Mortgage Market Regulation and Moral Hazard: Equity Stripping Under Sanction of Law

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Introduction

The concept of moral hazard has been used in recent literature to refer solely to incentives for increased risk taking by parties protected against the full consequences of their actions. Deposit insurance has often been criticized as creating such moral hazard issues, as has the too-big-to-fail doctrine. Such criticism focuses on federal guarantees against loss as creating moral hazard issues.

Traditionally the concept of moral hazard also described incentives for a second type of behavior – unethical conduct on the part of the party protected from loss. Initially the concept of moral hazard was introduced in the insurance industry and had a moral component – i.e. interference with the free market through the introduction of insurance would protect not only careless but also illegal or otherwise fraudulent behavior on the part of the insured. In turn, society had to be convinced that the insurer was not in the business of promoting such immoral or unethical behavior. In the 1960’s Kenneth Arrow utilized the concept of moral hazard and introduced it into the law and economics movement. Arrow was criticized for use of a phrase with emotive effect, with others arguing that “moral hazard” has, in fact, little to do with morality and instead was merely a rational response to a situation. In other words the emphasis was on the incentives created for excess risk-taking and their effect on efficient outcomes and not on the

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1 Moral hazard is the view that persons will act differently than they would when they are insulated from risk. Individuals that do not bear the full consequences of their actions have a tendency to act less carefully, leaving others to bear some or all of the consequences of those actions.
5 Mark V. Pauly, The Economics of Moral Hazard: Comment, 58 AM. ECON. REV. 531 (1968). This debate was discussed in Baker, supra note 3, at 267-269.
morality of the behavior or the outcome. This shift away from the moral or ethical
caracter of the practice and the outcome to a study of incentives and efficiency or
inefficiency of outcomes prevailed in the later law and economics literature.\textsuperscript{6}

This article examines the moral hazard issue from both viewpoints as well as the
proper role of government in achieving both outcomes. It explores risk-taking as moral
hazard not through the lens of a federal guarantee against loss, but through the lens of a
federal “guarantee” against regulatory sanction due to a deregulation of the mortgage
markets. It presents a case study of deregulation of the U.S. mortgage market over the
period 1982 to 2008. The first conclusion drawn is that it was deregulation – less
government interference – that led to unsafe practices in the mortgage market. The
second conclusion drawn is that it was deregulation that led to increasingly abusive
activities – unfair practices – among market participants. The story this article explores is a
story of the failure of market discipline. Several responses to the issue of risk-taking as
moral hazard have been debated: (a) market discipline including reliance on internal risk
management by corporate actors, (b) supervision of bank conduct by regulatory
authorities to offset the tendency toward increased risk-taking, and (c) policies and rules
that impose greater risks on industry creditors.\textsuperscript{7} In the period after 1982, the regulatory
response was a lifting of regulatory supervision\textsuperscript{8}, which then increasingly relied on

\textsuperscript{6} The most recent application of this view is found in the comments of Judge Richard Posner on moral
(risk-taking by banks was encouraged by government bailouts of financial institutions and deposit insurance).

\textsuperscript{7} Michael Krimminger, Controlling Moral Hazard in Bank Resolutions: Comparative Polices and

\textsuperscript{8} A decline in prudential regulation similarly contributed to the savings and loan crisis in the 1980s.
Lawrence G. Boxter, Administrative and Judicial Review of Prompt Corrective Action Decisions by the
market discipline to avoid both unsafe and unfair mortgage products and practices. This article documents the inherent inability of market discipline to control risk-taking moral hazard issues.

Given the adverse effects that decision produced, this article then explores a broader question: does U.S. society embrace the view that it is proper for U.S. businesses to profit by taking financial advantage of consumers who cannot protect themselves as long as society as a whole benefits from such actions? This question is part of the second moral hazard issue – incentives for unethical conduct produced by a “guarantee” against regulatory sanctions. This article explores the incentives for ethical and unethical conduct, again examining the failure of market discipline, and the overall ethical outcome resulting from government withdrawal from regulation.

Part one of this article explores the viewpoint of the federal regulatory agencies toward deregulation of the mortgage market. It examines their actions and viewpoints over the course of the last three decades. Two conclusions emerge. First, federal banking agencies preferred a free market approach and implemented such an approach whenever statutes provided the discretion to do so. Second, such regulatory agencies embraced a decision making model that relied on predictions of net societal benefits as the determinant of a decision to intervene in the mortgage markets. Such a viewpoint led the agencies to typically shun government intervention. Embrace of the net societal benefits standard is what triggers the ethical moral hazard issue, which is explored in Part three of this article.

Part two of this article examines the outcomes in such a deregulated mortgage market. It examines the incentives for risk aversion versus risk-taking and the long-term
outcome when government largely withdrew from regulation of the mortgage market over the last three decades. It examines unsafe mortgage products that emerged, which led to substantial losses of equity by consumers. It then examines unfair mortgage practices and products that emerged that also led to a recurring stripping of equity from consumers. Part two of this article also examines the failure of market discipline. Industry and regulatory practices, as well as perceptions, led industry participants to conclude that the offering of both unfair and also unsafe mortgage products was a reasonable business decision. Moreover, consumers were unable to protect themselves against unsafe and unfair mortgage practices which they did not understand, and could not fully effectively evaluate. Both unsafe and unfair products and practices were targeted at vulnerable groups of consumers, especially low-income consumers and senior citizens, including members of minority groups. Recent evidence confirms that targeted groups were especially unable to protect themselves from abusive practices and products. This raises the ethical dimension of the moral hazard issue—namely, the ethics of a regulatory regime that allows financial exploitation of vulnerable groups.

