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Commentary: Predatory Lending

Alvin C. Harrell, *Oklahoma City University School of Law*

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Commentary: Predatory Lending

By Alvin C. Harrell

I. Introduction

This issue of the *Quarterly Report* includes the first part of a Symposium on "Predatory Lending," focusing on recent developments at the federal level

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agricultural lien.[75] Section 9-315 then provides rules governing the perfection as to proceeds of a security interest, but comment 9 to revised section 9-315 notes that revised Article 9 does not similarly provide for continuation of an agricultural lien in proceeds. That depends on other law, including the law creating the lien.

In essence this will permit a person who provides goods or services to a farmer, in the ordinary course of the provider's business, and thereby obtains a statutory lien under other law, to "perfect" that lien under Article 9 and thereby gain access to the Article 9 rules on priority and enforcement. It is believed that this will provide a significant incentive for agricultural lienors to comply with Article 9, thereby giving public notice of their claims and avoiding the "secret lien" problem, in order to utilize the clear and certain priority and enforcement rules of Article 9 (as a superior alternative to the generally unclear and uncertain rules otherwise governing the priority and enforcement of statutory liens). This does not convert statutory liens, created by other law outside Article 9, into Article 9 security interests; it merely provides an Article 9 mechanism for perfection, priority, and enforcement of such liens.[76]

In terms of priority, an agricultural lien not perfected under Article 9 would be treated like an unperfected security interest, and generally subordinated to perfected security interests and other lien creditors.[77] Perfected agricultural liens will have priority based on the normal first-in-time rule;[78] under optional provisions, a "Production Money Security Interest" (PrMSI)[79] would be given the equivalent of purchase money priority as to crops and their proceeds, if certain requirements are met (*e.g.*, perfection by filing when new value is given, and direct notice to competing perfected secured parties).[80]

The revised Article 9 system for agricultural liens has been widely lauded, and a number of parties have urged expansion of this system to cover other (non-agricultural) statutory liens. The American Bar Association, Business Law Section, UCC Committee Subcommittee on Relation to Other Law prepared a Report on "Inclusion of Nonpossessory Statutory Liens in Article 9," analyzing these issues. The Report, dated September 1996, was presented to the Article 9 Drafting Committee on November 2, 1996 by Meredith S. Jackson, Chair of the Subcommittee on Relation to Other Law. The Report generally recommends extending the revised Article 9 provisions on agricultural liens to cover other nonpossessory statutory liens. The Article 9 Drafting Comment did not adopt this, but it remains on the table for possible future consideration.

75. Revised § 9-310(a).

76. *See also* revised § 9-302 (choice of law for perfection of agricultural liens—generally providing a rule based on the location of the debtor). *Cf.* revised § 9-301, for security interests.

77. Revised §§ 9-302, 9-310, 9-317, 9-322, and Pt. 6.

78. *Id.*

79. *See* revised Article 9, Appendix II, providing optional provisions for an Article 9 security interest (this must be consensual, not merely an agricultural lien) in crops for new value to enable the debtor to produce the crops.

80. *Id.*

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and in litigation. Part II in the next issue will focus on related developments at the state level. While the future direction of these developments necessarily will depend largely on political trends, the current debate on these issues makes consideration appropriate at this point.

II. Implications for the Credit Markets

Despite periodic lip-service to the contrary, the state and federal agencies that are most active with regard to Predatory Lending do not always seem well-attuned to the potential for damage to the credit markets that could result from some of their proposals. From the standpoint of a mortgage lender, some of these proposals seem so severe, on top of an already very difficult legal environment, that an exodus of legitimate lenders from the affected markets seems likely to result if such proposals are implemented.

One must admit that we have heard this before, and yet consumer credit has expanded dramatically even as the legal environment has become more complex and difficult. And this is not to suggest that all subprime lending will stop if any of these proposals is implemented. But it also should be admitted by proponents that such proposals have costs. While consumer credit is widely available today, the average cost of such credit has apparently moved upward in conjunction with new consumer protection laws and regulations, so that overall consumers today are paying considerably more than they were 25 years ago.

There can be little doubt that much of this increase is due to the more complex, sometimes punitive, always litigious and often economically damaging legal environment faced by consumer creditors today. Surely no one seriously believes that society can impose these kinds of costs and risks on creditors without experiencing a corresponding increase in the cost of such credit. Therefore an appropriate question for policy makers is whether even higher credit costs (perhaps, at some point, in the form of reduced credit availability) should be imposed on consumers in order to provide additional protections against Predatory Lending.

