as though it were a static factor in existence before the loan is made and constant after the loan is made. However, this concept of risk fails to consider whether the loan creates risk that did not exist prior to the loan's origination.⁴²¹ When an expensive or high loan-to-value loan is made to a borrower who can barely afford it, the loan itself creates its own risk of default. In other words, someone who is only marginally able to make payments on existing debt *before* taking out a home equity loan may be pushed over the limit by a loan that reflects a high debt-to-income ratio. This phenomenon is probably most clearly

418. See *supra* Part VI.A.

419. TWO STEPS BACK, *supra* note 1, at 11 (stating that "[u]nder appropriate risk-based [pricing] schemes, for example, loans with lower loan-to-value ratios, other things being equal, are made at lower rates.").

420. Robert B. Avery et al., *Credit Risk, Credit Scoring, and the Performance of Home Mortgages*, 82 FED. RES. BULL. 621 n.1 (1996) (stating that "[i]nstitutions that originate mortgages do not necessarily bear the credit risk of the loans; the risk is often borne, at least in part, by a mortgage insurer or by an institution that purchases mortgages."); see also Canner, *Recent Developments*, *supra* note 287, at 249. Canner notes:

Through such means as third-party insurance guarantees or senior/subordinate debt structures, investors in the securities are largely insulated from credit losses; and the securities receive triple-A ratings, yielding returns of only 50 to 150 basis points above Treasury securities of comparable maturity. Ultimately, the home equity lenders bear the bulk of the credit risk, designed to be covered by the sizable margin between the interest rates paid by the subprime borrowers and the yield to the security holders.

Id.

421. The Woodstock Institute study recognizes and describes how high-cost home equity lending creates risk by moving unsophisticated borrowers into loans they cannot afford that are secured by a residence, and traps them into refinancing and paying fees over and over. TWO STEPS BACK, *supra* note 1, at 9-10. The study also points out that the credit risk for a given borrower can appear to increase after the borrower becomes a victim of such predatory lending. *Id.* at 11.

demonstrated by the cases of senior citizens who have lived in the same home for a long time—sometimes decades—only to lose their home after beginning a relationship with a subprime lender.⁴²²

Thus, it does not appear that pricing is closely tied to actual risk or any other objective factors. Nonetheless, because of DIDMCA and an imperfect distribution of information in the subprime loan market, lenders can charge whatever rate they choose.

DIDMCA preempted state usury caps on loans secured by a first lien, and early decisions under DIDMCA concluded that this first-lien preemption applied to nonpurchase money loans as long as the lender was in first-lien position.⁴²³ Despite these early decisions applying DIDMCA to nonpurchase money loans, the practice of taking first-lien position and charging unregulated interest rates did not really catch on until the mid-1990s. Thus, while first-lien loans accounted for only about 50% of subprime home equity loans in 1993, by 1996 first-lien loans accounted for about 80% of subprime home equity loans.⁴²⁴ Similarly, one investment banking company study showed that Equicredit, which was ranked by origination volume as the eighth largest subprime lender by the National Mortgage News Quarterly Data Report for the fourth quarter of 1998,⁴²⁵ took first liens in more than 70% of its loan originations in 1995, compared with taking a first lien in only about 50% of its loan originations in 1989.⁴²⁶

Subprime lenders now take advantage of DIDMCA and early interpretations of DIDMCA to charge unlimited interest rates on nonpurchase money loans secured by the borrower's residence—regardless of the purpose for which the loan was made—and often through the concurrent refinancing of the existing mortgage loan. The refinanced loan is sometimes the purchase money loan used by the borrower to purchase the home, and in many cases the refinanced loan bears a greater interest rate than the loan it is replacing.⁴²⁷ As a result, nothing now regulates the maximum interest rate for loans such as debt consolidation loans, home improvement loans, refinance loans, and loans made for the purpose of obtaining consumer goods and services, provided the lender secures a first-lien position on the consumer's residential real estate.⁴²⁸

DIDMCA also set up a system in which the only possible control on rates

422. See, e.g., Jeff Bailey, *A Man and His Loan: Why Bennie Roberts Refinanced Ten Times*, WALL ST. J., Apr. 23, 1997, at A1 (recounting the story of a borrower who fell victim to repeated and unnecessary refinancings).

423. See *infra* Parts III.B and IV.B.

424. WEICHER, *supra* note 300, at 31-32.

425. National Mortgage News Quarterly Data Report, *Top Subprime Lenders in Q498* (visited Oct. 10, 1999) <<http://www.mortgagestats.com/demos/qdr/BCOrig.htm>>.

426. WEICHER, *supra* note 300, at 32.

427. See, e.g., Forrester, *supra* note 240, at 375-76; PREYING ON NEIGHBORHOODS, *supra* note 1, at 31 (reporting on a borrower whose refinance loan with an annual percentage rate of 14.18% paid off the borrower's FHA mortgage, which was at 9.5% and was in foreclosure).

428. This general rule does not apply to the states that opted out of DIDMCA during the first three years after it was passed. See *supra* note 201 and accompanying text.

was the market itself. In a working market, this would mean that home equity lenders whose rates or terms were out of step with competitors would be forced out of the market. One might also expect to see home equity loan rates and terms more closely correlated to the perceived risk involved in a given mortgage transaction. Competing lenders would be unwilling to go below a rate designed to reflect the borrower's risk of default, but would likewise resist going too far above that rate for fear of losing market share.

To make a market like this work, borrowers need enough information to choose between more expensive or abusive lenders and lenders who offer reasonable terms. To this end, Congress has made legislative attempts to increase information flow into the consumer market. In the home equity market, the relevant disclosure statutes are (1) the Truth in Lending Act (TILA), adopted in 1968, which requires mortgage lenders to disclose interest rates and the cost of credit to potential borrowers,⁴²⁹ and (2) the Real Estate Settlement Procedures Act (RESPA), which requires lenders to provide borrowers with a standard statement of settlement costs.⁴³⁰ The theory behind the Truth in Lending Act was that borrowers, who would now be given comparable disclosures by potential lenders, would be able to "shop around" for the best credit deal.⁴³¹ This in turn would mean less business for less competitive lenders, and would ultimately force them out of the market.⁴³² The theory behind RESPA was to provide borrowers with "greater and more timely information on the nature and costs of the [real estate] settlement process," which it was hoped would protect consumers from high costs and abusive practices.⁴³³

These statutes demonstrate a preference for regulatory models that do not interfere directly with the transaction being regulated, but merely enhance efficient information flow in the marketplace.⁴³⁴ However, both statutes have

429. 15 U.S.C. § 1601 (1994).

430. 12 U.S.C. § 2603 (1994).

431. *See, e.g.*, 15 U.S.C. § 102(a) (1994).

432. Indeed, when the Senate Committee on Banking, Housing, and Urban Affairs reported out its 1979 bill simplifying Truth in Lending compliance, it indicated that "[s]ince 1969 [when the Truth in Lending Act was first adopted], those creditors who charge the highest rates have experienced a substantial reduction in their share of the consumer credit market. While no conclusive proof of the act's role in this exists, some experts believe truth in lending is a principal cause of this market shift." S. REP. NO. 96-73, at 2 (1979), *reprinted in* 1980 U.S.C.C.A.N. 208, 281. For a discussion of this see Eskridge, *supra* note 135, at 1098 ("Theoretically, if there is uniform disclosure of credit charges and terms, buyers . . . will flock to the best credit opportunities, thus eliminating bad deals and making the mortgage market even more competitive.").

433. 12 U.S.C. § 2601(a) (1994).

434. BOARD OF GOVERNORS OF THE FED. RESERVE SYS. AND THE DEP'T OF HOUS. AND URBAN DEV., JOINT REPORT TO THE CONGRESS CONCERNING REFORM OF THE TRUTH IN LENDING ACT AND THE REAL ESTATE SETTLEMENT PROCEDURES ACT, 160 (1998) [hereinafter JOINT REPORT]; Eskridge, *supra* note 135, at 1098 ("The growth of a nationally competitive mortgage market has also fostered the view that regulations most helpful to the consumer are those that improve the mortgage market's competitiveness. Disclosure rules are therefore preferable to usury ceilings."). RESPA does contain some transaction regulations. *See, e.g.*, 12 U.S.C.

two essential flaws. First, the information required to be disclosed by TILA and RESPA is complex and probably incomprehensible to most subprime borrowers. Moreover, the information is not given to the borrower until the loan closing.⁴³⁵ Thus the information that is required to be disclosed to the individual borrower is not always usable by the individual borrower. Second, pricing information in the subprime market does not have to be disclosed on a marketwide basis, and indeed is not readily available to anyone.⁴³⁶ In contrast, prime mortgage market rates and points are in the news on a regular basis.⁴³⁷ Probably as a result of this, there is very little variance in pricing in the prime market.

Thus, although TILA and RESPA increase information in the market, these essential flaws in both statutes prevent borrowers from making informed choices.⁴³⁸ As a result, competition is not limiting prices.⁴³⁹ Lenders will not carefully correlate price to risk when they can just as easily charge whatever rate they choose.

It was clearly an unintended consequence of DIDMCA for lenders to gain the power to set prices so much higher than an efficiently working market would allow. This disjunction between subprime loan rates and market forces cannot be observed in the conventional mortgage market. In that market, rates have moved in relative step with the treasury and other market rates.⁴⁴⁰ This has

§ 2607(a) (1994) (prohibiting kickbacks and unearned fees).

435. JOINT REPORT, *supra* note 434; IRWIN S. KIRSCH ET AL., NATIONAL CTR. FOR EDUC. STATISTICS, ADULT LITERACY IN AMERICA: A FIRST LOOK AT THE RESULTS OF THE NATIONAL ADULT LITERACY SURVEY xiv (1993).

436. *See supra* Part V.D.

437. *See, e.g., Money Rates*, WALL ST. J., Jan. 5, 2000, at C24 (reporting the yields on thirty-year mortgage commitments posted by Freddie Mac and Fannie Mae on a daily basis). Monthly rates on mortgages current through the prior month are available on the Internet through the Mortgage Bankers Association of America at <<http://www.mbaa.org>>. These are just two of the many sources from which this information is readily available.

438. *See, e.g., TWO STEPS BACK*, *supra* note 1, at vi (stating that “[w]hile necessary, consumer disclosure—the primary approach of consumer lending laws—is a woefully inadequate tool.”).

439. *See, e.g., United Cos. Lending Corp. v. Sargeant*, 20 F. Supp. 2d 192, 203-04 (D. Mass. 1998) (finding that “informed consumer choice is the most effective mechanism for regulating the market,” but that this control was not working in the subprime mortgage market, which justifies regulatory control); Frey, *Home Buyer*, *supra* note 412, at D1 (recognizing that “lenders who take advantage of their customers theoretically should lose out in the marketplace” and quoting a consumer’s attorney as stating that “there are situations in which the free market doesn’t work.”). *But see Problems in Community Development Banking, Mortgage Lending Discrimination, Reverse Redlining, and Home Equity Lending: Hearings Before the Senate Comm. on Banking, Hous., & Urban Affairs*, 103d Cong. 283 (1993) [hereinafter *Problems in Community Development Hearings*] (statement of John Hamill, President of Fleet Bank, Mass.) (arguing that competition in the market sets prices).

440. *See infra* Appendix 2 (charting the thirty-year Treasury rate and the thirty-year conventional mortgage rate from 1980-1999). For recognition of this see *Russell v. Fidelity Consumer Discount Co.*, 72 B.R. 855, 867 (E.D. Pa. 1987) (observing a “Congressional prognostication that the conditions which made the DIDMCA seem appropriate at the time [of adoption of DIDMCA] would not be permanent,” and that as interest rates declined from the

held true even when Treasury rates declined.⁴⁴¹ This likely means that in the conventional mortgage market DIDMCA is having its intended effect: allowing rates to accommodate both high interest markets and low interest markets, and assuring a source of funds for home purchases even when market rates rise above levels that would have been usurious prior to DIDMCA.⁴⁴² This market control in the conventional market is aided by continued regulation of the business practices of lenders, such as banks, that make conventional mortgage loans.⁴⁴³ The fact that conventional mortgage rates have continued to move in step with the market suggests that DIDMCA has not harmed conventional mortgage borrowers by keeping rates higher than the market demands.

In contrast, it is not clear that pricing in the modern subprime home equity market has any basis at all. At the very least, pricing does not appear to be based on a legitimate assessment of risk and provision for an acceptable profit for the lender. Allowing subprime lenders to set prices without any effective controls is clearly an unintended consequence of DIDMCA.⁴⁴⁴

2. Points, Fees, and Loan Flipping

Another common feature of a subprime loan is very expensive points and fees. These are charges that are immediately taken out of the loan proceeds and paid to the lender and/or broker at closing. There is virtually no public source for comprehensive information about points and fees charged by subprime home equity lenders. However, at least some information about points and fees is available from recent individual cases and studies.⁴⁴⁵

highs they were experiencing when DIDMCA was adopted, conventional mortgage rates also declined to about one third of Pennsylvania's usury limit).

441. For example, the thirty-year Treasury rate in October 1981 was 14.68 and the thirty-year conventional mortgage rate was 18.45, a spread of 3.77. See *infra* Appendix 2. In October 1982 the thirty-year Treasury rate had fallen to 11.17, and the 30-year conventional mortgage rate had fallen to 14.61, a spread of 3.44. *Id.*

442. For example, the high conventional thirty-year rate of 16.33% in April 1980 would have been prohibited by a number of state usury laws. *Id.*

443. TWO STEPS BACK, *supra* note 1, at 47 (recommending that regulators be required to scrutinize and conduct fair lending examinations of subprime lenders).

444. As the director of Consumer Protection of the Federal Trade Commission observed:

Critics assert, however, that the interest rates and fees charged by some subprime lenders are excessive, and much higher than necessary to cover increased risks, particularly since these loans are secured by the value of a home. Some attribute lenders' high rates on first mortgages in part to federal deregulation of certain state interest rate ceilings in 1980.

Prepared Statement of the FTC Before the Senate Special Comm. on Aging, 105th Cong. 64 (1998) (statement of Jodie Bernstein, Dir. of the Consumer Protection Bureau of the FTC).

445. See, e.g., PREYING ON NEIGHBORHOODS, *supra* note 1, at 31 (reporting the case of a 62-year-old widow who received a \$46,278 refinance loan in 1997, was charged a 12.75% interest rate (14.18% APR), and was required to pay fees totaling \$5,071—which was just under

Points and other loan fees charged by subprime mortgage lenders have generated considerable litigation, with consumer advocates arguing that loan fees of 10% or more of the loan amount are unconscionable.⁴⁴⁶ Litigation under HOEPA⁴⁴⁷ indicates many subprime mortgage lenders are charging more than 8% of the loan amount in points or fees, including broker fees. For example, United Companies Lending seems to have routinely charged 10% to 20% of the loan amount in fees.⁴⁴⁸ Likewise, the New York Attorney General sued Delta Funding for systematically charging low-income minority homeowners in New York fees of up to 10% of the loan amount.⁴⁴⁹ In another suit involving Delta Funding, three borrowers paid between \$8,000 and \$11,700 in loan points and fees, resulting in a finding that their loans were covered by HOEPA.⁴⁵⁰ In certifying a class action against Associates, the largest subprime mortgage lender,⁴⁵¹ one court noted that Associates charges up to ten points on new loans and eight points on renewal loans.⁴⁵²

The purpose for charging origination fees in the conventional mortgage market is to cover the lender's cost in originating the loan. Average points in the conventional mortgage market are proportionate to these costs. Given the traditional tie between points and fees and the lender's origination and

11% of the principal—\$4,000 of which went to the broker); *Newton v. United Cos. Fin. Corp.*, 24 F. Supp. 2d 444, 447, 450 (E.D. Pa. 1998) (finding that one of the plaintiffs paid 25% in points and fees based on a home equity loan contract principal of \$11,600, and in reality paid almost 70% in points and fees based on the value she actually received from the loan). In some cases, broker fees have been charged and paid to brokers who had "no involvement whatsoever and provided no services." *Id.* at 449. In contrast, points and fees in a conventional loan are usually between 1% and 2%. For conventional points history see *Freddie Mac, News & Info, 30 Year Fixed-Rate Mortgages Since 1971* (visited Sept. 18, 1999) <<http://www.freddiemac.com/pmms/pmms30.htm>>. The Weicher report asserts that subprime mortgage originators charge an average of 2% to 6% of the principal amount of the loan in points. WEICHER, *supra* note 300, at 67. However, this statement is not attributed to any data source, and is contrary to the evidence that exists.

446. *United Cos. Lending Corp. v. Sargeant*, 20 F. Supp. 2d 192 (D. Mass. 1998); see also *Stewart v. Associates Consumer Discount Co.*, 183 F.R.D. 189, 192 (E.D. Pa. 1998) (holding that the lender's practices were unlawful and fraudulent).

447. See *infra* Part VII.A.

448. *Newton*, 24 F. Supp. 2d at 447 (E.D. Pa. 1998) (indicating that one of the plaintiff borrowers was charged 25% of the loan principal in points and fees); *Sargeant*, 20 F. Supp. 2d at 196-97 (D. Mass. 1998) (reporting that the borrower was charged 17% of the loan principal in points and fees); *United Cos. Lending Corp. v. Autrey*, 723 So. 2d 617, 619 (Ala. 1998) (stating that borrowers in the class were charged 8% of their loan principal in points and fees).

449. *People v. Delta Funding Corp.*, No. CV99-4951 (E.D.N.Y. Aug. 19, 1999) (complaint and jury demand).