Part three of this article explores whether Congress embraced the same deregulatory viewpoint embraced by the federal regulators, as well as a net societal benefits standard as the determinant of government intervention in the free market. It differentiates two types of deregulation: (a) lifting of statutory requirements and substituting regulatory constraints, and (b) lifting of all government mandates and substituting a preference for market discipline to police abusive practices. The latter is referred to as a free market approach in this paper. This article examines Congress’ actions and motivations over a thirty year period and initially concludes that Congress
embraced the former view and not the latter. This view was consistently embraced in the period 1982 to 1994. Unfortunately, Congress then provided mixed signals regarding its deregulation viewpoint in legislative enactments in 1994. This permitted regulatory agencies to continue to pursue a different deregulatory agenda even when faced with evidence of abusive lending practices, namely continued reliance on market discipline. Overall however, the conclusion drawn is that Congress rejected the ethical viewpoint that it is proper for U.S. business to profit from financial exploitation of vulnerable groups. In other words, it is the regulators and not the Congress that have created moral hazard problems in the U.S. mortgage industry.

Part One – Agencies’ Deregulation Viewpoint: Replacing Government Intervention With Market Discipline

Regulatory power to address mortgage market abuses depends on Congressional grant. The federal banking agencies have two grants of power: (a) the power to stop unsafe or unsound banking practices, contained in federal banking statutes, and (b) the power to stop unfair and deceptive acts and practices, contained in the Federal Trade Commission Act. (FTC Act) and, with respect to mortgage loans specifically, the Home Ownership and Equity Protection Act (HOEPA).

Part one of this article examines the regulatory viewpoint of the federal banking agencies toward abuses that surfaced in the mortgage market. The statements and actions

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9 12 U.S.C. §§ 371 (a) (real estate lending by national banks), 1463 (a) (1) (safe and sound operations of savings associations), 1828 (o) (safety and soundness in real estate lending by all insured depository institutions), and 1818 (b), (c), (e) and (i) (enforcement actions against insured depository institutions based on unsafe or unsound practices).
of the federal regulators are examined. First, the agencies’ real estate lending standards are explored in the period 1982 to 2008. The real estate lending standards were aimed at avoiding unsafe and unsound practices with respect to real estate mortgage lending activities. Second, the Federal Reserve Board’s HOEPA standards are explored in the period 1994 to 2008. The HOEPA standards were aimed at avoiding unfair lending practices. The former gauges the viewpoint of all the federal banking agencies and does so after the lifting of rigid statutory requirements in 1982. This provided the regulators with enormous discretion concerning the type of regulatory standards to impose, if any. The latter gauges the viewpoint of the Federal Reserve Board and does so in a context in which the regulator was faced with a statutory list of prohibited abusive practices. Thus, its discretion was in determining (a) the types of loans which would be subject to HOEPA’s statutory and the discretionary prohibitions, and (b) the additional practices, if any, it would choose to prohibit as unfair or deceptive practices.

The latter is particularly significant since the Federal Reserve’s power extends to all type of mortgage loans originated by all types of mortgage lenders. The federal banking agencies’ real estate lending standards govern the practices of all federally insured institutions, their subsidiaries, and, potentially, their affiliates. Independent mortgage companies are not subject to the regulations. However, the Federal Reserve’s power granted in HOEPA extends to all mortgage lenders including independent mortgage companies.

A. Real Estate Lending Standards: Unsafe Loans

The viewpoint of the federal banking agencies toward unsafe loans in the period 1983 to 2008 has been a free market viewpoint. The free market viewpoint was one that
relied upon bank management to avoid unsafe and unsound loans and practices based on individual, internal management policies, and relied on consumers to avoid both unsafe and unfair loans and practices.

The first time the regulators had to face the choice of whether to embrace a free market approach was in 1983. In 1982 Congress lifted rigid statutory constraints on mortgage lending by banks and thrifts. As a result, the regulators were faced with three possible options as the new form of mortgage market regulation. The Office of the Comptroller of the Currency summarized its options in 1983 as follows:

1. Adopt a regulation that reaffirms the limitations that existed under 12 U.S.C. 371 before the 1982 amendment . . .
2. Adopt a regulation that modifies the limitations that existed under 12 U.S.C. 371 before the 1982 amendment and currently exist in the interpretive rulings.
3. Adopt a regulation that imposes no limitations on national banks’ real estate lending and rescinds current regulations which do impose limitations.

It chose the third option, embracing a free market approach but for post facto intervention in individual cases to address financial losses. The free market approach is one that relied on bank management to determine which practices were and were not “unsafe.” The Comptroller justified this decision in the following terms:

The Office believes that aside from the regulations, factors such as market forces and management philosophies are the real determinants of banks’ real estate lending practices. . .