All of this may sound familiar to those familiar with the modern history of consumer credit. In the early part of this century, unrealistic usury laws stifled legitimate creditors in many states, and the result was a serious problem with illegal loansharking in some communities. The lesson was learned, the laws were (mostly) reformed, and our highly competitive credit markets are the result. Let's hope we don't have to learn that lesson again, the hard way.

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ment covering accounts of a debtor incorporated in a state other than the location of its chief executive office; (b) the filing of a financing statement covering inventory and equipment located in a state other than the state where the debtor is incorporated. In these examples, the filing does not constitute perfection under the new law because the place of filing has changed. In both examples, the new law calls for filing in the state where the debtor is incorporated. To continue these carry-over filings, it will be necessary to file, in the state of the debtor's incorporation, an initial financing statement under revised Article 9 (in lieu of a continuation statement).[113] This "in lieu of" financing statement must identify the old (pre-effective date) financing statement by indicating where and when it was filed and giving applicable filing numbers.

IX. Conclusion

Because of its great length (compared to other articles of the UCC) and the complexity of certain provisions (such as the transition rules), revised Article 9 might seem at first glance to emulate America's most-maligned statute, the Internal Revenue Code. Indeed, the casual first-time reader will find the going hard and might easily lose his or her way. However, greater familiarity with the revised text will reveal that the vice of prolixity is more than offset by the virtues of clarity and specificity. And, paradoxically, the system that the new law describes in such great detail will operate more easily and simply than the system it replaces. It will be easier and faster to create and perfect a security interest, one will encounter fewer priority disputes, and the rules governing nonjudicial enforcement of security interests will be more certain. All in all, it is a significant improvement in commercial and consumer law.

113. Revised § 9-706.

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III. Implications for the National Economy

Predatory Lending is an issue with broad public-policy ramifications. It is likely that the U.S. "growth recession" of the early 1990s, with all of its consequences for the national elections of that period, was induced or at least reinforced by draconian federal banking legislation enacted in 1989, 1990 and 1991.[1] The result of this legislation and a related regulatory crusade against the banking industry (apparently to some degree a political response to the insolvency of the deposit insurance funds)[2] was a credit contraction that adversely affected the national economy in the early 1990s. Indeed, some might argue that the banking industry has never fully recovered, as evidenced by its dwindling market share.

The consequences for the economy would have been much worse if nonbank subprime lenders had not been available to take up the slack. Fortunately, in the United States there are many sources of credit, and not all were affected by the deposit insurance fiasco. These nonbank lenders rushed to fill the void created when banking entered a contractionary and consolidation phase, a phase that cut off many subprime borrowers from bank financing sources just as the numbers of credit-impaired borrowers was increasing dramatically.

Probably no one knows for sure how the economy would have been affected if the subprime lending industry had not been there, ready to grow and meet this need. But it is not too much to say that subprime lending is now a major pillar supporting the national economy. True, consumer credit is at an all-time high, and there is evidence that many consumers are over-extended. But all of that is just another reason to be cautious about needless impairment of this important part of our credit system.

IV. Merits of Various Proposals

A. Asset-Based Financing

One of the common targets of various Predatory Lending proposals is asset-based lending, *i.e.*, lending on the basis of the collateral rather than the debtor's ability to repay. While your author is aware of the concerns that some lenders may intentionally loan more than the borrower can repay, in the hope of foreclosing on the collateral, the concern with asset-based lending as a national priority seems misplaced for several reasons.

First, it is hard to believe that this is a large-scale problem. How many lenders prefer foreclosure to repayment of the loan, especially for subprime loans where the loan interest rate is high and the collateral is likely to be somewhat less marketable than in prime lending? In your author's experience, most lenders suffer losses upon foreclosure, and view foreclosure as a last resort. This idea that subprime lenders want to foreclose seems ludicrous, but if there are exceptions surely they must be relatively few in number and easily dealt with under current law.[3]

Secondly, in your author's experience, asset-based consumer lending is a valuable service that allows more consumers to buy or improve a home (or a better home) than would otherwise be the case. There are simply lots of people who value a home or want to improve their home so much that they are willing to devote income levels above the normal industry or VA/FHA lending benchmarks. Indeed, that is probably one reason why these borrowers go to subprime lenders: Their income levels do not meet standardized requirements for the house they want to buy or the improvements they want to make. Rather than settle for another, less expensive house that they don't want, they are willing to forego other expenditures and devote more than the customary portion of their income to housing expense. It is also possible that a borrower may fail the customary debt-to-income ratio test because he or she has income that cannot be properly substantiated, or reasonably expects future income to be higher but cannot document that, or feels that fully disclosing his or her financial picture would be an invasion of privacy.