450. *Lopez v. Delta Funding Corp.*, No. 98-7204 (E.D.N.Y. Dec. 23, 1998).

451. Associates was ranked first in subprime loan origination volume in the fourth quarter of 1998 by the National Mortgage News Quarterly Data Report and continues to hold that position. National Mortgage News Quarterly Data Report, *Top Subprime Lenders in Q498* (visited Oct. 10, 1999) <<http://www.mortgagestats.com/demos/qdr/BCOrg.htm>>.

452. *Stewart v. Associates Consumer Discount Co.*, 183 F.R.D. 189, 197-98 (E.D. Pa. 1998).

servicing costs, there have been some attempts to correlate high points and fees to high origination and servicing costs in the subprime market.⁴⁵³ Particular assertions include that origination and servicing costs are higher for subprime loans because they require more employee time than comparable conventional mortgage loans.⁴⁵⁴ However, in at least one case evidence uncovered during litigation with a subprime lender suggested that points and fees in fact bear very little relation to the actual costs incurred in originating a subprime loan. In that case, *Newton v. United Lending Companies*,⁴⁵⁵ United produced the literature it used to attract mortgage broker business. One such document makes the following statement:

Mortgage brokers make their money on points that customers pay when their loan is closed. Legislation designed to protect the consumer is continuing to put pressure on the brokerage business. Disclosure of front-end and back-end fees is forcing brokers to justify these fees. In the future this may lead to brokers charging fees in accordance with the amount of service they provide the customer.⁴⁵⁶

The New York Attorney General's Office appears to have also concluded that points are not tied to costs, asserting in a complaint filed against Delta Funding Corporation that the points Delta charged were unrelated to its costs.⁴⁵⁷

Thus, it is not at all clear that there is any correlation between points and fees charged by subprime lenders and the amount of employee time spent closing a loan. Even if points and fees in the subprime market were found to correlate to cost, there is some evidence that these costs are partially caused by aggressive promotion on the part of lenders and brokers. For example, in one case about which the author was consulted, the broker essentially hounded the borrower until she agreed to take the loan, personally visiting the borrower at her home repeatedly over the course of a month. The broker was so aggressive that the borrower avoided going home between her jobs so that she would not have to face the loan broker, who often was waiting for her when she returned from work.

453. WEICHER, *supra* note 300, at 17. The Weicher report asserted that "[o]rigination costs appear to be substantially higher for subprime mortgages, in the range of 4 to 8 percent, compared with an average of 2 percent for prime mortgages." The report says that included in these origination costs are the costs of "salaries, commissions, and other personnel costs, data processing, and related expenses. They also include advertising and other expenses incurred in contacting borrowers, and the cost of unsuccessful leads." *Id.* at 67.

454. *Id.* at 70 (attributing higher origination costs to the "need for more intensive staffing").

455. *Newton v. United Cos. Fin. Corp.*, 24 F. Supp. 2d 444 (E.D. Pa. 1998).

456. *United Companies Lending Corporation, Originator Orientation Manual*, Trial Exhibit U-226, *Newton v. United Cos. Fin. Corp.*, 24 F. Supp. 2d 444 (E.D. Pa. 1998).

457. *People v. Delta Funding Corp.*, No. CV99-4951 (E.D.N.Y. Aug. 19, 1999) (complaint and jury demand).

There is also evidence of lender efforts to promote additional borrowing by maintaining a personal relationship with the borrower even when the borrower is not in default on the loan. This practice, known as "flipping," generally involves the lender making a series of several loans to the same borrower in a relatively short period of time.⁴⁵⁸ With each new loan, the lender pays off the balance of the old loan and gives the borrower some new, sometimes minimal, loan proceeds. With each new loan, the lender charges the borrower points and fees all over again.⁴⁵⁹

Loan flipping has benefits for the lender and for the particular salesperson who makes the loan. First, the loan salesperson makes a commission each time the loan is flipped; the commission is set by giving the employee half of the fees the employee charges over a set amount. The amount of the commission in some companies is also based on how many "extra charges," such as insurance, are added to the loan. Through the practice of flipping, the lending company secures the continued business of the borrower, which is extremely important in the market that exists today—a market flooded with lenders. The cumulative payment of fees to the lender can sometimes reach exorbitant amounts.⁴⁶⁰ On occasion, the points and fees paid to the lender might exceed the value of the new loan proceeds.⁴⁶¹ Thus both the lender as a company and the salesperson individually have a tremendous incentive to keep the loan with the company, and to remake or flip the loan.⁴⁶²

Some have argued that there is no incentive for lenders to flip loans

458. See, e.g., *Besta v. Beneficial Loan Co. of Iowa*, 855 F.2d 532, 533 (8th Cir. 1988) (noting that the borrower refinanced first loan through a second loan two years later); *PREYING ON NEIGHBORHOODS*, *supra* note 1, at 6-7 (describing as "abusive" the predatory lender's tactic of "flipping"); *Bailey*, *supra* note 422, at A1 (describing how the borrower was subjected to unnecessary refinancing). Loan flipping can occur after a borrower misses payments on a loan, after which the lender talks the borrower into covering missed payments by taking out another loan at a higher rate. Flipping can also occur when a borrower is talked into taking out additional principal, which is then added to the outstanding balance on the existing loan and issued as a new loan.

459. For an example of a case such as this see *Rah Bickley*, *Lending Practices Face Checks*, *RALEIGH NEWS & OBSERVER*, Apr. 6, 1999, at B4; *Frey*, *Home Buyer*, *supra* note 412, at D1. These articles describe two loans taken by a borrower from United Lending Companies in 1996. The first loan was a \$30,700 purchase money mortgage. The borrower paid \$7,700 in fees, or 25% of the amount loaned to him. Two years later the borrower had to make repairs to his furnace. United made a second loan to the borrower, but charged him \$2,500 in fees, which was 5% of the loan. In addition, United added so many extra charges that by the time the loan closed, the principal amount was up to \$48,500.

460. See, e.g., *Bailey*, *supra* note 422, at A1 (reporting that through flipping the lender made \$19,000 in fees and the borrower received \$23,000 in loan proceeds).

461. *Prepared Statement of the FTC before the Senate Special Comm. on Aging*, 105th Cong. 64 (1998) (statement of Jodie Bernstein, Dir. of the Consumer Protection Bureau of the FTC).

462. The Woodstock Institute Study recognizes that lenders have an "incentive to refinance all outstanding debt even if the rate of the new loan is higher than the existing mortgage," because doing so raises the loan principal and thus generates higher points and fees for the lender or broker. *TWO STEPS BACK*, *supra* note 1, at 19.

because flipping involves prepayment of a pre-existing loan.⁴⁶³ It is true that in the conventional market it does not benefit lenders when borrowers prepay their loans. This is because conventional borrowers generally prepay their loans in large numbers when interest rates go down and thereafter refinance at lower interest rates. When conventional loans prepay in a declining interest market, lenders and investors are forced to reinvest their money at market rates lower than the rates of return on the mortgage that has been paid off.⁴⁶⁴

However, in the subprime market, refinancings occur whether interest rates are falling or rising.⁴⁶⁵ Furthermore, subprime refinancings generally do not garner lower interest rates for borrowers.⁴⁶⁶ Therefore, subprime lenders are not forced to reinvest at lower interest rates when borrowers prepay their loans. This fact explains why prepayments are not harmful to subprime investors and lenders in the same way they are to investors in conventional mortgage-backed securities.

To successfully flip loans, a lender must spend time cultivating a relationship with the borrower. There is a certain psychology between the lender and the borrower that enables the lender to flip the loan. The lender earns the trust of the borrower to the extent that the borrower becomes convinced of two things: (1) that the borrower is lucky to have found this lender, because the lender's description of the borrower's abysmal creditworthiness makes it clear that only a lender who truly cared about the

463. For example, the Weicher report asserts that the benefits of repeated payment of points each time a loan is flipped is counterbalanced by the cost of early payment on a loan, which is a cost to the investor, lowering the rate of return. WEICHER, *supra* note 300, at 73. The report further states that "[t]he securitization process thus discourages flipping." *Id.* at 74. The report also observes that "[s]ubprime loans prepay more rapidly," leading to higher origination and servicing costs, and argues that subprime lenders suffer when loans are paid early. *Id.* at 69. Subprime loans prepay more rapidly, the report suggests, because borrowers earn a better credit grade and refinance at a lower rate. *Id.* at 72-73.

464. Canner, *Recent Developments*, *supra* note 302, at 249-50.

465. TWO STEPS BACK, *supra* note 1, at 6 (finding that subprime lending increased during times of rising interest rates in 1994, 1995, and 1997 and concluding "[t]his suggests that subprime refinancings are not driven by homeowners refinancing to save money during times of declining rates and that subprime lenders are aggressively marketing loans regardless of the rate environment.").

466. Canner, *Recent Developments*, *supra* note 287, at 249-50 (finding that investors in subprime home equity loan securities have a lower risk of prepayment when interest rates go down than they would have if investing in other mortgage-backed securities because subprime borrowers usually cannot obtain lower rate refinancing loans). However, there is also an indication that

[I]ately . . . prepayments for some pools of subprime home equity loans have been more rapid than anticipated in underwriting assumptions. These accelerated prepayments may imply that improvements in borrowers' financial positions have exceeded expectations or that intensified competition among lenders has enabled some lower-quality borrowers to refinance at rates below those they had originally obtained.

Id. at 250 n.18.

borrower would make the loan; and (2) that the lender is looking out for the interests of the borrower and would not make a loan that the borrower would be unable to pay.⁴⁶⁷ Given the relationship required to facilitate flipping, it is not surprising that servicing subprime loans takes more time and energy than servicing prime loans.⁴⁶⁸ However, aggressive marketing tactics and time spent cultivating the borrower-lender relationship and soliciting loan flips cannot justify higher origination costs.

Far from mere cost-recovery mechanisms, points are a substantial source of income and profit for some lenders. United Companies, for example, had close to \$441 million in revenues in 1997, of which \$115 million came from origination fees.⁴⁶⁹ United's expenses, however, were just under \$315 million—resulting in a pretax profit of \$126 million.⁴⁷⁰ United's annual report for 1997 includes the following data:

Finance income, fees earned and other loan income, which constitutes the second largest component of the Company's revenues, was comprised of the following items for the periods indicated:

	YEAR ENDED DECEMBER 31,		
	1997	1996	1995
	(IN THOUSANDS)		
Servicing fees earned.....	\$194,600	\$135,599	\$89,410
Loan origination fees.....	115,482	84,608	68,442
Loan interest.....	24,038	21,482	9,238

467. For a description of a flipping relationship see *Emery v. American General Finance, Inc.*, 71 F.3d 1343, 1345-46 (7th Cir. 1995), *dismissal aff'd*, 134 F.3d 1321 (7th Cir. 1998); *PrimeTime Live: Debt Reckoning Ford Motor Company's Lucrative Loan Business* (ABC television broadcast, Apr. 23, 1997) (describing how a borrower was continually talked into flipping his loan, reporting the borrower's comment: "Looked pretty good to me.").

468. WEICHER, *supra* note 300, at 17 (finding that servicing costs are one-third higher for subprime loans than for other loans, "largely reflecting the need for more intensive staffing" and that the "typical servicing employee can handle approximately half as many subprime loans as prime mortgages."). This report also asserts that "[b]ecause of the delinquencies, they [subprime lenders] incur higher servicing costs." *Id.* at 18.

469. United Companies Financial Corporation, Securities and Exchange Commission, Form 10-K (filed March 26, 1998), at 15, 21.

470. *Id.* at 15.

2000	THE SUBPRIME HOME EQUITY MARKET		551
Other loan income.....	13,259	9,623	8,576

The same report gives the following income and expense data:

Income Statement Data:

Total revenues.....	\$440,811	\$342,558	\$252,650
Total expenses.....	314,904	208,701	149,985
Income from continuing operations before income taxes.....	125,907	133,857	102,665
Provision for income taxes.....	45,326	47,665	37,740
Income from continuing operations.....	80,581	86,192	64,925
Income (loss) from discontinued operations.....	(5,981)	(4,532)	(4,543)
Net income.....	\$ 74,600	\$81,660	\$69,468 ⁴⁷¹

3. Other Charges: "Packing"

Another price inflator that may be present in a subprime home equity loan are charges for items or services that are not part of the primary loan package.⁴⁷² The most common type of charges in this category are fees for insurance. Loan insurance generally does not benefit the borrower, and the insurance fee is routinely financed over the life of the loan.⁴⁷³ Other charges

471. *Id.* at 21.

472. *Home Equity Lending Abuses, Hearings, supra* note 337; *PrimeTime Live: Debt Reckoning* (interviewing former Associates employees who state they were instructed to pack loans with as many extras as possible, that they had packing quotas, and that they often did not tell borrowers about added charges).

473. *See, e.g.,* PREYING ON NEIGHBORHOODS, *supra* note 1, at 6 (finding that "[o]ne egregious type of packing is when a lender sells the borrower unnecessary credit life or credit disability insurance, and finances the premiums over the life of the loan."); *see also Home Equity Lending Abuses, Hearings, supra* note 337, at 66 (recognizing that credit insurance may not benefit borrowers because it is high cost and claim rates are relatively low).

may include duplicative fees for services supposedly provided in order to make or close the loan.⁴⁷⁴ These charges are usually added into the loan without the borrower's consent, and then taken out only if the borrower objects.⁴⁷⁵

C. Ability to Repay, Risk of Defaults, and Foreclosures

1. Ability to Pay / Debt-To-Income Ratio

A subprime home equity loan may often be a loan that the borrower has no ability to repay.⁴⁷⁶ This problem is also referred to as asset-based lending or "in rem financing," and can often lead to "equity stripping," whereby the borrower loses not only the equity in her home, but also the home itself as the result of taking out a loan that she cannot repay.⁴⁷⁷

A borrower's inability to pay can result from taking a loan with an unaffordable monthly payment that may exceed the borrower's monthly income. It may also result from an affordable monthly payment followed by a balloon payment that the borrower will never be able to afford. The existence of the balloon payment in the contract allows the lender to focus the borrower's attention on the low monthly payment, even though the borrower clearly will not have any way to pay the balloon and will thus be forced to refinance the loan.⁴⁷⁸ Finally, loans may even be issued to borrowers who have no ability to pay based on loan applications falsified by mortgage brokers or lender employees eager for high commissions.⁴⁷⁹

474. PREYING ON NEIGHBORHOODS, *supra* note 1, at 6.

475. *Home Equity Lending Abuses, Hearings*, *supra* note 337, at 67. Even when borrowers object they may end up with such charges in their loans if the lender indicates that changing the loan terms close to closing will delay closing. *Id.*

476. *See, e.g., Newton v. United Cos. Fin. Corp.*, 24 F. Supp.2d 444, 453-54, 456-57 (E.D. Pa. 1998) (finding that United made loans in the case of the plaintiffs without regard for the borrowers' ability to repay the loan); PREYING ON NEIGHBORHOODS, *supra* note 1, at 31 (reporting on the case of a borrower whose monthly loan payment was \$558 even though she had an income of \$484 per month); Murray, *supra* note 337, at A4 (reporting on testimony by the daughter of an elderly couple before the Senate Special Committee on Aging stating that her elderly parents, whose only income was a monthly social security payment of \$1,156.22, were made a loan they could not afford and ended up in foreclosure); *see also Unregulated Subprime Loans*, *supra* note 346, at 2. For a list of "terms that trap borrowers into unaffordable financing," *see* TWO STEPS BACK, *supra* note 1, at 8.

477. *Home Equity Lending Abuses, Hearings*, *supra* note 337, at 66.

478. Balloon payments are permitted because of AMTPA. *See supra* Part III.C. For a discussion suggesting the significance of the monthly payment amount in persuading borrowers to take these loans, *see* August, *Survey*, *supra* note 294, at 548 ("Moreover, home equity loans also feature longer repayment periods than credit card debt. Thus finance companies have marketed home equity loans, in part, as a means of consolidating credit card debt because doing so can reduce the borrower's monthly payments substantially.")

479. For example, in a case examined in the NTIC study, a mortgage broker falsified the income of a borrower, indicating on her loan application that she had a monthly income of \$9,900 when in fact her monthly income was only \$1,100. PREYING ON NEIGHBORHOODS, *supra* note 1, at 32. The broker also wrote the loan for more than it was supposed to be for and took \$6,700 in broker fees, some of which were diverted to the brother of the mortgage broker. *Id.*

In the worst cases, the loan is so blatantly unaffordable that the borrower defaults on the very first payment due.⁴⁸⁰ Even if default does not occur quite this soon, subprime loans still generally default earlier than nonsubprime home equity loans,⁴⁸¹ and high interest rate loans—most of which are subprime—end up in foreclosure at a higher rate than nonsubprime loans.⁴⁸² At least one study attributes this trend to the borrower's inability to pay from the beginning.⁴⁸³

Loans that are too expensive for the borrower come from a lender focus on the value of the collateral rather than on the borrower's ability to pay the loan.⁴⁸⁴ This problem was exacerbated early on by the increasing ability of lenders to sell the loans on the secondary market,⁴⁸⁵ thus giving the lender, who would be paid off early in the loan, little incentive to care if the loan could be paid by the borrower.⁴⁸⁶ In more recent years, the heavy use of securitization of loan pools and insurance of those securitizations may have served the same purpose.⁴⁸⁷

2. Subprime Loan Delinquency, Default, and Foreclosure Rates

With the advent of the subprime home equity market, loan defaults and

480. The Weicher report found that, "[o]n some loan portfolios, 'first payment delinquencies' may run as high as 25 percent." WEICHER, *supra* note 300, at 80.