. . . the Office believes that, in the interest of facilitating national banks’

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12 Pub. L. 97-320 §§ 322 (real estate lending authority of thrifts) and 403 (a) (real estate lending authority of national banks).
ability to respond to market conditions, removal of the restrictions is warranted. Decisions concerning the forms and terms of national bank lending are properly the responsibility of each bank’s directorate and management.

. . . . at this time, regulatory restrictions are unnecessary to ensure the safety and soundness of national banks’ real estate lending activities. These activities can be monitored and evaluated through various means including the examination process, surveillance procedures, contact with the industry, and economic reviews.\textsuperscript{14}

Similarly, after initially proposing to retain some regulatory requirements such as loan-to-value ratios, the Federal Home Loan Board removed all regulatory requirements for real estate loans except for two – a loan could not exceed 100 percent of the appraised value of the real estate and a home loan could not have a maximum term longer than 40 years.\textsuperscript{15} However, the loan-to-value requirement was permitted to jump to 125 percent of initial appraised value in the event of a loan that was not fully amortized or was an adjustable rate loan.\textsuperscript{16} By 1996 even these limited requirements were lifted.

The 1991 Federal Deposit Insurance Corporation Improvement Act forced the federal regulators to “adopt uniform regulations prescribing standards for real estate lending by insured depository institutions.”\textsuperscript{17} In response, the regulators made two decisions that confirmed their preference for a free market approach to the extent governing statutes would permit. The first decision was to issue “guidelines” for real

\textsuperscript{14} Id. at 40699-40700.
\textsuperscript{15} Implementation of New Powers; Limitation on Loans to One Borrower, 48 Fed. Reg. 23032, 23035 to 23037 (May 23, 1983) (for home loans in excess of 90 percent of appraised value, private mortgage insurance was required for the part of the loan balance that exceeds 80 percent of the property’s value).
\textsuperscript{16} Id. at 23038.
estate lending, rather then impose regulations setting minimum requirements for real estate lending operations for all banks and thrifts. This was an approach the regulators continue to follow until the present, except for one regulation issued by the Comptroller’s Office in 2004 prohibiting loans by national banks without regard to the borrower’s ability to repay. A “guidelines” or “guidance” approach, and one stating only general principles, is an embrace of a free market approach to the extent permitted by Congressional enactments. Since Congress mandated “standards for real estate lending” in 1991 the former completely free market approach was no longer possible. Therefore, a substitute was put in place. The real estate guideline or guidance became the “standard” required by the 1991 statute. However, guidelines, unlike regulations, are not mandatory, minimum safe underwriting standards. Rather, the agencies issued “guidelines” insured institutions must “consider” in establishing their real estate lending policies. This permitted bank management to determine product terms and underwriting standards subject to post facto intervention in the event of financial losses or the risk of financial losses.

The second decision made by the regulators after the 1991 Act was to employ a principles approach in their guidelines, rather than requiring particular practices or prohibiting particular practices. After initially proposing specific loan-to-value ratio limits, the agencies decided to list general principles that should guide bank management in authorizing specific loan products and practices. They required that banks and thrifts establish and maintain written internal real estate lending policies that are consistent with

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safe and sound banking practices, including prudent underwriting standards.\footnote{Real Estate Lending Standards, 57 Fed. Reg. 62890, 62893 (Dec. 31, 1992) (emphasis added). The guidelines did contain loan to value ratios for different types of real estate loans. However, even the guidelines specified no loan-to-value limits for mortgages on owner-occupied one-to-four family residential property and for home equity loans. \textit{Id.} at 62893. Other requirements such as maximum maturity limits, amortization requirements and documentation requirements were rejected. 57 Fed. Reg. 36912 (Aug. 17, 1992).} Thus the 1992 agency standards relied on bank management to determine which products and practices were “safe and sound.”

For example, the OTS’ regulations on real estate lending require that (1) each savings association adopt and maintain written policies that establish appropriate limits and standards for extensions of credit secured by real estate, and that (2) the policies must be consistent with “safe and sound” banking practices and establish “prudent” underwriting standards.\footnote{Office of Thrift Supervision, 61 Fed. Reg. 50951, 50978 (Sept. 30, 1996) (real estate lending standard in 12 C.F.R. §560.100 and 101).}

In addition to issuing cautionary guidances expressing general principles, the regulators decided not to apply the guidelines to affiliates of banks and thrifts.\footnote{Real Estate Lending Standards, \textit{supra} note 19 at 62894.} The reasons given were that (a) federal deposit insurance funds would not be at risk – a macroeconomic decision making criterion – and (b) secondary market investors already establish underwriting requirements for such entities\footnote{\textit{Id.}} -- a market based approach to ensuring safe operations.

As a final example of a desire to limit the reach of even the guidelines issued, the agencies excluded from the guidelines regarding loan to value ratios, which were imposed for loans other than loans secured by one-to-four family residential property,
any loans that are to be “sold promptly after origination, within [sic] recourse, to a financially responsible third party.”

Both the nature of the standards – a principles approach and one contained in guidelines rather than regulations – and the limited reach and scope of the guidelines reflect a regulatory desire to rely on a free market approach to the fullest extent permitted by statute.