Whatever the reasons, in your author's experience, there is a large volume of asset-based consumer lending that serves very important social and economic needs. So much so that it should be considered a beneficial practice rather than a predatory one. The idea that these people should be cut

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1. *See, e.g.*, Alvin C. Harrell, *Deposit Insurance Issues and the Implications for the Structure of the American Financial System*, 18 Okla. City Univ. L. Rev. 179 (1993).

2. *See, e.g.*, Terry Carter, *Banking on Fear*, ABA J., July, 1999, at 40.

3. *See*, e.g.,David Eldridge, *The Consumer Protection Act: Why, Creditor (Banker, Seller, etc.), When We Owe You Money it is Your Fault*, 52 Consumer Fin. L. Q. Rep. 305 (1998).

language in loan documents to refer to "accounts as now or hereafter defined by Article 9."

In addition, because the transition rules are complex, it is advisable to begin reviewing and learning such transition rules immediately. *See supra* Pt. V.

Other news is that Texas has "joined the union" in making its revised Article 9 numbering system match the rest of the country. There will be no more use of (a) where the 49 other states use (1). However, Texas has a "Chapter 9" and most of the rest of the country has an "Article 9."

Among the most important changes effected by revised Article 9 are the changed filing requirements for perfection purposes. These, along with choice of law and transition issues, are the main focus of this article.

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off from reasonable access to credit, because they don't meet some arbitrary financial test devised by a federal agency, seems outrageously anti-consumer.

B. Loan Flipping

Once again the premise of this issue seems odd: Lenders are enticing borrowers to borrow money they don't really need or want. But who should make this decision, if not the consumer and lender? Should legislation or regulation be substituted for the judgement of the parties to the transaction? The HUD/Treasury proposal (described elsewhere in this issue) to prohibit the refinance of a mortgage loan into a HOEPA loan within 18 months of origination would surely work a hardship on those affected borrowers who have a true need to refinance within that period. Determined lenders could simply offer to refinance every 18 months. This approach does not seem promising.

Similarly, efforts to dictate the terms of a refinancing by the same lender (*e.g.*, limiting the origination fee) would simply encourage refinancings by different lenders, imposing an inconvenience on consumers and perhaps encouraging reciprocal arrangements between lenders. Alternatively, a refinancing lender might simply raise the interest rate or other fees. Again, this arbitrary approach does not seem a promising solution.

Loan flipping is in any case likely to be a self-defeating lender strategy. If a lender wants to lose money on a loan, loan flipping is one way to do it. Ultimately the debtor is likely to default, and maybe end up in court or in bankruptcy, with the lender suffering a loss. But again, who is better able to judge the risks, and make the decisions, than the lender and the borrower, subject to the possibility of review by a bankruptcy or other court in the event of abusive practices?

C. Mortgage Brokers

Mortgage brokers are a favorite target these days, and of course it is true that their economic incentive is to get the deal done rather than underwrite the credit risk; they typically leave the underwriting issues to someone else, and carry none of the credit risk. When the transaction is closed, the mortgage broker walks away. In this respect they are like any other broker or independent sales agent working for a commission. But that is their job, and it is not clear why we should try to make them be something else. Turning mortgage brokers into HOEPA police, or lenders into mortgage broker police, is inconsistent with the basic relationships involved.

It is inevitable that brokers and sales agents will be motivated by the commission structure. This is also true of real estate brokers, auto dealers, retail sales clerks and door-to-door salesmen. It is the reason why brokers and sales agents are so much more service-oriented than, say, bureaucrats who have no stake in the transaction. Often this incentive is needed to encourage the broker to do the groundwork necessary to match up the buyer and seller (or lender and borrower). Once this is done, others are properly responsible for underwriting and credit law compliance.

The HUD/Treasury report on Predatory Lending, discussed in this issue, laments the lack of state laws regulating mortgage brokers. It supports this view by noting that only 39 states require licensing or registration, 25 states require a licensing fee or net worth benchmark, and six states impose a competency test. But that sounds like a pretty active and diverse laboratory of state governance. Is this supposed to indicate that a federal remedy is now in order?

D. HOEPA Reform

HOEPA is illustrative of much that is wrong with regulation of subprime consumer credit today. HOEPA is clearly punitive, and sufficiently technical as to be dangerous and unworkable for many lenders. It seems designed to discourage lenders from serving subprime borrowers, and in many instances has done just that. It is also encouraging the emergence of HOEPA specialty lenders, to fill the void left by mainstream lenders leaving this market.