481. *Newton*, 24 F. Supp. 2d at 454 (referring to expert testimony that United's delinquency rates showed that "very young loans are going delinquent"); WEICHER, *supra* note 300, at 83 (finding that "[s]ubprime defaults peak in the second year of the mortgage, but FHA defaults peak during the fourth to sixth years."). One other study suggested that FHA loan foreclosures peak between the third and seventh year. PREYING ON NEIGHBORHOODS, *supra* note 1, at 23; *see also id.* at 4 (finding that between 1993 and 1998 "[f]oreclosures on home loans less than 4 years old tripled"); *id.* at 23 (finding that loans originated within four years accounted for 39.1% of foreclosures in the Chicago area in 1993, and for 60.11% of foreclosures in 1998); *id.* at 24-27 (demonstrating a correlation between subprime high interest loans and early foreclosure in the Chicago area).

482. *See infra* Part VI.C.3.

483. PREYING ON NEIGHBORHOODS, *supra* note 1, at 5, 23.

484. *See, e.g., id.* at 6 (finding that "[o]ne of the most destructive predatory practices victims often describe is when a lender bases the loan on the equity the borrower has in the home rather than the borrower's ability to repay the loan."); *see also* Bogdanich, *supra* note 279, at A1 ("Spurred by banking-industry deregulation and other market forces, the more aggressive lenders are seeking new customers by emphasizing the equity that secures a loan, rather than a borrower's ability to repay. While this practice enables more people to borrow, many homeowners borrow when they shouldn't and thus face bankruptcy or foreclosure."); Sing, *supra* note 279, at 1 ("Experts also fear that the rush to home-equity loans could lead to the wider entrance into this market of unscrupulous second-mortgage lenders and brokers, who have preyed on less sophisticated or less credit-worthy lower-income or elderly consumers in recent years."). Indeed, ads began appearing in the mid-1980s advertising for borrowers who had equity in their home, even if they had significant credit problems. Bogdanich, *supra* note 279, at A1.

485. The secondary market for second mortgages grew from \$10 billion in 1978 to \$75 billion in 1985. Wendy Swallow, "Last Resort" Lender Probed, Sued By 100 In Six States—Bankrupt Landbank Equity Under Siege, WASH. POST, Dec. 22, 1985, at A20.

486. *See, e.g.,* Bogdanich, *supra* note 279, at A1.

487. Avery, *supra* note 420, at 621 n.1.

foreclosures appear to be increasing at an almost frightening rate. Though there have been no nationally comprehensive studies of loan default and foreclosure rates for subprime home equity loans, the few studies that were published in the late 1990s suggest that there has been a marked and tragic increase in the number of home foreclosures as the result of subprime home equity lending.

For example, a Federal Reserve report in 1998 showed average delinquency rates on all traditional home equity loans to be around 1.25%.⁴⁸⁸ However, home equity loans in securitized pools had a delinquency rate generally ranging between 6% and 9%.⁴⁸⁹ The 1999 NTIC study found that completed foreclosures of all mortgage loans in the Chicago area went from 2,074 in 1993 to 3,964 in 1998—a 91% increase.⁴⁹⁰ A much more dramatic rise in subprime loan foreclosures could be observed during the same period. Subprime lenders foreclosed thirty loans in the Chicago region in 1993, which was 1.4% of all loan foreclosures that year, while in 1998 they foreclosed 1,417 loans, or 35.7% of total foreclosures for the year.⁴⁹¹ This was a 4,623% increase in subprime foreclosures between 1993 and 1998.⁴⁹² Within a defined thirty-six block area in Chicago, seventy-three of the foreclosures filed in 1998 were on loans originated since 1990, and sixty-nine of the loans had been originated since 1993.⁴⁹³ Of the seventy-three loans foreclosed, forty of the seventy-three foreclosures were initiated by subprime lenders.⁴⁹⁴ Another twenty-one loans foreclosed were FHA insured loans, of which fourteen had been originated by subprime lenders.⁴⁹⁵

488. Canner, *Recent Developments*, *supra* note 287, at 247.

489. *Id.* at 249 (graph).

490. PREYING ON NEIGHBORHOODS, *supra* note 1, at 3, 12-13; *Unregulated Subprime Loans*, *supra* note 346, at 1 (reporting that “[h]igh interest rates and fees associated with predatory subprime mortgage lending are pushing families in the greater Chicago area into foreclosure at epidemic levels . . .”). The NTIC study points out that because it looked at only completed foreclosures in which the property was sold at auction, “a large number of properties on which foreclosure had been started” were excluded from these already high numbers. PREYING ON NEIGHBORHOODS, *supra* note 1, at 10.

491. PREYING ON NEIGHBORHOODS, *supra* note 1, at 17.

492. *Id.* at 4, 12-13. The NTIC study also found that foreclosures on high interest rate loans increased more than 400% between 1993 and 1998, that this increase was “linked to lenders and servicers who specialize in subprime loans,” and that “[f]oreclosed loans originated after 1994 have higher interest rates on average than loans originated before 1994 that foreclosed during the same period.” *Id.* at 4.

493. *Id.* at 28.

494. *Id.*

495. *Id.* The Weicher report asserted that at any time approximately 3% of subprime loans are in foreclosure, while less than 2% of government-guaranteed loans and less than 1% of prime loans are in foreclosure. WEICHER, *supra* note 300, at 26-27, 74-75, 80. The Weicher report based its conclusions on nonpublic information about subprime loans from the Mortgage Information Corporation and the Home Equity Lenders Leadership Organization, on publicly available information from the Mortgage Bankers Association (mixed prime and subprime data), and on some publicly available securities offerings. The study also concluded that 94% of subprime home equity borrowers are current on their payments at any time, compared to a rate of 97% on prime mortgages and 92% for government-guaranteed mortgages. *Id.* at 17-18, 74-75. However, the charts used in the report show different results. Those charts show a 6.5% delinquency rate, not including foreclosures, *id.* at 75 tbl. 5.2, and a foreclosure rate of 3.1% or

Thus, it appears that subprime mortgage loans have very high delinquency rates, especially when one looks at more serious delinquencies and foreclosures. In addition, many lenders are experiencing continual increase in their delinquency rates as the loans get older. According to reports filed with the Securities and Exchange Commission, ContiMortgage⁴⁹⁶ had delinquencies of 2.81% and defaults (e.g., foreclosures, bankruptcies) of 7.51% as of September 30, 1999 in its \$12 billion portfolio.⁴⁹⁷ The defaults rose from 5.32% as of September 30, 1998⁴⁹⁸ to 7.51% as of September 30, 1999.⁴⁹⁹ Aames Financial Corp.⁵⁰⁰ reported delinquencies and defaults of 16.3% as of December 1998 and predicted that “[t]he seasoning of the old portfolio without the addition of new loans could cause delinquency rates to rise.”⁵⁰¹ In contrast, the delinquency rate for residential mortgages as a whole was a little over 5%, composed of 4.1% delinquent loans and 1.16% of mortgages in foreclosure.⁵⁰²

The costs to a borrower of losing his or her home in a foreclosure are obvious and tragic. A foreclosure becomes even more tragic in cases in which the home had been in the family for generations before a subprime home equity loan led to foreclosure. In these cases, but for the encounter with the subprime lender, the borrower would most likely still own and inhabit the home.⁵⁰³

Another cost of high foreclosure rates is the devastation of America’s housing infrastructure. As more and more homes go into foreclosure and lay vacant until they can be resold, neighborhoods suffer.⁵⁰⁴ For example, the NTIC study showed that in a thirty-six block area of Chicago’s south side, an average

3.5%, *id.* at 82 tbl. 5.5. This information, taken together, renders a total default/delinquency rate of 10%. Moreover, the Weicher report is based on data from 1996. *Id.* at 74-85. In 1996 subprime lenders had fairly recent loan portfolios, and default and delinquency rates appear to have increased since that time. The report does recognize that “Wall Street” estimates of cumulative foreclosure rates show that “[a]fter six years, approximately 13 percent of mortgages were in default.” *Id.* at 83. A similar rate of 11% to 12% was reported by United Lending Companies in 10-K reports filed with the SEC. *Id.*

496. ContiMortgage had the third largest number of subprime originations in the fourth quarter of 1998. National Mortgage News, *supra* note 391

497. Conti Fin. Corp., SEC, Form 10-Q (filed Nov. 15, 1999), at 19.

498. Conti Fin. Corp., SEC, Form 10-Q (filed Nov. 16, 1998), at 17.

499. Conti Fin. Corp., SEC, Form 10-Q (filed Nov. 15, 1999), at 19.

500. Aames was the twentieth-largest subprime loan originator in the fourth quarter of 1998. National Mortgage News, *supra* note 391

501. Aames Fin. Corp., SEC, Form 10-Q (filed Feb. 22, 1999), at 24.

502. Mortgage Bankers Association of America, *MBA Survey Reports Mortgage Delinquency Rate at its Lowest Level in Four Years* (visited Jan. 4, 2000) <<http://www.mbaa.org/news/99/nds0199.html>>; *Worker Productivity Soars*, WASH. POST, Dec. 8, 1999, at E2.

503. See, e.g., Bill Dedman, *Study Discerns Disadvantage for Blacks in Home Mortgages*, N.Y. TIMES, Nov. 14, 1999, at 18 (reporting on a borrower who had lived in her home for thirty years and owned it free and clear, and who, after taking a subprime loan, is faced with foreclosure).

504. TWO STEPS BACK, *supra* note 1, at 39.

of two properties per block were in foreclosure in 1998.⁵⁰⁵ The study further found that “[a] third of the properties in foreclosure that were secured by loans originated after 1990 were abandoned. Sixty-four percent of these abandoned properties were originated by subprime lenders or were high interest rate loans.”⁵⁰⁶ Oddly enough, this is the same concern that led Congress into the home mortgage market during the Great Depression,⁵⁰⁷ and the opposite result of what Congress intended when it passed DIDMCA.⁵⁰⁸

D. Other Abusive Terms and Practices

1. Balloon Payments and Prepayment Penalties

Another feature that may be present in a subprime loan is a large balloon payment due at the end of the repayment period.⁵⁰⁹ A balloon loan is one that is calculated to amortize over a given period of time and is required to be paid early through the payment of a large lump sum before the entire amortization period runs. The converse arrangement may also be part of a subprime home equity loan contract, wherein the borrower is prohibited from paying the loan off early.⁵¹⁰

Both of these arrangements, balloon payments and prepayment penalty clauses, are generally regulated or prohibited by state law.⁵¹¹ However, state regulation of these terms in home equity loan transactions was preempted by the Alternative Mortgage Transaction Parity Act (AMTPA).⁵¹²

2. Loan Solicitation Techniques

Early on, subprime home equity lenders began aggressively marketing their

505. PREYING ON NEIGHBORHOODS, *supra* note 1, at 4, 28-29; *Unregulated Subprime Loans*, *supra* note 346, at 1.

506. PREYING ON NEIGHBORHOODS, *supra* note 1, at 4; *see also Unregulated Subprime Loans*, *supra* note 346 (discussing the findings of the study).

507. *See supra* Part II.

508. *See supra* Part III.B.

509. *See, e.g.*, PREYING ON NEIGHBORHOODS, *supra* note 1, at 34 (reporting the case of a borrower who had a rate that adjusted up every six months, ending with a balloon payment “almost equivalent to the original loan amount” that she did not know about when she took out the loan); *PrimeTime Live: Debt Reckoning*, *supra* note 467 (reporting on borrowers who had large balloon payments about which they did not know).

510. Subprime borrowers are reportedly more likely to have prepayment penalty clauses in their loan contracts, making it expensive to refinance should they qualify. Carol Frey, *How Lenders Can Sabotage Low Rates*, RALEIGH NEWS & OBSERVER, Nov. 18, 1998, at D1.

511. *See, e.g.*, IOWA CODE ANN. § 537.3308 (West 1997) (providing consumers with the right to refinance any balloon payment on the same terms as the rest of the loan); IOWA CODE ANN. § 537.2509 (West 1997) (giving consumers the right to prepay the unpaid balance of any consumer credit transaction); IOWA CODE ANN. § 537.2510 (West 1997) (providing for a rebate of unearned interest upon a consumer’s prepayment).

512. Alternative Mortgage Transaction Parity Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469 (codified as amended at 12 U.S.C. §§ 3801-3806). For a discussion of AMTPA *see supra* Part III.C.

loans as convenient ways to consolidate consumer debt with the added benefits of tax deductibility and rates lower than credit card rates.⁵¹³ Marketing techniques currently run the gamut from relatively unobtrusive television commercials in which athletes or actors promote home equity loans, to more invasive techniques.⁵¹⁴ The more invasive techniques include lenders culling lien, purchase, and foreclosure information from public records and repeatedly contacting potential borrowers with loan offers.⁵¹⁵ In between are the lenders who send mailers and postcards promoting their loans, and lenders who send "checks" to borrowers that really represent loan proceeds from an as yet unmade loan.⁵¹⁶ Another loan solicitation technique is to tie the loan to a home repair contract⁵¹⁷ and then make the loan for more than the value of the home repairs—and sometimes for the entire debt obligation owed on the home

513. See August, *Survey*, *supra* note 294, at 548. This report also suggests that subprime home equity lending signifies finance companies' attempts to compete with banks, which can issue credit cards, for subprime debt obligations. *Id.* at 549; see also WEICHER, *supra* note 300, at 58 (discussing that subprime equity loans have lower interest rates than credit cards); Canner, *Recent Developments*, *supra* note 285, at 249 ("Subprime home equity loans are commonly marketed as bill-consolidation loans, particularly as a means to pay off credit card debt."). The comparison to credit card rates rather than to other home equity loan rates was no doubt made possible by the mass availability of credit cards to anyone without regard to credit history, and the resulting overborrowing by consumers. TWO STEPS BACK, *supra* note 1, at 14. As for claims about tax deductibility, some lenders have been criticized lately for advertising that loans with a loan-to-value ratio of 125% are tax deductible when in fact only a portion of the loan is likely to be tax deductible. Carol Frey, *125 Percent Mortgage Loans May Be Taxing*, RALEIGH NEWS & OBSERVER, May 16, 1998, at D1 [hereinafter Frey, *125 Percent Mortgage*].

514. See, e.g., Bill Rumbler & Alex Rodriguez, *Mortgage Foreclosures Here Go Through the Roof*, CHI. SUN-TIMES, Mar. 28, 1999, at 29A ("Some predatory lenders blanket neighborhoods with leaflets hawking their financing programs, or even go door-to-door looking for unsophisticated, older homeowners.").

515. PREYING ON NEIGHBORHOODS, *supra* note 1, at 31 (reporting a case in which the borrower found out about the possibility of obtaining a refinance loan when the sheriff served a foreclosure notice on her and "offered to 'help' her by directing her to a broker," and in which the new, more expensive loan also ended up in foreclosure after the borrower had paid 12% of the new loan principal in points and fees); *Id.* at 35 (telling the story of a potential borrower who was targeted for a subprime loan when she fell behind on her chapter 13 (bankruptcy) payments, including her FHA mortgage, and ended up paying a company \$2,500 to arrange financing to help her out of her arrearages, but the company did not find financing for her and took the fee for its services); Bogdanich, *supra* note 279, at A1 (indicating that home equity lenders search land records to find recent land buyers to offer them home equity loans); Watterson, *supra* note 285, at 17 (recognizing that some lenders look through public land records to find impending foreclosures and then attempt to make expensive home equity loans to those facing foreclosure); *PrimeTime Live: Debt Reckoning*, *supra* note 467.

516. See, e.g., Frey, *125 Percent Mortgage*, *supra* note 513, at D1 (recognizing that lenders send checks or items that appear to be checks to targeted borrowers, with a pitch by a famous person who tells the targets that they can get a loan without a problem); Pulliam, *supra* note 339, at C1 ("The lenders thrived by pitching their products through mailers that resembled checks and through television ads that feature sports stars such as Miami Dolphins quarterback Dan Marino.").

517. *Newton v. United Cos. Fin. Corp.*, 24 F. Supp. 2d 444, 447 (E.D. Pa. 1998); see *infra* note 601 and accompanying text.

through refinancing of the first mortgage⁵¹⁸—or to promise more money will be available for home repairs or debt consolidation than is issued at the loan closing.⁵¹⁹ Lenders have also been accused of advertising “teaser” interest rates and then giving the borrower a higher rate at closing.⁵²⁰

3. *Borrower Understanding of Loan Terms, Knowledge of Pricing Information and Inability to Negotiate Terms*

One loan transaction feature familiar to consumer advocates, and certainly not unique to subprime home equity lending, is the borrower’s lack of knowledge of loan terms when entering into the loan. There can be many causes for this, ranging from the borrower’s inability to understand a complex transaction to the lender’s obscuring or misrepresenting loan terms in order to actively mislead the borrower about aspects of the transaction.⁵²¹ Furthermore, even when borrowers do understand loan terms, the loan is likely to be offered on a take-it-or-leave-it basis, precluding negotiation of particularly onerous

518. *Home Equity Lending Abuses, Hearings, supra* note 337, at 68 (indicating that subprime loans made in connection with home repairs are particularly problematic because they may lead a borrower with no mortgage loan or a low interest loan into a high interest subprime loan, simply because the borrower sought to make a relatively inexpensive home repair); Whelan, *supra* note 2, at C10.