By the 1990’s abusive lending practices directed at consumers had again surfaced. One response was Congressional enactment of the 1994 Home Ownership and Equity Protection Act (HOEPA). The Federal Reserve was charged with formulating the regulatory response under HOEPA. This is examined below. However, the other federal banking agencies have always been charged with the duty to ensure bank lending practices are conducted in a safe and sound manner and are in compliance with applicable consumer protection laws, including fair lending requirements and, prior to the Comptroller’s decision to preempt state law, state consumer protection laws.

In 1995 the Comptroller of the Currency proposed revisions to its real estate lending regulations. No mention was made of possible abusive lending practices. The response in 1996 of the Office of Thrift Supervision, as successor to the Federal Home Loan Bank Board, was even more revealing. In 1996 it embraced the same, largely free market approach earlier embraced by the Comptroller of the Currency. In addition, at

23 Id.
24 Pub. L. 103-325, Title I, Subtitle B.
that time it converted its earlier regulations into “handbook guidance.” This was done to allow the exercise of judgment by the industry and bank examiners. In other words, bank management would set their own policies for real estate lending, “guided” by the OTS handbook, subject to post facto intervention to address financial losses.

Abusive practices again surfaced after the 1996 revisions to the real estate lending standards, just as they had surfaced prior to Congressional intervention in 1988 and in 1994. The regulators responded through a series of additional guidelines on real estate lending. These subsequent regulatory actions continued the pattern of relying primarily on free market forces to police abuses, and embracing very narrow forms of government intervention.

Specifically, between 1999 and 2001 the federal bank regulatory agencies issued three guidances on real estate lending. The first was on Subprime Lending. It was

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27 Id. at 1163. The reliance on bank management in setting polices for real estate lending and other activities was made clear when the OTS explained the role that its “guidance” should play:

In most circumstances, supervisory guidance provided in Regulatory Bulletins, Thrift Bulletins, the Thrift Activities Handbook and other sources can and should be relied upon to define safe and sound practices.

In its ongoing training programs, however, the OTS will continue to emphasize to examiners that guidance documents should not be confused with regulations. In particular situations, it may be prudent for institutions to deviate from what is stated in standard guidance documents. Examiners and thrift management both have a responsibility to consider what is safe and sound under all the facts of each circumstance. Neither should rely on the regulations and guidance documents in rote fashion.

Provided both management and examiners understand the proper role of regulations and guidance, and the overarching requirement for safe and sound operations and practices, a move away from detailed regulations and toward greater reliance on guidance should provide institutions with more flexibility without diminishing safety and soundness. The OTS believes that regulations should be reserved for core safety and soundness requirements. Details on prudent operating practices should be relegated to guidance. Otherwise, regulated entities can find themselves unable to respond to market innovations because they are trapped in a rigid regulatory framework developed in accordance with conditions prevailing at an earlier time.

Id. at 1164.
28 Infra notes 282 and 287 and accompanying text.
motivated by insured depository institutions increasingly originating subprime loans to increase profits, which exhibited significantly higher risks of default than traditional bank lending.\textsuperscript{29} The second was on High LTV (Loan-to-Value) Residential Real Estate Lending. It was motivated by insured depository institutions increasingly originating residential real estate loans in amounts exceeding 80 percent of appraised value, to increase profits, and the far greater risks of default and severity of the losses associated with such loans.\textsuperscript{30} The third was an Expanded Guidance on Subprime Lending.\textsuperscript{31} It was motivated again by the higher risks inherent in subprime lending programs and, for the first time, by a recognition that some forms of subprime lending may be abusive or predatory. All three continued to rely on bank management to set policies to control the risks inherent in subprime and high loan-to-value lending programs, and to avoid possible violations of consumer protection laws.\textsuperscript{32}

The 2001 guidance recognized, for the first time, the existence of abusive lending practices, i.e. practices that unfairly burden consumers rather than possibly imposing

\textsuperscript{29} Interagency Guidance on Subprime Lending (March 1, 1999).
\textsuperscript{30} Interagency Guidance on High LTV Residential Real Estate Lending (Oct. 8, 1999).
\textsuperscript{31} Expanded Guidance for Subprime Lending Programs (Jan. 31, 2001).
\textsuperscript{32} \textit{E.g.} the 1999 Interagency Guidance on Subprime Lending, \textit{supra} note 29, stated:

Institutions should recognize the additional risks inherent in subprime lending and determine if these risks are acceptable and controllable given the institution’s staff, financial condition, size, and level of capital support. Institutions that engage in subprime lending in any significant way should have board-approved policies and procedures, as well as internal controls that identify, measure, monitor, and control these additional risks.

It also provided that with respect to consumer compliance issues:

Institutions that originate or purchase subprime loans must take special care to avoid violating fair lending and consumer protection laws and regulations. Higher fees and interest rates combined with compensation incentives can foster predatory pricing or discriminatory “steering” of borrowers to subprime products for reasons other than the borrower’s underlying creditworthiness. An adequate compliance management program must identify, monitor and control the consumer protection hazards associated with subprime lending.
losses on lenders. However, the regulators did not prohibit the abusive practices. The 2001 Expanded Guidance on Subprime Lending recognized that: “. . .some forms of subprime lending may be abusive or predatory. Some such lending practices appear to have been designed to transfer wealth from the borrower to the lender/loan originator without a commensurate exchange of value.” The guidance identified the characteristics of lending transactions that are typically abusive or predatory:

- Making unaffordable loans based on the assets of the borrower rather than on the borrower’s ability to repay an obligation;
- Inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced (“loan flipping”); or
- Engaging in fraud or deception to conceal the true nature of the loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower.