HOEPA specialty lenders will typically charge higher-than-ever rates and fees, to compensate for the increased compliance costs and liability risks of HOEPA lending. They will probably also maintain minimal capitalization, as a safeguard against HOEPA liability. The costs of these practices will be borne by HOEPA borrowers.

In the face of all this, the HUD/Treasury report recommends a dramatic expansion of HOEPA coverage, so that a large new range of previously mainstream borrowers can experience the benefits of HOEPA lending. With friends like these, consumers hardly need enemies.

E. Prepayment Charges

Prepayment charges typically are designed to assure the real estate lender of sufficient income from the loan to compensate for the considerable compliance costs and resource burdens associated with originating and closing such a loan. We have all seen cases where a lender invested considerable time and resources in originating a loan, perhaps foregoing other lending opportunities, with the expectation of receiving the resulting income stream over a period of years, only to have the borrowers promptly pay off the loan for some reason. (Apparently this kind of "loan-flipping" by the consumer is OK.) It seems reasonable that a lender should be able to guard against this risk by negotiating with (and disclosing to) the borrower a contractual prepayment clause to assure the lender of at least a minimum return for its efforts. Indeed, this is a common and long-standing arrangement.

For some reason, this is now deemed by some to be an abusive practice. The HUD/Treasury report recommends that lenders be required to offer a higher interest rate as an alternative. Of course the highest rate in town won't do any good if the loan is paid off very quickly, and many lenders may consider this an inadequate substitute. So, probably, closing costs would also have to be raised. At least the HUD/Treasury report recognizes that the price of eliminating the prepayment charge will be imposition of other, higher charges.

Will consumers be better off if higher closing costs and interest rates are used in lieu of a prepayment charge? Is this what most consumers want? If so, there are plenty of competing lenders out there offering alternative variations of this theme. Is it too much to expect the consumer to call around to find the terms he or she prefers? It does not seem

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measure on the deference to federal law in Article 9.

VI. Sales of Accounts

Old Article 9 has always applied to sales of accounts. However, old Article 9 defines "accounts" to include only payment obligations arising out of the sale of goods or the provision of service.[21]

Under old Article 9, this leaves many kinds of payment rights within the definition of "general intangibles." As discussed above, revised Article 9 broadens the definition of "accounts" to include: (1) payment obligations arising out of the sale, lease or license of all kinds of tangible and intangible property, and (2) credit card receivables.[22]

Thus, under revised Article 9 a licensee's payment obligations, under a license or a "lease" of software, is an "account" because the definition of "account" no longer requires the sale or lease of "goods."[23] The broader definition of "account" expands the scope of revised Article 9 by bringing into Article 9 more transactions through the continued application of Article 9 to sales of "accounts" (as newly defined).[24]

Sales of payment intangibles are also subject to revised Article 9.[25] However, a sale of other general intangibles (other than payment intangibles) remains outside the scope of Article 9 and indeed outside the scope of the UCC. This is a rare instance of a sale of personal property not covered anywhere in the UCC. But note again that a security interest in any form of general intangible will be governed by Article 9, under either the old or revised version.

21. Old § 9-106.

22. Revised § 9-102(a)(2).

23. Revised § 9-102(a)(2).

24. *Id.*

25. Revised § 9-109(a)(3).

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that this is such a severe problem as to require still another federal regulatory solution.

V. Conclusion

Some of the attacks on "Predatory Lending" seem to confuse the wrongful intent of a few bad actors, easily dealt with under traditional legal standards, with the propriety of customary and appropriate practices in the mortgage industry. One can assume there will always be a few bad actors in the business, on both the consumer and lender sides. This is certainly nothing new, and the law has long dealt with such matters in a variety of ways. The question is whether the resulting issues should now be a basis for new, detailed and possibly punitive federal regulations designed to restructure valid industry practices that otherwise may benefit creditors and borrowers alike.

In October 2000, America's Community Bankers reported a likelihood the federal banking regulators would issue "recommendations" for combating predatory lending by year-end.[4] In December 2000, this prediction proved accurate, as the Federal Reserve Board proposed amendments to Regulation Z section 226.32 directed at predatory lending.[5] While this seems premature, it reflects an apparent eagerness to expand federal regulatory authority in this area of law. The extent and effectiveness of this expansion are likely to be controversial issues in the year ahead, and the debates on these issues deserve the attention of anyone interested in consumer financial services law.

4. IX Wash. Perspective No. 44, at 4 (Oct. 30, 2000).

5. 65 Fed. Reg. 81,438 (Dec. 26, 2000).

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For more information contact:

Professor Alvin C. Harrell
Editor, Consumer Finance Law Quarterly Report
Oklahoma City University School of Law
2501 N. Blackwelder
Oklahoma City, OK 73106