519. For example, a borrower discussed in the NTIC study had owned her home since 1985 when she took out a \$29,000 debt consolidation loan. PREYING ON NEIGHBORHOODS, *supra* note 1, at 32. The borrower decided to refinance the loan and take out new proceeds in order to make \$15,000 in home improvements. When the loan actually closed, there was only \$2,000 for home improvements, and the borrower did not actually receive the loan proceeds that the documents indicated were given to her. *Id.*; see also *id.* at 34 (reporting on a borrower who took out a home improvement loan which, after fees were paid from the proceeds, did not cover the home improvements that had motivated the loan). Another story in the same study involves a borrower who did not get all of the loan proceeds represented by the documents. *Id.* at 33; *Newton*, 24 F. Supp. 2d at 447.

520. PREYING ON NEIGHBORHOODS, *supra* note 1, at 6.

521. See, e.g., *id.* at 7 (finding that subprime home equity lenders “often fail to properly disclose the cost of the loan and the fact that the house is collateral for the loan” and that “such lenders have rushed many unsophisticated borrowers through the loan closing, preventing borrowers from understanding what they are signing.”); Frey *Home Buyer, supra* note 412, at D1 (describing a loan transaction in which the borrower could not read and claimed to have not understood the documents); Pulliam, *supra* note 339, at C1 (reporting on the case of a borrower who thought she was borrowing \$140,000 from First Alliance, but wound up with a principal amount of \$161,080, in addition to a loan origination fee of \$21,950); Murray, *supra* note 337, at A4 (reporting on testimony by the daughter of an elderly couple before the House Special Committee on Aging stating that her elderly parents were “lured . . . into a costly loan without [the lender (Associates)] informing them it was a \$75,000 mortgage on their home with an interest rate of 17.7%,” that the lender used forged documents to garner approval of her parents’ loan application, that her parents’ only income was derived from Social Security payments of \$1,156.22, that the lender misrepresented the amount of the monthly payment, and that her parents couldn’t afford the loan and ended up in foreclosure).

terms.⁵²²

Lack of information about the transaction at hand is not the only information gap relevant to subprime lending. There is also little market information available to borrowers. Funding matrices and credit scoring systems are not publicly available, and subprime lenders, like all lenders, are under no obligation to divulge a borrower's credit score to the borrower. Moreover, pricing information is difficult, if not impossible, to obtain.⁵²³ This, combined with the diversity in underwriting standards and lenders' failure to follow their own underwriting standards, means that borrowers often have no idea how credit history correlates with a loan at certain rates and points, making it hard for borrowers to know if their loan's terms are justified by their credit blemishes. All of this taken together means that borrowers who may qualify for conventional loans are likely entering the subprime loan market, and that some borrowers are being funneled into rate categories in which they do not belong (i.e., a B borrower is made a C loan with C rates and points). Indeed, a recent study by Freddie Mac suggests that as many as 35% of borrowers in the subprime market—including all subprime loans—would actually have qualified for prime credit.⁵²⁴

4. *Disparate Impact on Minorities*

While many uninformed borrowers are being made expensive loans not justified by their credit records, not all such uninformed borrowers are treated alike. One of the concerns that has been raised regarding subprime loans is whether lenders are targeting minorities, the elderly, and the poor.⁵²⁵ This concern is particularly legitimate regarding elderly borrowers, who are the most likely to have both accumulated equity in their homes and limited incomes.⁵²⁶

522. *United Cos. Lending Corp. v. Sargeant*, 20 F. Supp. 2d 192, 203-04 (D. Mass. 1998) (implying that subprime mortgage borrowers do not have the power to negotiate points and interest rates).

523. See *infra* Part VII.C.

524. Karen Hube, *In the Wild West of Subprime Lending, Borrowers Have to Dodge Many Bullets*, WALL ST. J., March 18, 1998, at C1.

525. See, e.g., *Home Equity Lending Abuses, Hearings*, *supra* note 337, at 65; PREYING ON NEIGHBORHOODS, *supra* note 1, at 5-6 (finding that "many subprime lenders push high-interest, high-fee loans on poorer homeowners, even if they have good credit records" and that the group targeted by subprime lenders consists of "senior citizens, the working class, and less affluent homeowners as well as homeowners with high levels of credit card debt"); Fred Faust, *Minorities Likely to Pay More for Loans, Report Says*, ST. LOUIS POST-DISPATCH, Oct. 22, 1999, at C8, available in Knight-Ridder Trib. Bus. News Database 1999 WL 28700679; Whelan, *supra* note 2, at C10 (reporting on allegations that lenders market subprime loans to minority individuals even if they have good credit histories that would qualify them for prime loans).

526. *Home Equity Lending Abuses, Hearings*, *supra* note 337, at 65; Dedman, *supra* note 530, at 18; *PrimeTime Live: Debt Reckoning*, *supra* note 494 (reporting on borrowers who when they had almost paid off the home they had lived in for twenty-five years, then were courted by a loan broker and took a subprime loan, and who then worried about foreclosure; and on borrowers who, after taking a subprime loan, lost in foreclosure the home in which they had

It is also a tremendous problem in African-American neighborhoods, threatening to undo much of the progress generated by the Community Reinvestment Act and other laws meant to promote fair lending.⁵²⁷

There is very little comprehensive information about the group of borrowers receiving subprime home equity loans, although in 1999 several studies were published on the subject.⁵²⁸ Each of these studies looking specifically at borrower data concluded that credit history does not appear to be the determining factor in whether borrowers are courted and made conventional or subprime loans. Rather, race and other such characteristics appear to be more important.

One of those studies, published by the Association of Community Organizations for Reform Now (ACORN), concluded that in St. Louis the top ten subprime lenders made 7% of all the home refinance and improvement loans in the entire area, but they made 30% of all of those loans in areas comprised of 80% to 100% minorities.⁵²⁹

Another study published by The Woodstock Institute showed that race, rather than income, home value, debt, the borrower's education, or the location or age of the home, is the strongest factor in the Chicago housing market in determining whether a borrower is offered a prime or subprime loan.⁵³⁰ The study found that "58 percent of conventional (not government guaranteed) refinance loans in predominantly African-American neighborhoods were made by subprime lenders, compared to less than 10% in predominantly white neighborhoods."⁵³¹ The study further found that subprime lenders accounted for 74% of loan applications in black census tracts, but only 21% of loan applications in white census tract areas.⁵³² Banks, thrifts, and bank-owned mortgage companies did most of the lending in white areas, while independent mortgage companies did most of the lending in black areas.⁵³³ This disproportionately high number of subprime loans existed even when

raised their child). A 1994 Federal Reserve Board study found that homeowners with no mortgage debt were more likely to be elderly, and to have limited incomes compared to other homeowners. Canner & Luckett, *Recent Surveys*, *supra* note 279, at 574.

527. 12 U.S.C. §§ 2901-2907 (1994); TWO STEPS BACK, *supra* note 1, at 10.

528. On the lack of available information about subprime borrower groups, see WEICHER, *supra* note 300, at 47 (stating that "[u]nfortunately, there are few sources of systematic information about subprime borrowers.").

529. Faust, *supra* note 354, at C8; Ted Sickinger, *When the Door is Blocked to Buying a Home—Minorities Denied Loans at Higher Rate Than Whites*, KANSAS CITY STAR, Feb. 28, 1999, at A1.

530. TWO STEPS BACK, *supra* note 1, at 17-38; Dedman, *supra* note 503, at 18.

531. TWO STEPS BACK, *supra* note 1, at iii. The study also found that nineteen of the top twenty lenders in white tracts were prime lenders, and fourteen of the top twenty lenders in black tracts were subprime lenders. *Id.*

532. *Id.* Similarly, the study found that "[o]f the 20 lenders accounting for the most conventional refinance applications in white tracts in 1998, 17 were prime lenders." *Id.* However, in black tracts, eighteen of the top twenty lenders (based on loan applications) were subprime lenders. *Id.*

533. *Id.*

neighborhoods with similar incomes were compared.⁵³⁴ Thus, individuals living in middle income black neighborhoods were more likely than individuals living in middle income white neighborhoods to have a subprime, rather than a prime, loan.⁵³⁵ Furthermore, subprime loan activity increased at a much greater rate in black neighborhoods than in white neighborhoods between 1993 and 1998, growing by almost thirty times in black neighborhoods, and only 2.5 times in white neighborhoods.⁵³⁶

National Home Mortgage Disclosure Act (HMDA)⁵³⁷ data also shows that subprime home equity lenders generally lend disproportionately to minorities. For example, of Aames's borrowers in 1996, 25% were black, 11% were hispanic, 1.6% were Asians, and 58% were white.⁵³⁸ The ContiMortgage report shows that for the same year, 16% of its borrowers were black, 3% were hispanic, 59% were white, and 19.6% were "not provided."⁵³⁹ Thus, the studies indicate that subprime home equity lending is having a greater impact on the lives of not only the poor and the elderly, but also members of minority groups.

VII. LEGISLATIVE AND OTHER GOVERNMENTAL ACTION

As the severity of the subprime home equity lending market has come to light, various attempts have been made to bring abuses under control through legislative enactments. The states have been hamstrung by DIDMCA and AMTPA; they are forced to carefully draft state proposals addressing a significant local problem so as not to run afoul of these acts.⁵⁴⁰ It is probably for this reason that the first major effort to curtail predatory subprime mortgage lending was at the federal level.

534. *Id.* at iii, 25. By one estimate half of all middle income black individuals who took out home-secured loans borrowed from subprime lenders. Dedman, *supra* note 503, at 18. The Dedman article also reported that to test whether lenders are making subprime loans to black individuals and others who qualify for better credit terms, housing advocacy groups in thirty-four cities would be using black, white, and Hispanic testers with comparable credit scores to apply for subprime loans to see if they are treated equally, or if minority applicants are made subprime loans while nonminority applicants are directed to prime lenders. *Id.*

535. TWO STEPS BACK, *supra* note 1, at iii.

536. *Id.* The study found that subprime lending had increased by 136% in predominantly white neighborhoods and by 2,874% in predominantly black neighborhoods between 1993 and 1998. *Id.* at 29.

537. 12 U.S.C. §§ 2801-2810 (1994).

538. Home Mortgage Disclosure Act Data for Aames Capital Corporation for 1996 (visited Jan. 4, 2000) <http://db.rtknet.org/ix-bin/hmda/nph-cgihmda_b>.

539. Home Mortgage Disclosure Act Data for ContiMortgage Corporation for 1996 (visited Jan. 4, 2000) <http://db.rtknet.org/ix-bin/hmda/nph-cgihmda_b>. Failure to provide race data is a common problem with subprime HMDA reports, making it difficult to determine the actual racial composition of a company's borrowers.

540. For example, the North Carolina Attorney General's office expressed concern that Office of Thrift Supervision or the OCC might try to nullify the new North Carolina predatory lending law (discussed in Part VII.B, *infra*) by enacting regulations preempting the statute. Brian Collins, *Laws Raise Fears of Preemption*, ORIGINATION NEWS, Oct. 1, 1999, at 43.

A. *The Home Ownership and Equity Protection Act (HOEPA)*⁵⁴¹

In 1994 Congress enacted the Home Ownership and Equity Protection Act in response to the widespread abuses occurring in the home equity market.⁵⁴² The legislation was designed to protect people who were the targets of "reverse redlining," a practice that involves targeting those who are denied traditional means of credit with high interest, high cost loans.⁵⁴³ The Act provides for increased disclosures for mortgages made with an annual percentage rate of interest greater than 10% above the yield on Treasury securities,⁵⁴⁴ or loans with closing fees and total points in excess of 8% of the total loan or \$400, whichever is greater.⁵⁴⁵ These loan terms are sometimes referred to as the HOEPA "triggers." The triggers can be increased or decreased by the Federal Reserve Board every two years, provided the changes are consistent with the consumer protection objectives of HOEPA and are warranted by the need for credit, and as long as the Board consults with representatives of consumers (including low-income consumers) and lenders.⁵⁴⁶

For the purposes of HOEPA, points and fees are defined as "all items included in the finance charge, except interest or the time-price differential",⁵⁴⁷ compensation paid to brokers,⁵⁴⁸ and

each of the charges listed in section 1605(e) (except an escrow for future payment of taxes) unless the charge is reasonable, the creditor receives no direct or indirect compensation, and the charge is paid to a third party unaffiliated with the creditor, and such other charges as the Board determines to be appropriate.⁵⁴⁹

The HOEPA provisions cover anyone who makes two or more high cost, high fee loans in a twelve month period or anyone originating one or more such

541. The author wishes to acknowledge Heather Campbell for researching and writing the initial draft of this section of the Article.

542. Home Ownership and Equity Protection Act of 1994, Pub. L. 103-325, 108 Stat. 2160 (codified in various sections of 15 U.S.C.).

543. *The Home Ownership and Equity Protection Act of 1993: Hearings on S. 924 Before the Comm. on Banking, Hous., & Urban Affairs*, 103rd Cong. 1 (1993) (statement of Sen. Donald Riegle, Jr., Chairman).

544. 15 U.S.C. § 1602(aa)(1)(A) (1994).

545. *Id.* § 1602(aa)(1)(B).

546. *Id.* § 1602(aa)(2). The Board is not allowed to lower the Treasury yield trigger to below eight percentage points above the thirty-day securities yield or increase it to greater than twelve percentage points. *Id.*

547. *Id.* § 1602(aa)(4)(A).

548. *Id.* § 1602(aa)(4)(B).

549. *Id.* § 1602(aa)(4)(C). The charges listed in § 1605(e) include fees for title examination or title insurance, preparation of loan related documents, fees for notarizing deeds and other documents, appraisal fees, and credit reports. *Id.* § 1605(e).

mortgages through a mortgage broker.⁵⁵⁰ Once a lender is covered, the lender must disclose to potential borrowers the annual percentage rate of the loan and the monthly payment for a loan with a fixed rate of interest or, on a variable rate loan, the percentage rate of the loan, the monthly payment obligation, and a statement that the interest and payment might increase, accompanied by the amount of the maximum monthly payment.⁵⁵¹ The lender must also give to the borrower a notice of the possibility of foreclosure if the borrower defaults and a notice that the borrower is not obligated to complete the transaction on the basis of having received disclosures or signing a loan application.⁵⁵² These disclosures must be made three business days prior to the consummation of the transaction, and once these disclosures are made, the lender cannot change the terms of the agreement as disclosed, unless the new disclosures also meet the HOEPA requirements.⁵⁵³

HOEPA also provides that consumers taking covered mortgages cannot be charged a penalty for prepaying principal⁵⁵⁴ except in certain circumstances,⁵⁵⁵ and that if a borrower defaults on a covered mortgage, the lender cannot refinance the loan at a higher rate.⁵⁵⁶ HOEPA also prohibits balloon payments on covered mortgages with a term of less than five years,⁵⁵⁷ negative amortizations,⁵⁵⁸ and prepaid payments.⁵⁵⁹

Perhaps one of the most significant provisions of HOEPA is its prohibition of regularly extending credit without regard to the ability of the consumer to pay the loan.⁵⁶⁰ In the congressional hearings on HOEPA, consumers and advocates recounted numerous stories of abuses regarding lenders who extended credit to homeowners who clearly had little ability to pay their loans.⁵⁶¹ In addition, many consumers who were being offered such loans

550. *Id.* § 1602(f).

551. *Id.* § 1639(a)(2).

552. *Id.* § 1639(a)(1).

553. *Id.* § 1639(b).

554. *Id.* § 1639(c)(1)(A).

555. *Id.* § 1639(c)(2)(A)-(D). These provisions allow for prepayment penalties when, at the time the mortgage is made, the consumer is not liable for a monthly indebtedness of greater than 50% of his gross monthly income, and the income and expenses of that consumer are verified by a signed financial statement, credit report, and in the case of employment income, by payment records or verification from the employer. In addition, the prepayment penalty is allowed if it applies only to a prepayment made by means other than a refinancing by the creditor under the mortgage, or if the penalty does not apply after five years from the date of the making of the mortgage, or is not prohibited under any other law. *Id.*

556. *Id.* § 1639(d).

557. *Id.* § 1639(e).

558. *Id.* § 1639(f). For a description of a negative amortization, see *supra* note 210.

559. *Id.* § 1639(g) (providing that a mortgage covered under HOEPA "may not include terms under which more than 2 periodic payments required under the loan are consolidated and paid in advance from the loan proceeds provided to the consumer.").

560. *Id.* § 1639(h).

561. See, e.g., *Problems in Community Development, Hearings, supra* note 439, at 291-92 (statement of Eva Davis, consumer) (stating she had a monthly income of just under \$1,100 per month and was given a loan that made her monthly payments nearly \$2,000 per

initially had contacted a contractor for home improvement repairs and were directed to lenders for refinancing of their homes to pay for these repairs.⁵⁶² These homeowners frequently had very little left to pay on their initial mortgages and needed very little money to finance the home improvement repairs; yet, by the time a lender was through with finance charges and the like, the consumer was essentially borrowing at 66.6% interest in some cases.⁵⁶³ HOEPA now prohibits lenders from directly paying HOEPA-covered loan proceeds to contractors by lenders, except in situations where the proceeds are payable to the consumer or jointly to the contractor and the consumer,⁵⁶⁴ or where a third party escrow agent pays the contractor in accordance with terms and conditions in a written agreement signed by the consumer, creditor, and contractor before the date of payment.⁵⁶⁵

Finally, HOEPA provides for civil liability in the event of violations and for damages in the amount of all fees and finance charges paid by the consumer unless the creditor establishes that its HOEPA violation was immaterial.⁵⁶⁶ The act also gives state attorneys general the power to prosecute HOEPA violations if an action is brought within three years of the date of the violation.⁵⁶⁷

During the hearings on HOEPA, consumer advocates argued that although HOEPA was a good start to consumer protection, more should be done in this area—specifically, interest rate caps.⁵⁶⁸ Industry representatives argued, on the other hand, that reimposing interest rate caps would dry up credit for needy borrowers who would not otherwise qualify for loans.⁵⁶⁹ Although several senators made comments during the HOEPA debates regarding the possible need to regulate interest rates in the subprime mortgage industry,⁵⁷⁰ Congress

month); *see also supra* Part VI.C.1 (discussing debt-to-income ratio).