However, it then did nothing to address the last two forms of abusive or predatory lending. As to the first it merely advised institutions that examiners will criticize the practice as imprudent and refer the matter to the agencies consumer compliance specialists for “additional review.” In fairness, the agencies may have been following the view that under the safety and soundness standard they only had the power to prohibit practices that create an abnormal risk of loss or damage to the institution or the insurance fund. Loan flipping and fraud are therefore abusive but not unsafe for the institution.

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34 Id.
35 Id.
36 See discussion infra note 260 and accompanying text.
However, the agencies still did not prohibit loans made without regard to ability to repay, a practice the courts had identified as a safety and soundness concern.37

In 2003 and 2004 there was a small shift in regulatory approach in the Comptroller’s Office, although reliance on free market forces remained the dominant viewpoint. In 2003 the Comptroller had advised national banks to avoid originating loans without regard to the borrower’s ability to repay, and extended the warning to avoid purchasing such loans originated by others.38 At that time the Comptroller relied on bank management to formulate and implement appropriate policies to ensure that the borrower has the capacity to make scheduled payments to service and repay the loan,39 and that the loans purchased comport with the bank’s general lending policies.40

In January 2004 the Comptroller’s Office did finally prohibit loans made without regard to ability to repay.41 It is the only regulatory prohibition that a federal agency has issued in real estate lending standards. This timing is revealing because it was done at the same time and in the same regulation that preempted state predatory lending laws.42 Thus the net effect was to impose far fewer prohibitions on possible abusive lending practices by national banks.

37 See infra note 261 and accompanying text.
42 Community and consumer advocates expressed concern that preemption would expose consumers to widespread predatory and abusive practices by national banks. Id.at 1906. The Comptroller’s Office, however, was concerned about the costs and burdens state predatory lending laws impose on national banks, Id. at 1908, and concluded that enforcement actions under federal law, such as the FTC Act, can ensure fair treatment of consumers. Id. at 1913-1914.
One final point regarding the regulatory viewpoint. All of the agencies’
guidances applied only to the banks or thrifts themselves and their operating subsidiaries. They did not apply to mortgage affiliates of these institutions. This failure to extend the regulatory guidance to bank and thrift affiliates was not explainable by a lack of supervisory power over mortgage affiliates. This was demonstrated by the fact that in October, 2006 the agencies again issued new guidelines on real estate lending and for the first time imposed some of those guidelines on bank and thrift affiliates.\textsuperscript{43} The Federal Reserve Board has supervisory authority over bank affiliates, including the power to determine which activities are “so closely related to banking as to be a proper incident thereto”\textsuperscript{44}, and which activities produce possible adverse effects such as “unsound banking practices.”\textsuperscript{45} The Office of Thrift Supervision has similar authority over thrift affiliates.\textsuperscript{46}

Thus, prior to 2005 the federal banking regulators relied almost completely on a free market approach to address unsafe and otherwise abusive lending practices. They relied on bank management to formulate and implement whatever policies they thought necessary, subject only to post facto regulatory intervention on a case by case basis, and they relied on consumers to protect themselves against abusive practices. The only practice prohibited, by the Comptroller’s Office in 2004, was lending without regard to

\textsuperscript{43} See discussion infra note 57 and accompanying text.  
\textsuperscript{44} 12 U.S.C. § 1843 (c) (8); BankAmerica Corporation v. Board of Governors of the Federal Reserve System, 491 F. 2d 985, 988 (9th Cir. 1974) (Board is permitted to consider the risks of a particular activity to the holding company in determining whether a proposed activity is a proper incident to banking and consider such adverse effects “unsound banking practices”); Association of Bank Travel Bureaus, Inc. v. Board of Governors of the Federal Reserve System, 568 F. 2d 549, 551-552 (7th Cir. 1978) (Board’s two-tier test has been adopted and endorsed by every circuit to consider the question).  
ability to repay, and this prohibition, as well as all regulatory guidelines issued, did not extend to affiliates. At the same time federal regulators preempted state predatory lending and consumer protection laws – laws that rejected a free market approach.

The Comptroller’s last revision of its own real estate lending guidelines was issued in 2005. In 2005 it reaffirmed its decision to issue guidelines and not regulations to address risks posed by real estate lending practices, including risks to consumers. It explained the reason for and significance of that decision as follows:

. . . if a national bank fails to meet a standard prescribed by regulation, the OCC must require it to submit a plan specifying the steps it will take to comply with the standard. If a national bank fails to meet a standard prescribed by guideline, the OCC has the discretion to decide whether to require the submission of such a plan. Issuing these residential mortgage lending practices standards by guideline rather than regulation provides the OCC with the flexibility to pursue the course of action that is most appropriate, taking into consideration the specific circumstances of a national bank’s noncompliance with one or more standards, and the bank’s self-corrective and remedial responses.