562. *See, e.g., The Role of Community Development Banks: Hearings Before the Subcomm. on Fin. Inst. Supervision, Regulation & Deposit Ins. of the House Comm. on Banking, Fin., & Urban Affairs, 103rd Cong. 541-42 (1993)* (statement of Kathleen Keest, National Consumer Law Center).

563. *Id.* at 542.

564. 15 U.S.C. §1639(i)(1).

565. *Id.* §1639(i)(2).

566. *Id.* §1640(a)(4).

567. *Id.* §1640(e).

568. *Community Development Banks, Hearings, supra* note 562, at 547 (statement of Kathleen Keest, National Consumer Law Ctr.); *see also Problems in Community Development, Hearings, supra* note 439, at 259 (statement by Terry Drent, Ann Arbor Community Dev. Dept.) (describing local conditions when the interest rate increases and exceeds the growth rate of fixed incomes).

569. *Problems in Community Development, Hearings, supra* note 439, at 282 (statement of John Hamill, Pres. of Fleet Bank of Mass.) (arguing that high interest rates are the cost of credit for some borrowers who nevertheless still deserve access to credit, a service his company provided).

570. *Id.* at 264 (statement of Sen. Riegle) (stating in regard to interest rates "I gag on the theory that there's even one loan in 21 percent or 19 percent or 18 percent"); *Id.* at 277 (statement by Sen. Shelby) (stating "[b]ut perhaps, if people are going to be exploited like this, this is an area that we're going to have to look into, nationally and State by State"); *Id.* at 283 (statement by Sen. Boxer). Senator Boxer explained

did not fully consider these suggestions, instead opting for the above-described restrictions on high cost mortgages.

HOEPA is a relatively new statute. However, it already appears to be having some success in limiting predatory lending practices, and has been used in various predatory lending actions brought by private litigants and governmental agencies.⁵⁷¹ Nevertheless, critics charge that the trigger for a high-cost loan in HOEPA is too high,⁵⁷² that high-cost loans should have greater protections,⁵⁷³ and that because HOEPA is primarily a disclosure statute, it does not adequately shield borrowers from predatory lending

I'm not a person that likes to set caps on things, because I come from a free market economy. I was a stockbroker. I don't like to set limits, but I think what Mr. Shelby was getting at . . . is that in the face of such outrageous behavior it's almost impossible not to consider having the Government impose some limits.

Id.

571. For example, the FTC announced in July 1999 that it had investigated and charged seven lenders with violating HOEPA by defrauding homeowners into taking loans they had no ability to repay, failing to give required disclosures, and failing to give required notices before foreclosing. Whelan, *supra* note 2, at C10. Six of the seven lenders agreed to pay a total of \$572,500 to consumers. *Id.* The seventh lender was out of business. *Id.* The FTC also announced it would be cracking down on subprime home equity lending abuses. *Id.*; see also *Newton v. United Cos. Fin. Corp.*, 24 F. Supp. 2d 444, 451, 456 (E.D. Pa. 1998) (finding that the lender had violated HOEPA by not making required disclosures three days before the loan closing, but that the borrower had failed to prove a pattern and practice by the lender of making loans that borrowers could not repay). One of the effects HOEPA appears to be having is that some lenders now make loans at a rate just under the HOEPA triggers, so as to avoid making what are now called "HOEPA loans." Other lenders are continuing to make high-cost loans, as defined by HOEPA, and so it is unclear if the HOEPA high-cost cutoff is having the effect of bringing interest rates down.

572. See, e.g., PREYING ON NEIGHBORHOODS, *supra* note 1, at 22 (suggesting that "high cost loans" subject to regulation should be defined as "those with APR of Treasury rate plus 4%"); TWO STEPS BACK, *supra* note 1, at iv, 44 (suggesting that high-cost loans should be those in which there are "fees exceeding 5 percent of the total loan amount or an annual percentage rate (APR) exceeding the corresponding treasury rate plus 8 percentage points").

573. PREYING ON NEIGHBORHOODS, *supra* note 1, at Insert 22 (recommending that restrictions for high-cost loans include no balloon payments, no negative amortization, no increased interest rate after default, no mandatory arbitration clauses, no lending without homeownership counseling, no direct payments to home improvement contractors, and that there should be a private right of action to enforce these protections, and that assignees should be held liable for all borrower claims); TWO STEPS BACK, *supra* note 1, at iv (recommending that "[t]he restrictions on HOEPA loans should be increased, including, for example, prohibiting loan flipping, restricting financing of fees for high-cost loans, prohibiting loans with high debt-to-income ratios, and expanding restrictions on prepayment penalties."); see also *id.* at 39-40. The Department of Housing and Urban Development also recommends lowering the HOEPA threshold and prohibiting loan flipping, requiring lenders to account for the consumer's ability to pay, expanding the class of prohibited prepayment penalties, and requiring education and pretransaction counseling for certain consumers. JOINT REPORT, *supra* note 434, at 50.

practices.⁵⁷⁴

B. North Carolina 1999 Senate Bill 1149

Faced with subprime lending issues that “exploded over the past 18 months or so in terms of the impact on North Carolina,” North Carolina adopted state legislation in July 1999 meant to limit predatory mortgage practices.⁵⁷⁵ The legislation, S.B. 1149, which goes into effect on July 1, 2000, prohibits certain terms and practices in high-cost home loans as defined by the statute.⁵⁷⁶ Pursuant to these limitations, a subprime lender⁵⁷⁷ may not contract (1) for the right to call the loan before default,⁵⁷⁸ (2) for a balloon payment,⁵⁷⁹ (3) for a payment schedule that will cause the principal balance to increase (i.e. a negative amortization),⁵⁸⁰ (4) for an increase in the interest rate after default,⁵⁸¹ (5) for the payment of more than two payments paid out of closing,⁵⁸² or (6) for a charge for a modification or deferral of the loan.⁵⁸³

The statute further prohibits high-cost lending without home-ownership counseling;⁵⁸⁴ high-cost lending without regard for the borrower’s ability to repay;⁵⁸⁵ the financing of prepayment fees or penalties if the lender is refinancing its own loan or the loan of an affiliate;⁵⁸⁶ and the financing of points, fees, or charges payable to a third party.⁵⁸⁷ Lenders also cannot charge “points and fees in connection with a high-cost home loan if the proceeds of the high-cost home loan are used to refinance an existing high-cost home loan held

574. Collins, *supra* note 540, at 43 (quoting a United States Department of Justice attorney as stating that “[f]ederal efforts to stop predatory lending have been ineffective. The Department of Housing and Urban Development is not enforcing the Real Estate Settlement Procedures Act and the Home Owners and Equity Protection Act is simply a disclosure law that is a ‘waste of time.’”); accord TWO STEPS BACK, *supra* note 1, at 10, 48.

575. Bickley, *supra* note 459, at B4 (quoting the director of the Consumer Protection section of the North Carolina Attorney General’s office).

576. N.C. GEN. STAT. § 24-1.1E(1999). High-cost home loans are: (1) those covered by HOEPA; (2) those in which the borrower is charged points and fees of more than 5% of the total loan amount for loans of \$20,000 or more, or 8% of the loan amount or \$1,000 (whichever is less) if the total loan amount is less than \$20,000 (although the statute excludes from this calculation certain points); and (3) those in which the “loan documents permit the lender to charge or collect prepayment fees or penalties more than 30 months after the loan closing or which exceed, in the aggregate, more than two percent (2%) of the amount prepaid.” *Id.* § 24-1.1E(6).

577. Under this statute the term “lender” includes a mortgage banker or mortgage broker who originates a loan in a table funded transaction. *Id.* § 24-2.5.

578. *Id.* § 24-1.1E(b)(1).

579. *Id.* § 24-1.1E(b)(2).

580. *Id.* § 24-1.1E(b)(3).

581. *Id.* § 24-1.1E(b)(4).

582. *Id.* § 24-1.1E(b)(5).

583. *Id.* § 24-1.1E(b)(6).

584. *Id.* § 24-1.1E(c)(1).

585. *Id.* § 24-1.1E(c)(2).

586. *Id.* § 24-1.1E(c)(3)(a).

587. *Id.* § 24-1.1E(c)(3)(b-c).

by the same lender as noteholder.⁵⁸⁸ The legislation also places restrictions on high-cost loans used to pay home-improvement contractors;⁵⁸⁹ defines and prohibits certain unfair and deceptive acts or practices;⁵⁹⁰ prohibits unreasonable and phony charges for loan-related goods, products, and services;⁵⁹¹ prohibits the financing of premiums for credit life, disability, or unemployment insurance;⁵⁹² and prohibits flipping.⁵⁹³

Finally, for all first-lien loans (not just high-cost loans), the legislation provides that points can only be charged if they are "paid for the purpose of reducing, and in fact result in a bona fide reduction of the interest rate or time-price differential."⁵⁹⁴ The statute also limits other fees paid to the lender to not more than one-fourth of 1% of the principal amount of the loan or \$150, whichever is greater;⁵⁹⁵ limits deferral fees;⁵⁹⁶ and prohibits prepayment fees and penalties for loans secured by the borrower's principal dwelling for all loans of \$150,000 or less.⁵⁹⁷

It did not take long for the North Carolina Attorney General's Office to begin using the new statute. The day the statute was adopted, the Attorney General's Office subpoenaed from Associates First Capital⁵⁹⁸ all loan documents generated between January 1996 and June 1999 in eleven North Carolina counties.⁵⁹⁹ The Attorney General also subpoenaed Associates' telephone solicitation scripts, training materials, and sales directives.⁶⁰⁰

C. New York 1999 Senate Bill 5046, Assembly Bill 4744

In early 1999 both houses of the New York Legislature began considering identical bills entitled the "Home Equity Fraud Act."⁶⁰¹ In the preamble to the bill, the legislature describes the predatory lending problem that prompted the legislation:

588. *Id.* § 24-1.1E(c)(4).

589. *Id.* § 24-1.1E(c)(5).

590. *Id.* § 24-1.1E(d).

591. *Id.* § 24-8(d).

592. *Id.* § 24-1.10.2(b).

593. *Id.* § 24-1.10.2(c-d).

594. *Id.* § 24-1.1A(c)(1)(b).

595. *Id.* § 24-1.1A(c)(1)(f).

596. *Id.* § 24-1.1A(g).

597. *Id.* § 24-1.1A(b)(1).

598. Associates First Capital, located in Irving, Texas, and formerly owned by Ford, had the highest subprime home equity loan origination volume in the fourth quarter of 1998. See National Mortgage News, *supra* note 417.

599. Carol Frey, *Lending Law Showing Its Teeth*, RALEIGH NEWS & OBSERVER, Sept. 10, 1999, at D1. By this time the Attorney General's Office had received over fifty complaints about Associates' practices, including upfront fees of more than 10% of the loan. *Id.*

600. *Id.* Interestingly, after the North Carolina legislation passed, subprime lenders in North Carolina agreed to have more meetings with consumer groups. *Id.*

601. S. 5046, 222nd Leg., Reg. Sess. (N.Y. 1999); A. 4744, 222d Leg., Reg. Sess. (N.Y. 1999).

The legislature hereby finds that many senior citizens and minority homeowners in New York have been targeted by unethical home improvement contractors, mortgage companies, mortgage brokers and finance companies who induce these homeowners into entering into high cost high interest rate mortgage agreements which the homeowner is often unable to afford with the intent of foreclosing on the home and stripping the equity.

The legislature further finds that in order to entice people into entering into these agreements they are promised refinancing of primary mortgages, consolidation of loans and outstanding bills and are given cash but often are not told or do not understand that they are securing the loan with a mortgage lien on their home which will lead to foreclosure in the event of default. Often these loans are documented with false and misleading documentation provided by brokers which could easily be determined to be false if checked by the lender. Despite prohibitions contained in federal law many of these loans are based on equity in the home and not on the borrower's ability to pay. Since many of these homeowners live on a fixed income, they are unable to make the required payments and end up losing their homes. This practice appears to be targeted in neighborhoods with a high concentration of senior and minority residents.

The legislature further finds that it is in the best interest of the citizens of this state that these unethical practices should be prohibited by law and that unscrupulous people should be denied the benefit of the courts of this state in perpetrating these actions upon the senior citizens of this state and does therefore enact this Home Equity Fraud Act.⁶⁰²

The bill allows for the imposition of a fine or penalty on any mortgage banker or broker who charges more than 3% for services performed by a mortgage broker or charges or allows to be charged more than 6% in points and fees (with some exclusions).⁶⁰³ Further, the bill requires that mortgage bankers and brokers disclose either before or at the time the borrower makes a loan application whether the loan will be sold after closing or retained by the original lender.⁶⁰⁴ Under the bill, a licensed lender's license may be revoked or suspended if the lender engages in various business activities with a home-improvement contractor unless the lender fully discloses the activities and

602. N.Y. S. 5046 § 2; N.Y. A. 4744 § 2.

603. N.Y. S. 5046 § 3; N.Y. A. 4744 § 3.

604. N.Y. S. 5046 § 4; N.Y. A. 4744 § 4. The bill also prohibits the transfer of a loan for 180 days after closing if the borrower is not told that the loan may be sold. *Id.*

secures the written agreement of all parties to the transaction.⁶⁰⁵ Moreover, loans secured by the borrower's home may not have a balloon payment, and the loan-to-value ratio may not exceed 80%.⁶⁰⁶ The bill also provides for an extended notice to borrowers subject to a foreclosure action alerting them of potential predatory lending defenses to foreclosure⁶⁰⁷ and requires foreclosing lenders to prove they have complied with all mortgage banker and broker regulations.⁶⁰⁸

A defense to foreclosure or enforcement exists under the bill if (1) the loan being foreclosed or collected upon was a refinance loan to a borrower who owned the property for more than five years prior to the loan date, and (2) the borrower did not have the ability to repay the loan and the lender knew or should have known this. Another defense exists if the broker or banker violated applicable mortgage banker and broker regulations. Furthermore, in a foreclosure action, the court may consider the age, income source, and debt-to-income ratio of the borrower at the time the loan was made.⁶⁰⁹ The bill also increases the time to cancel a home-improvement contract from three to fifteen days⁶¹⁰ and prohibits default judgments on loans that refinance a personal residence unless the court makes a written affirmative finding that the relevant regulations were complied with.⁶¹¹ This bill is still pending.

D. Other Legislative Proposals

Although New York and North Carolina are the only two states to have gone so far as to introduce or adopt legislation addressing predatory home mortgage lending, other such action appears inevitable.⁶¹² For example, the City of Baltimore recently formed a citywide Coalition to End Predatory Real Estate Practices.⁶¹³ The coalition is working to draft predatory lending legislation to be introduced in the next session of the Maryland General Assembly.⁶¹⁴

Additionally, Congress has begun to recognize that a problem still exists despite its adoption of HOEPA. In March 1998, in the wake of continued concern about abuses in the subprime home equity market, the Senate Special Committee on Aging, chaired by Senator Charles E. Grassley (R-IA), held

605. N.Y. S. 5046 § 5; N.Y. A. 4744 § 5. A companion piece of the bill similarly limits home improvement contractors. N.Y. S. 5046 § 11; N.Y. A. 4744 § 11.

606. N.Y. S. 5046 § 7; N.Y. A. 4744 § 7.

607. N.Y. S. 5046 § 8; N.Y. A. 4744 § 8.

608. N.Y. S. 5046 § 9; N.Y. A. 4744 § 9.

609. N.Y. S. 5046 § 9, 12; N.Y. A. 4744 § 9, 12.

610. N.Y. S. 5046 § 10; N.Y. A. 4744 § 10.

611. N.Y. S. 5046 § 12; N.Y. A. 4744 § 12.

612. Since North Carolina approved its law twenty-three attorneys general have contacted the North Carolina Attorney General for information on how to enact a similar law. *State Level Most Important to Broker Regulation*, 9 ORIGINATION NEWS 50, Oct. 1, 1999, available in 1999 WL 11126684.

613. Daniel P. Henson III, *City Not Silent Partner in Real Estate 'Flipping'*, BALTIMORE SUN, August 21, 1999, at 13A.

614. *Id.*

hearings on abuses in the subprime market.⁶¹⁵ The hearings were not meant to spur any legislation, but only to expose the problem and educate consumers.⁶¹⁶ These same concerns have also played a part in proposals to reform the Truth in Lending Act and the Real Estate Settlement Procedures Act.⁶¹⁷

VIII. SOLUTIONS AND RECOMMENDATIONS

Clearly, legislatures and other policy makers must continue trying to find solutions to the problem of predatory home equity lending.⁶¹⁸ The question is, how should regulators and others go about doing so? The remainder of this Article makes some suggestions in this direction.

A. Better Data Collection and the Home Mortgage Disclosure Act (HMDA)⁶¹⁹

The information necessary to fully understand the problem of predatory home equity lending is currently not collected anywhere, nor is it required to be reported anywhere.⁶²⁰ Thus there are currently only inadequate and

615. Murray, *supra* note 337, at A4.

616. *Id.*

617. JOINT REPORT, *supra* note 434, at 50 (recommending additional substantive consumer protections); *Regulatory Burden Relief: Hearing Before the Subcomm. on Fin. Inst. & Consumer Credit of the House Comm. on Banking & Fin. Servs.*, 105th Cong. 319 (1998) (statement of Margot Saunders, Managing Attorney, National Consumer Law Ctr.) (seeking to modify TILA and RESPA to protect consumers).

618. As one recent observer put it, "[i]t will become increasingly important for regulators to distinguish between loans that make housing attainable for a larger segment of the community and those that serve only to generate quick fees for lenders without consideration for a borrower's ability to repay." Ellen Seidman, *CRA in the 21st Century*, MORTGAGE BANKING, Oct. 1, 1999, at 58, 63.

619. 12 U.S.C. §§ 2801-2811 (1994).

620. For example, the authors of the Woodstock Institute study recognized that "HMDA data lack key information on costs and terms, do not include many second mortgage home equity loans, and miss some lenders entirely due to exemptions in the law. Ideally, of course, such data would be collected at the federal level." TWO STEPS BACK, *supra* note 1, at v; *see also id.* at 46; PREYING ON NEIGHBORHOODS, *supra* note 1, at 11, 37-38 (recognizing the difficulties of researching and of public policy enforcement where data is not sufficiently nor timely reported); WEICHER, *supra* note 300, at 48 (stating that "[t]he information about borrowers that has featured in public policy discussions has been anecdotal. This is virtually unavoidable, given the paucity of systematic data").

The authors of the NTIC study similarly complained about the lack of data differentiating between prime and subprime loans and the fact that not all lenders are required to report under HMDA:

To meaningfully estimate the subprime market and its impact NTIC attempted to overcome two problems. The first has to do with the definition of the subprime market. Lending data such as that provided through HMDA do not differentiate between subprime and other loans. Nor does federal law require all subprime lenders to report HMDA data.

PREYING ON NEIGHBORHOODS, *supra* note 1, at 10; *see also id.* at 9, 11, 37-38 (stating that the

incomplete sources for information about rates and points charged by subprime lenders and to whom such loans are being made. Lenders have absolutely no incentive to collect such information, and yet this information is essential to a complete understanding of subprime home equity lending and what regulation may be appropriate.⁶²¹

The Home Mortgage Disclosure Act already requires many mortgage lenders to report various data about the loans they make.⁶²² However, much information essential to understanding predatory home equity lending is not collected, and compliance is not adequately monitored. Amending HMDA to require collection of essential data and better compliance and monitoring would be an easy way to provide policy makers with the information they need to fully understand the magnitude and severity of the problem. Therefore, this article first recommends that HMDA be amended to cover all home equity lenders, and to require the reporting of information such as (1) loan interest rates and APR; (2) points and fees; (3) loan-to-value ratios; (4) the borrower's debt-to-income ratio (determined by a national standard); (5) whether the lender deems the loan to be subprime; (6) what category lender deems the loan to be and why; (7) whether the loan is a refinance of an existing mortgage, regardless of the "purpose" for the loan; (8) how many times the lender and/or affiliated lenders have made a loan to the same borrower; (9) all fees charged in the loan; and (10) the cost and type of any insurance included in the loan.⁶²³

lack of data on subprime lenders makes accurate industry characterization difficult.

621. This fact was recognized by the Weicher report:

Unfortunately, there are few sources of systematic information about subprime borrowers. Although the demographic and economic attributes of borrowers are important to policymakers, they have not been of particular interest to Wall Street analysts. Nor have individual subprime lenders found it useful to collect and analyze such data about their borrowers for business purposes What does matter to a lender are the credit history of the borrower, the characteristics of the property, and the characteristics of the loan. This information does serve important business purposes, whereas demographic information about the borrower is not directly relevant.

WEICHER, *supra* note 300, at 47-48.

622. The Act requires certain depository institutions to record and report "the number and total dollar amount of mortgage loans which were (A) originated (or for which the institution received completed applications), or (B) purchased by that institution during each fiscal year . . ." 12 U.S.C. § 2803(a)(1)(1994). Among other things, the Act further requires lenders to indicate "the number and dollar amount of home improvement loans" and "the number and dollar amount of mortgage loans and completed applications involving mortgagors or mortgage applicants grouped according to census tract, income level, racial characteristics, and gender." *Id.* § 2803(b).

623. The Woodstock Institute study contained a similar proposal, finding that states should:

require licensed mortgage lenders to report data on loans, including rates, fees, etc., and can make these data available to the public. Home Mortgage

As the NTIC study concluded, “[u]nless and until all lenders directly report, in a timely and accurate fashion, such data as interest, Annual Percentage Rate, fees, and the like, it will be impossible to get a more accurate picture of subprime lending practices than that provided here.”⁶²⁴

B. Increased Information in the Market

All efforts thus far at increasing the information in the market in order to make it work more efficiently have been at the individual level. Thus, TILA and RESPA both dictate certain information that must be disclosed to individual borrowers before consummation of the loan transaction. The Truth in Lending Act does not mandate disclosure of rates and terms in the market except through these disclosures at the individual level. The only regulation of advertising contained in the Truth In Lending Act is set up as “trigger term” regulation. This means that if a lender chooses to advertise one of several rate trigger terms, it must also advertise other relevant terms.⁶²⁵ In this way, the current regulation of advertising of rates and terms is woefully inadequate.

Consumers need to know what they are looking at before they decide to buy. Therefore, lenders should be required to advertise rates and fees so that a borrower can know long before entering into a relationship with a potential lender whether they are truly interested in taking a loan from the lender. This would further protect borrowers from becoming unsuspecting victims of predatory lending practices and would also help the market work more efficiently.

Still, increasing the information provided to borrowers probably cannot, on its own, solve the problems faced by subprime home equity borrowers. As the Woodstock Institute study concluded:

Ideally, [homeowners] would be equipped, either through education or technical assistance, to judge whether the potential advantages of a subprime loan merits the costs of the loan as well as the risk of credit problems or even foreclosure. Because it is not feasible to give such skills to all

Disclosure Act data has proven a powerful tool in improving access to credit. But HMDA data lack key information on costs and terms, do not include many second mortgage home equity loans, and miss some lenders entirely due to exemptions in the law. Ideally, of course, such data would be collected at the federal level.

TWO STEPS BACK, *supra* note 1, at v; *see also* PREYING ON NEIGHBORHOODS, *supra* note 1, at 37-38 (advocating that subprime lenders, mortgage brokers, and home-improvement contractors be required to report interest rates, fees and APRs as well as the term of loans made, and the broker or home-improvement contractor involved in the loan).

624. PREYING ON NEIGHBORHOODS, *supra* note 1, at 11.

625. 12 C.F.R. § 226.24 (1999).

homeowners and due to the scale of the problem, it is incumbent upon public policy to reduce the opportunities for lenders and brokers to originate predatory loans.⁶²⁶

C. Rate and Fee Regulation

During the process of adopting HOEPA, neither the establishment of a federal usury limit, nor the elimination of the federal preemption contained in DIDMCA for purposes of nonpurchase money first-lien loans, were considered. This was a mistake.

Rate regulation has historically served—and in all areas except first-lien mortgage lending, continues to serve—several important public functions. First, usury limits protect the borrower from overreaching and fraud by setting a maximum charge that can be imposed by lenders, good and bad alike. These maximum limits also set a societal cap on the value of the use of another's money, thereby preventing overcompensation to lenders with control over lent assets.

Usury limits also protect the borrower from his or her own inability to understand complex financial transactions and from making poor financial decisions with stakes that are unacceptably high, such as eviction from and foreclosure on the borrower's home. This protective function is served by much of the legislation that governs our society. For example, we require the use of seat belts because it protects the driver and occupants from serious injury in the event of an accident.⁶²⁷ Similarly, we should protect borrowers from loss of their homes by setting maximum rates and fees that can be charged by lenders, and by requiring lenders to take into account a borrower's ability to pay. In some cases, borrowers simply should not have access to credit because they cannot pay for the credit without losing their home.

Finally, usury limits protect loan source funds, whether supplied by depositors or Wall Street investors. Usury limits do this by recognizing that lending beyond a certain maximum limit causes extremely high risks of loss of the invested capital, whether the risk is generated by the borrower or caused by the loan. This sort of protection compensates for the fact that the parties making decisions about which individuals will get loans from a pool of assets are sometimes more concerned with personal profit through commissions and fees than with the security of investors' or depositors' assets.

626. TWO STEPS BACK, *supra* note 1, at 10; *see also id.* at 48 (noting that the debt problems of low income borrowers may be ameliorated by increasing the capacity of homeowners to discern unfair credit offers).

627. This concept is derived from a speech made by Ralph Nader at the Eighth Annual National Consumer Rights Litigation Conference on November 6, 1999 in Washington, D.C. Mr. Nader observed that even though more traffic accidents may be beneficial to the economy in terms of increased production of new cars, increased labor requirements at hospitals and so forth, no one thinks that we ought to have a public policy that encourages more car accidents. He then indicated that laws protecting borrowers are no different.

DIDMCA, quite unintentionally, left home equity borrowers with no protections from overreaching.⁶²⁸ The legislative history of DIDMCA clearly shows that Congress never imagined that in attempting to allow rates to move with the market, and to increase the income for regulated thrift institutions, it was also paving the way for high-rate subprime home equity lending completely unrestrained by government regulation or by market control. The unintended consequence of this statute has been that "most of the ways greedy speculators take advantage of poor and unsophisticated buyers, though cruel and immoral, are not illegal."⁶²⁹

It is now time for Congress to recognize that there should be usury limits on subprime home equity lending. As the executive director of NTIC recognized after NTIC completed its study in Chicago, "[u]nless we regulate the interest rates and fees that subprime, high-interest-rate lenders can charge, more families are going to lose their homes and more communities in the city and suburbs will have abandoned buildings."⁶³⁰ This does not necessarily mean that Congress has to set an ironclad limit that cannot adjust to an increase in market interest rates. Congress could just as plausibly adopt a floating maximum rate, as it did in its definition of a high-rate loan under HOEPA.⁶³¹ There also must be regulation of points and fees that can be charged by home equity lenders. In this regard, the NTIC study recommended a 3% cap on points and fees on all home equity loans, not just high-cost loans.⁶³²

The next question that must be addressed is whether regulation should be at the federal level—which would require a continuation of federal preemption of state usury laws, but would replace deregulation with regulation—or whether the preemption should be lifted so that states can address the problems of subprime home equity. One of the strongest arguments for regulation at the federal level is that there is a tremendous amount of interstate loan activity. Regulation by the various states may make compliance more difficult for lenders and may also allow lenders to maneuver around state regulation.⁶³³ On the other hand, the states appear eager to help resident homeowners, and there is at least some feeling that the states would be likely to adopt more stringent

628. The NTIC study fully attributes high interest rates, points, and fees to DIDMCA, and considers the Act one of the worst problems with subprime home equity lending because it has legalized the charging of such rates and fees. *PREYING ON NEIGHBORHOODS*, *supra* note 1, at 7.

629. Henson, *supra* note 613, at 13A.

630. *Unregulated Subprime Loans*, *supra* note 346; *see also* Forrester, *supra* note 240, at 438, 447-48 (arguing that Congress should preempt state usury ceilings only for purchase money home mortgage loans).

631. 15 U.S.C. § 1602(aa) (1994).

632. *PREYING ON NEIGHBORHOODS*, *supra* note 1, at 36.

633. In this regard, the Woodstock Institute study raises the concern that if regulation is permitted at the state level, lenders will simply take advantage of DIDMCA's most favored lender provision: "[S]tate laws may be subject to preemption by national banking laws. If state regulations improve generally, thrifts and national banks may increasingly become vehicles for avoiding state rules." *TWO STEPS BACK*, *supra* note 1, at v; *see also id.* at 39-40, 46 (noting that improving state regulation of home lending laws may lead to thrifts and national banks being used to avoid state rules).

regulation.⁶³⁴

IX. CONCLUSION

Whether at the state level or at the federal level, subprime borrowers clearly need the help of regulators in curbing abusive practices, ad hoc pricing, and unaffordably high rates. From 1933 until 1979, mortgage loan rate abuse was prevented by rate ceilings imposed at the federal level for some loans and at the state level for others. Such ceilings still exist at the state level for many kinds of consumer loans. The subprime home equity market that has developed in the absence of mortgage loan rate regulation demonstrates that justifications for rate limits still apply today, and that fees and rates in the market must be regulated.

634. In this regard, even after expressing concerns about lenders seeking to avoid state regulation, the Woodstock Institute study concludes that "unless the federal government changes HOEPA to follow the North Carolina and New York models, federal preemption laws should be modified to allow states to protect their homeowners." *TWO STEPS BACK*, *supra* note 1, at v; *see also id.* at 39-40, 46 (recommending removal of federal preemption of the state consumer lending laws). The NTIC study, on the other hand, concluded that, "Undoubtedly, the most effective regulation of usurious subprime lenders for the Chicago area and the nation would be to impose federal caps on interest rates." *PREYING ON NEIGHBORHOODS*, *supra* note 1, at 36.

One disadvantage of setting a maximum rate cap is that borrowers may still be funneled, or upsold, into rate categories not justified by their credit history. Freddie Mac is currently working on setting up standard subprime underwriting credit systems that it hopes can be used to appropriately categorize borrowers into rates. Arnold S. Kling, *Get Set for Loan-Level Pricing* (visited Oct. 10, 1999) <<http://www.freddiemac.com/finance/smm/July97/html/riskbase.htm>>. Some industry experts believe that if Fannie Mae and Freddie Mac become players in the subprime mortgage industry this might standardize rates, curb abusive practices, and lower interest rates.

APPENDIX I

1995-1999 DISTRIBUTION OF MORTGAGE RATES BY RATE AND LENDER

GRAPH 1: MORTGAGE RATE DISTRIBUTION 1995-1999

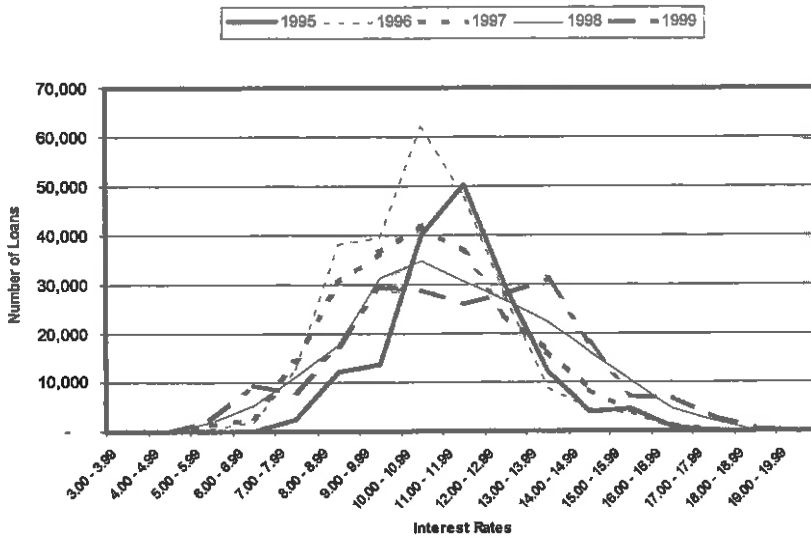


TABLE 1: MORTGAGE RATE DISTRIBUTION 1995-1999

Rate	1995	1996	1997	1998	1999
3.00 - 3.99	-	-	-	-	1
4.00 - 4.99	-	2	20	16	23
5.00 - 5.99	3	597	1,332	1,876	2,009
6.00 - 6.99	33	1,860	2,681	5,218	9,544
7.00 - 7.99	2,432	12,527	14,339	11,138	8,024
8.00 - 8.99	12,032	38,226	30,312	17,739	17,367
9.00 - 9.99	13,715	39,602	36,192	31,193	29,361
10.00 - 10.99	40,114	62,220	41,763	34,796	29,004
11.00 - 11.99	50,144	47,866	36,692	30,517	26,132
12.00 - 12.99	29,716	27,588	23,758	26,856	28,274
13.00 - 13.99	12,217	8,564	16,202	22,499	31,116
14.00 - 14.99	3,890	4,519	8,515	16,331	18,104
15.00 - 15.99	4,365	3,517	4,212	10,184	7,139
16.00 - 16.99	789	441	1,349	4,464	6,846
17.00 - 17.99	35	71	245	1,995	2,765
18.00 - 18.99	-	8	22	16	425
19.00 - 19.99	-	1	3	6	44
Totals	169,485	247,609	217,637	214,844	216,178