The Comptroller incorporated into its 2005 Guidance the key provisions of its February 2003 advisory letters. Once again the guidance was applied only to banks and their operating subsidiaries and not to affiliates. However, the difference was one of tone. It firmly advised banks, in developing their internal policies, to ensure that they do not become involved in certain practices identified as abusive, predatory, unfair or deceptive. Specifically, it advised against:

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48 Id. at 6331 and 6333.
1. Equity Stripping and Fee Packing. Repeat refinancings where a borrower’s equity is depleted as a result of financing excessive fees for the loan or ancillary products.

2. Loan Flipping. Repeat refinancings under circumstances where the relative terms of the new and refinanced loan and the cost of the new loan do not provide a tangible economic benefit to the borrower.

3. Refinancing of Special Mortgages. Refinancing of a special subsidized mortgage that contains terms favorable to the borrower with a loan that does not provide a tangible economic benefit to the borrower relative to the refinanced loan.

4. Encouragement of Default. Encouraging a borrower to breach a contract and default on an existing loan prior to and in connection with the consummation of a loan that refinances all or part of the existing loan.\(^{49}\)

Additional practices were also subject to scrutiny, but these would be considered on a case by case basis in light of, inter alia, acceptable risk mitigation measures.\(^{50}\)

Thus, in 2005 the Comptroller of the Currency for the first time expressed concern over a larger number of abusive lending practices and signaled it might intervene, on a case by case basis, more frequently to address issues of consumer protection.

While the Comptroller’s Office had begun to consider a bit of re-regulation in 2004, the uniform standards on real estate lending did not reflect a similar shift. Interagency, regulatory guidelines, including guidelines applicable to affiliates of banks and thrifts, were not issued until October, 2006 and March, 2007. This was due in part to

\(^{49}\) Id. at 6333.

\(^{50}\) This included financing single premium credit insurance, balloon payments in short-term transactions, prepayment penalties that are not limited to the early years of the loan, absence of an appropriate assessment and documentation of the consumer’s ability to repay, original principal balance of the loan in excess of appraised value, and pricing terms that result in the loan being subject to HOEPA.
intense resistance among regulatory policy makers to challenge the practices of the lending industry. By then it was too late.51

The agencies’ last revisions of its uniform real estate lending standards came in 2006 and 2007. An interagency guidance on nontraditional mortgage products was issued in October 2006.52 The guidance was motivated by the increased offering of loans that allowed borrowers to defer payment of principal and, sometimes, interest, i.e. interest only and payment-option adjustable rate mortgages, and that imposed reduced documentation requirements.53 The guidance continued to rely on bank management to decide the policies and products that will serve to minimize risks to the banks and thrifts.54 It made only two changes to its earlier complete reliance on bank management and narrow scope of coverage. First, it cautioned banks to include an evaluation of the borrower’s ability to repay the debt at final maturity at the fully indexed rated and assuming a fully amortizing repayment schedule,55 and to demonstrate mitigating factors supporting the underwriting decision in the event of risk layering such as reduced documentation loans.56 Second, for the first time the agencies applied the guidance to bank and thrift affiliates.57

54 71 Fed. Reg. at 58213, 58615.
55 Id. at 58614.
56 Id.
While the agencies recognized the consumer protection issues raised by many product offerings, they continued to rely on disclosure to address such concerns. Thus, a largely free market approach continued to be favored with bank management determining the appropriate policies to employ and products to offer and consumers determining the risks such products pose for them.

The last interagency guidance on real estate lending was issued in July 2007. It was motivated by concern over the increasing use of adjustable rate mortgage products with low initial payments based on an introductory rate that expires after a short period. The final guidance also applies to bank and thrift affiliates.

The 2007 guidance reiterates the principles announced in the earlier guidances dating back to 1993. In addition, it includes a statement that prudent underwriting standards should include analysis of a borrower’s repayment capacity at the loan’s final maturity at the fully indexed rate assuming a fully amortizing repayment schedule. The guidance does not prohibit stated income and reduced documentation loans but such

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58 More than traditional ARMS, mortgage products such as payment option ARMs and interest-only mortgages can carry a significant risk of payment shock and negative amortization that may not be fully understood by consumers. Communication should help minimize potential consumer confusion and complaints, foster good customer relations, and reduce legal and other risks to the institution.

Id. at 58616-58617. See also Id. at 58612, and Interagency Guidance on Nontraditional Mortgage Products, 70 Fed. Reg. 77249, 77255 (Dec. 29, 2005) (institutions should ensure consumers have information that is timely and sufficient for making a sound product decision).

59 Final Guidance – Statement on Subprime Lending, 72 Fed. Reg. 37569 and 37572 (July 10, 2007) (these products, typically offered to subprime borrowers, present heightened risks to lenders and borrowers and often have additional characteristics that increase risks such as qualifying borrowers based on limited or no documentation of income or imposing substantial prepayment penalties or prepayment penalties that extend beyond the initial fixed interest period).