GRAPH 2: 1995 DISTRIBUTION OF MORTGAGE RATES

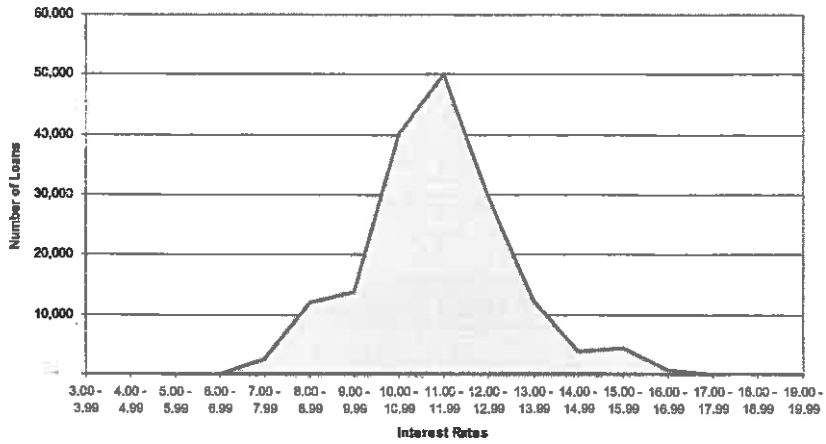


TABLE 2: 1995 DISTRIBUTION OF MORTGAGE RATES BY LENDER

Rate	Associates	Household Francis	Corfi Mortgage	Green Tree Francis	Money Store	Commercial Cr/Travelers	Adventis Mortgage USA	Equicredit Corporation	Amesco	Option One Mg. Corp.	New Century Francis	Impact	Long Beach Mortgage	Residential Fund/ GMAC	TOTAL	%
3.00 - 3.99	N/A	N/A	N/A	-	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	-	-	0%
4.00 - 4.99	N/A	N/A	N/A	-	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	-	-	0%
5.00 - 5.99	N/A	N/A	N/A	-	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	3	3	0%
6.00 - 6.99	N/A	N/A	N/A	-	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	33	33	0%
7.00 - 7.99	N/A	N/A	N/A	-	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	2,432	2,432	1%
8.00 - 8.99	N/A	N/A	N/A	8,195	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	5,837	12,032	7%
9.00 - 9.99	N/A	N/A	N/A	13,414	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	301	13,715	8%
10.00 - 10.99	N/A	N/A	N/A	40,105	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	8	40,114	24%
11.00 - 11.99	N/A	N/A	N/A	50,143	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	1	50,144	30%
12.00 - 12.99	N/A	N/A	N/A	29,715	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	1	29,716	18%
13.00 - 13.99	N/A	N/A	N/A	12,217	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	-	12,217	7%
14.00 - 14.99	N/A	N/A	N/A	3,890	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	-	3,890	2%
15.00 - 15.99	N/A	N/A	N/A	4,365	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	-	4,365	3%
16.00 - 16.99	N/A	N/A	N/A	789	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	-	789	0%
17.00 - 17.99	N/A	N/A	N/A	35	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	-	35	0%
18.00 - 18.99	N/A	N/A	N/A	-	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	-	-	0%
19.00 - 19.99	N/A	N/A	N/A	-	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	-	-	0%
Lender Total	N/A	N/A	N/A	160,899	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	8,616	169,485	100%

GRAPH 3: 1996 DISTRIBUTION OF MORTGAGE RATES

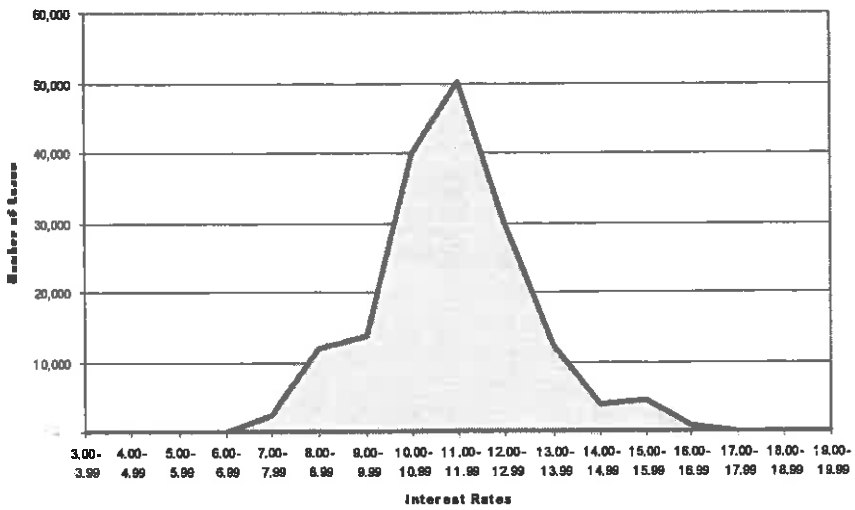


TABLE 3: 1996 DISTRIBUTION OF MORTGAGE RATES BY LENDER

Rate	Associates	Household Friends	Conf Mortgage	Green Tree Friends	Money Store	Commercial C/T/Trust	Advent Mortgage USA	Equibest Cooperative	Amresco	Option One Mtg. Corp.	New Century Friends	Impos	Long Beach Mortgage	Residential Fund/ GNAC	TOTAL	%
3.00 - 3.99	N/A	N/A	-	-	N/A	N/A	-	N/A	-	N/A	N/A	N/A	N/A	-	-	0%
4.00 - 4.99	N/A	N/A	-	-	N/A	N/A	1	N/A	1	N/A	N/A	N/A	N/A	-	2	0%
5.00 - 5.99	N/A	N/A	-	-	N/A	N/A	1	N/A	8	N/A	N/A	N/A	N/A	588	597	0%
6.00 - 6.99	N/A	N/A	1	44	N/A	N/A	9	N/A	83	N/A	N/A	N/A	N/A	1,723	1,860	1%
7.00 - 7.99	N/A	N/A	91	218	N/A	N/A	158	N/A	308	N/A	N/A	N/A	N/A	11,751	12,527	5%
8.00 - 8.99	N/A	N/A	663	17,789	N/A	N/A	1,068	N/A	1,631	N/A	N/A	N/A	N/A	17,075	38,228	15%
9.00 - 9.99	N/A	N/A	2,146	24,842	N/A	N/A	2,947	N/A	3,017	N/A	N/A	N/A	N/A	6,650	39,602	16%
10.00 - 10.99	N/A	N/A	3,344	46,147	N/A	N/A	3,155	N/A	2,780	N/A	N/A	N/A	N/A	6,784	82,220	29%
11.00 - 11.99	N/A	N/A	3,158	35,499	N/A	N/A	2,477	N/A	1,753	N/A	N/A	N/A	N/A	4,979	47,666	19%
12.00 - 12.99	N/A	N/A	2,312	19,585	N/A	N/A	2,188	N/A	1,089	N/A	N/A	N/A	N/A	2,404	27,568	11%
13.00 - 13.99	N/A	N/A	1,363	4,582	N/A	N/A	1,209	N/A	577	N/A	N/A	N/A	N/A	803	8,564	3%
14.00 - 14.99	N/A	N/A	825	2,773	N/A	N/A	523	N/A	258	N/A	N/A	N/A	N/A	140	4,519	2%
15.00 - 15.99	N/A	N/A	357	2,917	N/A	N/A	180	N/A	52	N/A	N/A	N/A	N/A	11	3,517	1%
16.00 - 16.99	N/A	N/A	110	283	N/A	N/A	39	N/A	9	N/A	N/A	N/A	N/A	-	441	0%
17.00 - 17.99	N/A	N/A	57	7	N/A	N/A	4	N/A	3	N/A	N/A	N/A	N/A	-	71	0%
18.00 - 18.99	N/A	N/A	7	-	N/A	N/A	1	N/A	-	N/A	N/A	N/A	N/A	-	8	0%
19.00 - 19.99	N/A	N/A	1	-	N/A	N/A	-	N/A	-	N/A	N/A	N/A	N/A	-	1	0%
Lender Total	N/A	N/A	14,465	154,666	N/A	N/A	13,980	N/A	11,570	N/A	N/A	N/A	N/A	52,918	169,465	100%

GRAPH 4: 1997 DISTRIBUTION OF MORTGAGE RATES

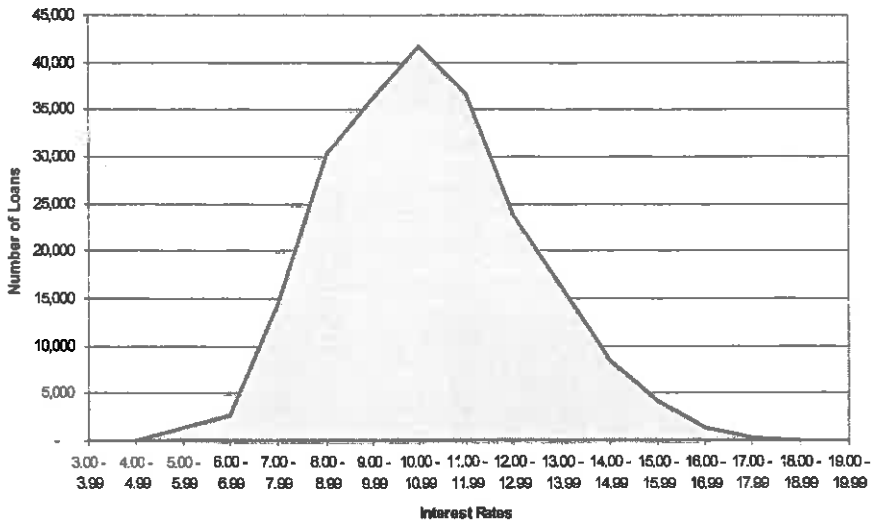


TABLE 4: 1997 DISTRIBUTION OF MORTGAGE RATES BY LENDER

Rate	Associates	Household Financial	Com'l Mortgage	Green Tree Financial	Money Store	Commercial Cr7Travelers	Advent Mortgage USA	Equibest Capital	Amesco	Option One Mtg. Corp.	New Century Financial	Impact	Long Beach Mortgage	Resident Fund/ GMAC	TOTAL	%
3.00 - 3.99	N/A	N/A	-	-	N/A	N/A	-	N/A	-	N/A	N/A	N/A	N/A	-	-	0%
4.00 - 4.99	N/A	N/A	-	17	N/A	N/A	-	N/A	3	N/A	N/A	N/A	N/A	-	20	0%
5.00 - 5.99	N/A	N/A	1	160	N/A	N/A	-	N/A	11	N/A	N/A	N/A	N/A	1,160	1,332	1%
6.00 - 6.99	N/A	N/A	10	2,552	N/A	N/A	11	N/A	67	N/A	N/A	N/A	N/A	41	2,691	1%
7.00 - 7.99	N/A	N/A	161	4,135	N/A	N/A	152	N/A	584	N/A	N/A	N/A	N/A	9,287	14,339	7%
8.00 - 8.99	N/A	N/A	1,837	10,865	N/A	N/A	1,521	N/A	3,118	N/A	N/A	N/A	N/A	12,941	30,312	14%
9.00 - 9.99	N/A	N/A	8,559	16,450	N/A	N/A	3,755	N/A	5,594	N/A	N/A	N/A	N/A	3,843	36,192	17%
10.00 - 10.99	N/A	N/A	10,114	17,964	N/A	N/A	4,172	N/A	5,450	N/A	N/A	N/A	N/A	4,053	41,783	19%
11.00 - 11.99	N/A	N/A	8,222	17,324	N/A	N/A	3,653	N/A	3,221	N/A	N/A	N/A	N/A	4,272	36,662	17%
12.00 - 12.99	N/A	N/A	5,495	10,798	N/A	N/A	2,882	N/A	1,605	N/A	N/A	N/A	N/A	2,989	23,758	11%
13.00 - 13.99	N/A	N/A	2,905	8,259	N/A	N/A	1,416	N/A	728	N/A	N/A	N/A	N/A	4,894	16,202	7%
14.00 - 14.99	N/A	N/A	1,557	1,191	N/A	N/A	648	N/A	389	N/A	N/A	N/A	N/A	4,730	8,515	4%
15.00 - 15.99	N/A	N/A	594	1,201	N/A	N/A	249	N/A	106	N/A	N/A	N/A	N/A	2,132	4,212	2%
16.00 - 16.99	N/A	N/A	320	273	N/A	N/A	50	N/A	16	N/A	N/A	N/A	N/A	680	1,349	1%
17.00 - 17.99	N/A	N/A	126	29	N/A	N/A	15	N/A	-	N/A	N/A	N/A	N/A	75	245	0%
18.00 - 18.99	N/A	N/A	18	-	N/A	N/A	3	N/A	-	N/A	N/A	N/A	N/A	1	22	0%
19.00 - 19.99	N/A	N/A	3	-	N/A	N/A	-	N/A	-	N/A	N/A	N/A	N/A	-	3	0%
Lender Total	N/A	N/A	37,872	89,236	N/A	N/A	18,528	N/A	20,882	N/A	N/A	N/A	N/A	51,117	217,637	100%

GRAPH 5: 1998 DISTRIBUTION OF MORTGAGE RATES

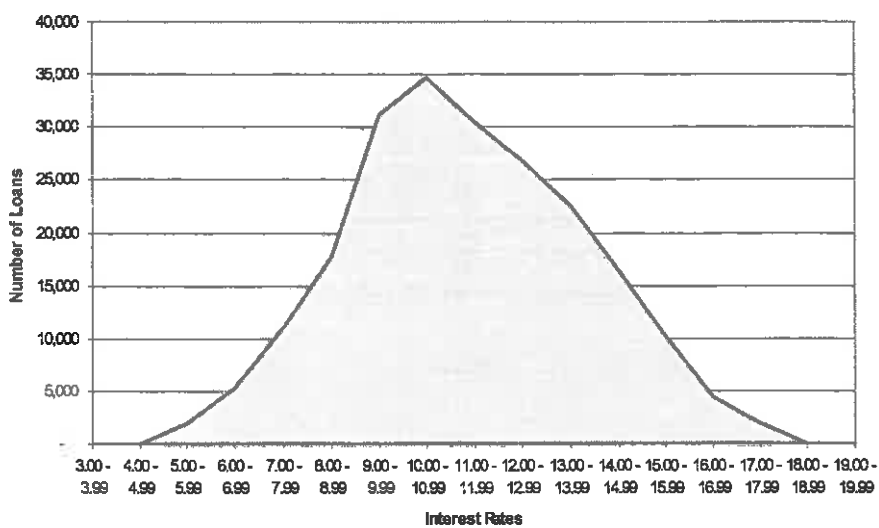


TABLE 5: 1998 DISTRIBUTION OF MORTGAGE RATES BY LENDER

Rate	Associates	Household Financial	Com'l Mortgage	Green Tree Financial	Money Store	Commercial Cr/Tireless	Adventa Mortgage USA	Equibedit Cooperation	Arresso	Optim One Mg. Corp.	New Century Financial	Impac	Long Beach Mortgage	Residentia Fund/ GMAC	TOTAL	%
3.00 - 3.99	N/A	N/A	-	-	N/A	N/A	-	N/A	-	N/A	N/A	-	N/A	-	-	0%
4.00 - 4.99	N/A	N/A	-	16	N/A	N/A	-	N/A	-	N/A	N/A	-	N/A	-	16	0%
5.00 - 5.99	N/A	N/A	-	113	N/A	N/A	1	N/A	3	N/A	N/A	-	N/A	1,759	1,876	1%
6.00 - 6.99	N/A	N/A	6	3,736	N/A	N/A	7	N/A	188	N/A	N/A	-	N/A	1,281	5,218	2%
7.00 - 7.99	N/A	N/A	203	5,761	N/A	N/A	143	N/A	1,033	N/A	N/A	376	N/A	3,622	11,138	5%
8.00 - 8.99	N/A	N/A	1,771	8,699	N/A	N/A	1,078	N/A	3,257	N/A	N/A	1,819	N/A	1,117	17,739	8%
9.00 - 9.99	N/A	N/A	4,439	14,108	N/A	N/A	2,453	N/A	8,097	N/A	N/A	1,884	N/A	2,203	31,193	15%
10.00 - 10.99	N/A	N/A	5,040	16,843	N/A	N/A	2,682	N/A	6,420	N/A	N/A	123	N/A	3,578	34,796	16%
11.00 - 11.99	N/A	N/A	3,166	15,777	N/A	N/A	2,127	N/A	3,409	N/A	N/A	368	N/A	5,660	30,517	14%
12.00 - 12.99	N/A	N/A	1,880	14,108	N/A	N/A	1,546	N/A	1,786	N/A	N/A	1,350	N/A	6,186	26,856	13%
13.00 - 13.99	N/A	N/A	1,085	13,143	N/A	N/A	639	N/A	777	N/A	N/A	2,238	N/A	4,617	22,499	10%
14.00 - 14.99	N/A	N/A	505	9,877	N/A	N/A	235	N/A	402	N/A	N/A	1,521	N/A	3,791	16,331	8%
15.00 - 15.99	N/A	N/A	139	6,794	N/A	N/A	84	N/A	139	N/A	N/A	815	N/A	2,213	10,184	5%
16.00 - 16.99	N/A	N/A	121	3,274	N/A	N/A	17	N/A	16	N/A	N/A	191	N/A	845	4,464	2%
17.00 - 17.99	N/A	N/A	32	1,742	N/A	N/A	5	N/A	2	N/A	N/A	31	N/A	183	1,985	1%
18.00 - 18.99	N/A	N/A	2	-	N/A	N/A	1	N/A	1	N/A	N/A	3	N/A	9	16	0%
19.00 - 19.99	N/A	N/A	1	-	N/A	N/A	-	N/A	-	N/A	N/A	-	N/A	5	6	0%
Lender Total	N/A	N/A	18,379	113,981	N/A	N/A	11,026	N/A	23,530	N/A	N/A	10,749	N/A	37,168	214,844	100%

GRAPH 6: 1999 DISTRIBUTION OF MORTGAGE RATES

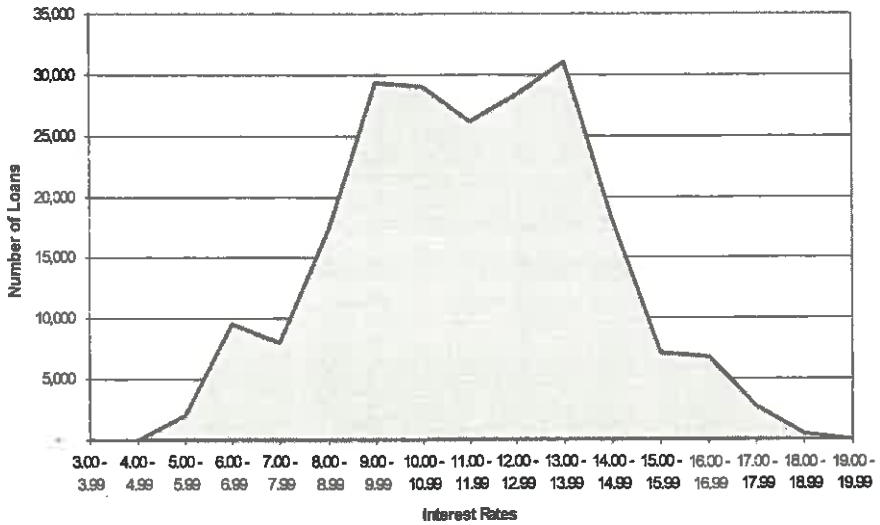


TABLE 6: 1999 DISTRIBUTION OF MORTGAGE RATES BY LENDER

Rate	Associates	Household Financial	Com'l Mortgage	Green Tree Financial	Money Store	Commercial Cr/Travelers	Askeria Mortgage USA	Equusoft Corporation	Amesco	Option One Mtg. Corp.	New Century Financial	Impac	Long Beach Mortgage	Residents Fund/ GMAC	TOTAL	%
3.00 - 3.99	N/A	N/A	N/A	-	N/A	N/A	N/A	-	-	-	N/A	1	N/A	-	1	0%
4.00 - 4.99	N/A	N/A	N/A	22	N/A	N/A	N/A	-	-	-	N/A	1	N/A	-	23	0%
5.00 - 5.99	N/A	N/A	N/A	212	N/A	N/A	N/A	-	1	-	N/A	24	N/A	1,772	2,009	1%
6.00 - 6.99	N/A	N/A	N/A	4,890	N/A	N/A	N/A	-	9	-	N/A	227	N/A	4,418	9,544	4%
7.00 - 7.99	N/A	N/A	N/A	6,599	N/A	N/A	N/A	9	91	188	N/A	597	N/A	200	8,024	4%
8.00 - 8.99	N/A	N/A	N/A	13,483	N/A	N/A	N/A	287	402	546	N/A	1,028	N/A	1,811	17,357	8%
9.00 - 9.99	N/A	N/A	N/A	20,458	N/A	N/A	N/A	1,889	708	819	N/A	1,711	N/A	3,698	29,361	14%
10.00 - 10.99	N/A	N/A	N/A	19,914	N/A	N/A	N/A	1,818	763	718	N/A	830	N/A	5,173	29,004	13%
11.00 - 11.99	N/A	N/A	N/A	17,803	N/A	N/A	N/A	800	387	479	N/A	172	N/A	6,391	26,132	12%
12.00 - 12.99	N/A	N/A	N/A	14,742	N/A	N/A	N/A	516	126	273	N/A	387	N/A	12,230	28,274	13%
13.00 - 13.99	N/A	N/A	N/A	14,588	N/A	N/A	N/A	626	21	75	N/A	719	N/A	15,067	31,118	14%
14.00 - 14.99	N/A	N/A	N/A	7,576	N/A	N/A	N/A	156	12	7	N/A	562	N/A	9,791	18,104	8%
15.00 - 15.99	N/A	N/A	N/A	4,328	N/A	N/A	N/A	71	2	2	N/A	238	N/A	2,500	7,139	3%
16.00 - 16.99	N/A	N/A	N/A	3,285	N/A	N/A	N/A	31	1	-	N/A	54	N/A	3,475	6,846	3%
17.00 - 17.99	N/A	N/A	N/A	1,521	N/A	N/A	N/A	4	-	-	N/A	-	N/A	1,240	2,765	1%
18.00 - 18.99	N/A	N/A	N/A	420	N/A	N/A	N/A	-	-	-	N/A	1	N/A	4	425	0%
19.00 - 19.99	N/A	N/A	N/A	44	N/A	N/A	N/A	-	-	-	N/A	-	N/A	-	44	0%
Lender Total	N/A	N/A	N/A	130,333	N/A	N/A	N/A	6,287	2,543	3,105	N/A	6,352	N/A	67,588	218,178	100%

APPENDIX 2

THIRTY YEAR TREASURY AND CONVENTIONAL MORTGAGE RATES: 1980-1999

Month/Year	30 Year Treasury Rate	Conventional Mortgage Rate	Variance
04/1980	11.40	16.33	4.93
05/1980	10.36	14.26	3.9
06/1980	9.81	12.71	2.9
07/1980	10.24	12.19	1.95
08/1980	11.00	12.56	1.56
09/1980	11.34	13.20	1.86
10/1980	11.59	13.79	2.2
11/1980	12.37	14.21	1.84
12/1980	12.40	14.79	2.39
01/1981	12.14	14.90	2.76
02/1981	12.80	15.13	2.33
03/1981	12.69	15.40	2.71
04/1981	13.20	15.58	2.38
05/1981	13.60	16.40	2.8
06/1981	12.96	16.70	3.74
07/1981	13.59	16.83	3.24
08/1981	14.17	17.29	3.12
09/1981	14.67	18.16	3.49
10/1981	14.68	18.45	3.77
11/1981	13.35	17.83	4.48
12/1981	13.45	16.92	3.47
01/1982	14.22	17.40	3.18
02/1982	14.22	17.60	3.38
03/1982	13.53	17.16	3.63
04/1982	13.37	16.89	3.52
05/1982	13.24	16.68	3.44
06/1982	13.92	16.70	2.78
07/1982	13.55	16.82	3.27
08/1982	12.77	16.27	3.5
09/1982	12.07	15.43	3.36
10/1982	11.17	14.61	3.44
11/1982	10.54	13.83	3.29
12/1982	10.54	13.62	3.08
01/1983	10.63	13.25	2.62
02/1983	10.88	13.04	2.16
03/1983	10.63	12.80	2.17
04/1983	10.48	12.78	2.30
05/1983	10.53	12.63	2.10
06/1983	10.93	12.87	1.94
07/1983	11.40	13.42	2.02

Month/Year	30 Year Treasury Rate	Conventional Mortgage Rate	Variance
08/1983	11.82	13.81	1.99
09/1983	11.63	13.73	2.10
10/1983	11.58	13.54	1.96
11/1983	11.75	13.44	1.69
12/1983	11.88	13.42	1.54
01/1984	11.75	13.37	1.62
02/1984	11.95	13.23	1.28
03/1984	12.38	13.39	1.01
04/1984	12.65	13.65	1.00
05/1984	13.43	13.94	0.51
06/1984	13.44	14.42	0.98
07/1984	13.21	14.67	1.46
08/1984	12.54	14.47	1.93
09/1984	12.29	14.35	2.06
10/1984	11.98	14.13	2.15
11/1984	11.56	13.64	2.08
12/1984	11.52	13.18	1.66
01/1985	11.45	13.08	1.63
02/1985	11.47	12.92	1.45
03/1985	11.81	13.17	1.36
04/1985	11.47	13.20	1.73
05/1985	11.05	12.91	1.86
06/1985	10.45	12.22	1.77
07/1985	10.50	12.03	1.53
08/1985	10.56	12.19	1.63
09/1985	10.61	12.19	1.58
10/1985	10.50	12.14	1.64
11/1985	10.06	11.78	1.72
12/1985	9.54	11.26	1.72
01/1986	9.40	10.88	1.48
02/1986	8.93	10.71	1.78
03/1986	7.96	10.08	2.12
04/1986	7.39	9.94	2.55
05/1986	7.52	10.14	2.62
06/1986	7.57	10.68	3.11
07/1986	7.27	10.51	3.24
08/1986	7.33	10.20	2.87
09/1986	7.62	10.01	2.39
10/1986	7.70	9.97	2.27
11/1986	7.52	9.70	2.18

Month/Year	30 Year Treasury Rate	Conventional Mortgage Rate	Variance
12/1986	7.37	9.31	1.94
01/1987	7.39	9.20	1.81
02/1987	7.54	9.08	1.54
03/1987	7.55	9.04	1.49
04/1987	8.25	9.83	1.58
05/1987	8.78	10.60	1.82
06/1987	8.57	10.54	1.97
07/1987	8.64	10.28	1.64
08/1987	8.97	10.33	1.36
09/1987	9.59	10.89	1.30
10/1987	9.61	11.26	1.65
11/1987	8.95	10.65	1.70
12/1987	9.12	10.65	1.53
01/1988	8.83	10.43	1.60
02/1988	8.43	9.89	1.46
03/1988	8.63	9.93	1.30
04/1988	8.95	10.20	1.25
05/1988	9.23	10.46	1.23
06/1988	9.00	10.46	1.46
07/1988	9.14	10.43	1.29
08/1988	9.32	10.60	1.28
09/1988	9.06	10.48	1.42
10/1988	8.89	10.30	1.41
11/1988	9.02	10.27	1.25
12/1988	9.01	10.61	1.60
01/1989	8.93	10.73	1.80
02/1989	9.01	10.65	1.64
03/1989	9.17	11.03	1.86
04/1989	9.03	11.05	2.02
05/1989	8.83	10.77	1.94
06/1989	8.27	10.20	1.93
07/1989	8.08	9.88	1.80
08/1989	8.12	9.99	1.87
09/1989	8.15	10.13	1.98
10/1989	8.00	9.95	1.95
11/1989	7.90	9.77	1.87
12/1989	7.90	9.74	1.84
01/1990	8.26	9.90	1.64
02/1990	8.50	10.20	1.70
03/1990	8.56	10.27	1.71

Month/Year	30 Year Treasury Rate	Conventional Mortgage Rate	Variance
04/1990	8.76	10.37	1.61
05/1990	8.73	10.48	1.75
06/1990	8.46	10.16	1.70
07/1990	8.50	10.04	1.54
08/1990	8.86	10.10	1.24
09/1990	9.03	10.18	1.15
10/1990	8.86	10.18	1.32
11/1990	8.54	10.01	1.47
12/1990	8.24	9.67	1.43
01/1991	8.27	9.64	1.37
02/1991	8.03	9.37	1.34
03/1991	8.29	9.50	1.21
04/1991	8.21	9.49	1.28
05/1991	8.27	9.47	1.20
06/1991	8.47	9.62	1.15
07/1991	8.45	9.58	1.13
08/1991	8.14	9.24	1.10
09/1991	7.95	9.01	1.06
10/1991	7.93	8.86	0.93
11/1991	7.92	8.71	0.79
12/1991	7.70	8.50	0.80
01/1992	7.58	8.43	0.85
02/1992	7.85	8.76	0.91
03/1992	7.97	8.94	0.97
04/1992	7.96	8.85	0.89
05/1992	7.89	8.67	0.78
06/1992	7.84	8.51	0.67
07/1992	7.60	8.13	0.53
08/1992	7.39	7.98	0.59
09/1992	7.34	7.92	0.58
10/1992	7.53	8.09	0.56
11/1992	7.61	8.31	0.70
12/1992	7.44	8.22	0.78
01/1993	7.34	8.02	0.68
02/1993	7.09	7.68	0.59
03/1993	6.82	7.50	0.68
04/1993	6.85	7.47	0.62
05/1993	6.92	7.47	0.55
06/1993	6.81	7.42	0.61
07/1993	6.63	7.21	0.58

Month/Year	30 Year Treasury Rate	Conventional Mortgage Rate	Variance
08/1993	6.32	7.11	0.79
09/1993	6.00	6.92	0.92
10/1993	5.94	6.83	0.89
11/1993	6.21	7.16	0.95
12/1993	6.25	7.17	0.92
01/1994	6.29	7.06	0.77
02/1994	6.49	7.15	0.66
03/1994	6.91	7.68	0.77
04/1994	7.27	8.32	1.05
05/1994	7.41	8.60	1.19
06/1994	7.40	8.40	1.00
07/1994	7.58	8.61	1.03
08/1994	7.49	8.51	1.02
09/1994	7.71	8.64	0.93
10/1994	7.94	8.93	0.99
11/1994	8.08	9.17	1.09
12/1994	7.87	9.20	1.33
01/1995	7.85	9.15	1.30
02/1995	7.61	8.83	1.22
03/1995	7.45	8.46	1.01
04/1995	7.36	8.32	0.96
05/1995	6.95	7.96	1.01
06/1995	6.57	7.57	1.00
07/1995	6.72	7.61	0.89
08/1995	6.86	7.86	1.00
09/1995	6.55	7.64	1.09
10/1995	6.37	7.48	1.10
11/1995	6.26	7.38	1.12
12/1995	6.06	7.20	1.14
01/1996	6.05	7.03	0.98
02/1996	6.24	7.08	0.84
03/1996	6.60	7.62	1.02
04/1996	6.79	7.93	1.14
05/1996	6.93	8.07	1.14
06/1996	7.06	8.32	1.26
07/1996	7.03	8.25	1.22
08/1996	6.84	8.00	1.16
09/1996	7.03	8.23	1.20
10/1996	6.81	7.92	1.11
11/1996	6.48	7.62	1.14

Month/Year	30 Year Treasury Rate	Conventional Mortgage Rate	Variance
12/1996	6.55	7.60	1.05
01/1997	6.83	7.82	0.99
02/1997	6.69	7.65	0.96
03/1997	6.93	7.90	0.97
04/1997	7.09	8.14	1.05
05/1997	6.94	7.94	1.00
06/1997	6.77	7.69	0.92
07/1997	6.51	7.50	0.99
08/1997	6.58	7.48	0.90
09/1997	6.50	7.43	0.93
10/1997	6.33	7.29	0.96
11/1997	6.11	7.21	1.10
12/1997	5.99	7.10	1.11
01/1998	5.81	6.99	1.18
02/1998	5.89	7.04	1.15
03/1998	5.95	7.13	1.18
04/1998	5.92	7.14	1.22
05/1998	5.93	7.14	1.21
06/1998	5.70	7.00	1.30
07/1998	5.68	6.95	1.27
08/1998	5.54	6.92	1.38
09/1998	5.20	6.72	1.52
10/1998	5.01	6.71	1.70
11/1998	5.25	6.87	1.62
12/1998	5.06	6.72	1.66
01/1999	5.16	6.79	1.63
02/1999	5.37	6.81	1.44
03/1999	5.58	7.04	1.46
04/1999	5.55	6.92	1.37
05/1999	5.81	7.15	1.34
06/1999	6.04	7.55	1.51
07/1999	5.98	7.63	1.65
08/1999	6.07	7.94	1.87
09/1999	6.07	7.82	1.73
10/1999	6.26	7.85	1.59
11/1999	6.15	7.74	1.59
12/1999	6.35	7.91	1.56

APPENDIX 3

PROFITS, LOSSES AND EARNINGS PER SHARE FOR SELECTED SUBPRIME LENDERS

PROFITS AND LOSSES

Company Name	1998 Q1	1998 Q2	1998 Q3	1998 Q4	1999 Q1	1999 Q2	1999 Q3
Associates	\$281 Mil.*	\$292.9 Mil.*	\$317.6 Mil.*	\$332 Mil.*	\$336.8 Mil.*	\$358.1 Mil.*	\$386.8* Mil.*
Household	\$235.1 Mil.**	\$245.3 Mil.**	\$313.9 Mil.*	\$347.3 Mil.**	\$318.5 Mil.**	\$324.6 Mil.**	\$397.6 Mil.**
Conti	N/A	N/A	\$35.1 Mil.**	N/A	\$6 Mil.*	\$-114.3 Mil.*	\$-58.8 Mil.*
Green Tree							
Conseco	N/A	N/A	\$297.8 Mil.**	N/A	\$303 Mil.**	\$316 Mil.**	\$241.5 Mil.**
Money Store							
First Union	N/A	\$883 Mil.**	\$1 Bil.**	N/A	\$965 Mil.**	\$873 Mil.**	\$802 Mil.**
Advanta	N/A	N/A	N/A	\$4.6 Mil.*	\$10.2 Mil.*	\$12.3 Mil.*	\$14.2 Mil.*
Amresco	\$14 Mil.*	\$19.6 Mil.*	N/A	N/A	\$10.2 Mil.*	\$12.1 Mil.*	\$-82 Mil.*
Impac	\$11.1 Mil.*	N/A	\$-20.6 Mil.*	\$8.1 Mil.*	\$6.2 Mil.*	\$5.2 Mil.*	\$5.4 Mil.*
			N/A = Not Available * = net income ** = operating income				

EARNINGS PER SHARE

Company Name	1998 Q1	1998 Q2	1998 Q3	1998 Q4	1999 Q1	1999 Q2	1999 Q3
Associates	\$0.81	\$0.84	\$0.09	\$0.47	\$0.46	\$0.49	\$0.53
Household	\$0.47	\$0.49	\$0.63	\$0.71	\$0.65	\$0.67	\$0.83
Conti	N/A	N/A	N/A	N/A	\$0.13	N/A	N/A
Green Tree							
Conseco	N/A	N/A	\$0.86	N/A	\$0.92	\$0.96	\$0.73
Money Store							
First Union	N/A	\$0.92	\$1.02	N/A	\$1.00	\$0.90	\$0.84
Advanta	N/A	N/A	N/A	\$0.16	\$0.40	\$0.49	\$0.55
Amresco	\$0.35	\$0.45	N/A	N/A	\$0.21	\$0.20	N/A
Impac	\$0.48	N/A	N/A	\$0.33	\$0.22	\$0.21	\$0.22
			N/A = not available or no earnings				