60 Id. at 37573.

61 Id.
loans should be made to subprime borrowers only if there are mitigating factors such as substantial liquid reserves or assets.62

With respect to consumer protection concerns, apart from cautioning that loan underwriting should consider the borrower’s ability to repay, disclosure was once again relied upon to protect consumers.63

In summary, after the lifting of statutory requirements for mortgage loans in 1982, regulatory requirements were lifted as well. The federal regulators relied on bank management to ensure safe and sound operations and consumers to protect themselves against abusive loan practices. The only loan product actually prohibited were loans made without regard to the ability to repay and even this prohibition was embraced only by the Comptroller of the Currency and only for national banks and their subsidiaries – not for bank affiliates. In the entire 1982 to 2007 period deregulation in the form of a reliance on free market forces was the dominant viewpoint of the regulatory agencies to address unsafe loans, as well as other abusive loan practices.

B. HOEPA Standards: Unfair Loans

The power of federal banking agencies to regulate unfair mortgage lending practices comes from two sources: (a) the FTC Act64, and (b) HOEPA.65 This article focuses on regulatory viewpoint and power under HOEPA. Such power is vested in the

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62 Id.
63 Fundamental consumer protection principles relevant to the underwriting and marketing of mortgage loans include:
   • Approving loans based on the borrower’s ability to repay the loan according to its terms; and
   • Providing information that enables consumers to understand material terms, costs, and risks of loan products at a time that will help the consumer select a product.
Id. at 37574. These were the only two principles announced.
64 15 U.S.C. §§45 and 57a(f).
Federal Reserve and applies to the activities of banks, thrifts, their subsidiaries and affiliates, as well as independent mortgage companies.66

The actions of the Federal Reserve evidence a reliance on a free market approach to regulating unfair mortgage loans to the extent the statute vested discretion in the Fed. As in the earlier discussion of real estate lending standards, bank management was relied upon to avoid unfair mortgage products and practices and, more importantly, consumers were relied upon to protect themselves against unfair mortgage products and practices. However, in addition, the Federal Reserve Board also embraced a net societal benefits test as the determinant of the Fed’s decision to intervene or not intervene in the mortgage market to stop unfair products and practices. These viewpoints are discussed below.

Embracing Limited Government Intervention

The Federal Reserve’s initial set of standards under HOEPA were issued in 1995.67 HOEPA provided the Federal Reserve with the discretion to lower the threshold for coverage initially set by Congress and therefore subject more subprime loans to the Act’s prohibitions. It did not do so until 2001. As a result only a small percentage of subprime loans were subject to the Act’s prohibitions.68

The Act also granted the Federal Reserve the discretion to prohibit unfair or deceptive practices in addition to the practices explicitly prohibited by Congress.69 The Federal Reserve decided to prohibit no additional practice, subject to further study and

66 15 U.S.C. §1602 (f) (creditor is a person who regularly extends credit and is the person to whom the debt is initially payable). The statute applies to “consumer credit transactions” which would include residential real estate loans. 15 U.S.C. §1602 (h) (primarily for personal, family, or household purposes).
68 See infra note 72.
evaluation. In other words, its regulations were narrowly drawn to prohibit or otherwise regulate only the types of loans and practices Congress had required and no others.

The Federal Reserve did not act again until 2001. This time it did exercise its discretion, but to a limited degree. It now recognized that the threshold for loan coverage had caused very few subprime loans to be subject to HOEPA. It therefore lowered the threshold for first lien mortgages subject to the Act.

Unfortunately, lowering the threshold for coverage under HOEPA, and therefore subjecting such loans to the statutory prohibitions against enumerated abusive loan practices, is not the solution to the issue of abusive loan practices. The statute limits the extent to which the Federal Reserve can lower the threshold, and lenders easily avoided the new, lower threshold imposed by the Fed in 2001 by lowering somewhat the interest rates and fees they imposed. The issue of delay in lowering the statutory threshold is

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72 In response to the Board’s request in the proposal, a few commenters provided data on the number of loans they offered in recent years that would have been affected by a rate trigger of 8 percentage points above a comparable Treasury security. The most extensive data were submitted by a trade association representing nondepository institution lenders. The association collected data from the subprime lending divisions of nine member institutions. The number of loans surveyed is about 36 percent of the number of loans of subprime lenders recorded under HMDA during the survey period (mid-year 1995 through mid-year 2000). Overall, the trade association data show that for these loans, HOEPA’s existing APR trigger would have covered about 9 percent of the first-lien loans, and that lowering the APR trigger by 2 percentage points would have resulted in coverage of nearly 26 percent of the first-lien loans surveyed. Id. at 65608. However, a study by the Office of Thrift Supervision had drawn a different conclusion. That study concluded only 1 percent of subprime loans were covered by the 10 percent threshold, and this would increase to 5 percent if the threshold was lowered to 8 percent. See Governor Edward M. Gramlich, Subprime Lending, Predatory Lending, Remarks at the Federal Reserve Bank of Philadelphia, December 6, 2000 <http://www.federalreserve.gov/boarddocs/speeches/2000/20001206.htm>.
74 The 2004 HMDA data show that just 0.003 percent of home-secured refinance and home improvement loans are made above HOEPA’s threshold. Robert B. Avery, Glenn B. Canner and Robert E. Cook, New Information Reported Under HMDA and its Application in Fair Lending Enforcement, 91 FED. RES. BULL. 344-96 (2005). Moreover, the HOEPA prohibitions do not apply to home purchase loans.
raised, therefore, to highlight the Federal Reserve’s overall reluctance to intervene in the mortgage market.

In 2001 the Federal Reserve recognized increased reports of abusive loans which:

. . . generally included one or more of the following: (1) making unaffordable loans based on the borrower’s home equity without regard to the borrower’s ability to repay the obligation; (2) inducing a borrower to refinance a loan repeatedly, even though the refinancing may not be in the borrower’s interest, and charging high points and fees each time the loan is refinanced, which decreases the consumer’s equity in the home; and (3) engaging in fraud or deception to conceal the true nature of the loan obligation from an unsuspecting or unsophisticated borrower - for example, “packing” loans with credit insurance without a consumer’s consent.\(^75\)

Finally, it also recognized evidence of targeting of vulnerable groups. The Board noted:

Most of the information the Board received about predatory lending is anecdotal, as it was when Congress passed HOEPA in 1994. The reports of actual cases (including additional Congressional testimony by consumers) are, however, widespread enough to indicate that the problem warrants addressing. Homeowners in certain communities - frequently the elderly, minorities, and women - continue to be targeted with offers of high-cost, home-secured credit with onerous loan terms. The loans, which are typically offered by nondepository institutions, carry high up-front fees and may be based solely on the equity in the consumers’ homes without regard to their ability to make the scheduled payments. When homeowners have trouble repaying the debt, they are often pressured into refinancing their loans into new unaffordable, high-fee loans that rarely provide economic benefit to the consumers. These refinancings may occur frequently. The loan balances increase primarily due to fees that are financed resulting in reductions in the consumers’ equity in their homes and, in some cases,

\(^{75}\) Truth in Lending, supra note 71 at 65604.
foreclosure may occur. The loan transactions also may involve fraud and other deceptive practices.\textsuperscript{76}

The Federal Reserve’s response to the four or more abusive practices it had identified was to address only one of these practices – loan flipping – and the one constraint it imposed was a very narrow one. It imposed a prohibition on refinancing a HOEPA loan into another HOEPA loan unless the new loan was in the borrower’s interest, and even that prohibition only applied only during the first year of the loan.\textsuperscript{77}

The Federal Reserve did not address lending without regard to ability to repay, concealed costs such as credit insurance, or targeting of vulnerable groups with high fees. It did not even address refinancing of low-rate loans originated through mortgage assistance programs with high cost loans.\textsuperscript{78} The Board used cost-benefit analysis to set aside that proposed prohibition reasoning “(w)hile borrowers with low-rate mortgage loans could benefit from the rule, the benefits appear to be far outweighed by the potential compliance burden for all home-equity lenders.”\textsuperscript{79}

This leads us to explore further the viewpoint of the Federal Reserve with regard to regulatory intervention in the mortgage markets. I examined the speeches of the Federal Reserve Governors addressing mortgage market issues in three periods in which abusive lending practices were being investigated by Congress-- 1999-2000, 2003-2004 and 2007-2008. All three periods reveal the same regulatory viewpoint. First, there is a preference for free market solutions to predatory practices, primarily disclosure and consumer education programs. Second, regulatory intervention is determined by cost-

\textsuperscript{76} Id. at 65607.
\textsuperscript{77} Id. at 65612-65613. The Board also prohibited an additional troubling practice, the use of “due-on-demand” clauses in HOEPA loans. Id. at 65611.
\textsuperscript{78} Id. at 65613.
\textsuperscript{79} Id. The proposed rule would allow such refinancing only when it was in the borrower’s interest. The Board did not explain or document the “compliance burden.”
benefit analysis and not by Congress’ stated goal of protecting consumers against abusive practices. Third, no action is taken until it is expected that net societal benefits will result from intervention.

Reliance on consumers to protect themselves in a largely free market is apparent, for example, from these remarks on the part of Federal Reserve Governor Gramlich in 2000:

We should all recognize that the best defense against predatory lending is a thorough knowledge on the part of consumers of their credit options and resources. Educated borrowers who understand their rights under lending contracts and know how to exercise those rights can thwart predatory lenders. As the knowledge base of consumers grows, the market for credit-at-any-cost diminishes. Unfortunately, as is usually the case, the best solutions are often the most difficult to implement. A massive educational campaign is needed to bring about this expanded consumer knowledge.  

In fairness, Governor Gramlich privately sought greater oversight over risky mortgage loans consumers could not afford, including investigation and oversight of the practices of bank affiliates. This was especially true after risky loan products proliferated in the period after 2004. However, he was rebuffed by other Federal Reserve officials.

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80 Governor Edward M. Gramlich, Subprime Lending, Predatory Lending, Remarks at the Federal Reserve Bank of Philadelphia, December 6, 2000 <http://www.federalreserve.gov/boarddocs/speeches/2000/20001206.htm>. See also the following remarks by Governor Gramlich eight months earlier:

Predatory lending would not exist, or would be relatively rare, if prospective borrowers understood the true nature of their loan contracts. The Neighborhood Reinvestment Corporation (NRC) has an active borrower education program to promote just that type of understanding, and many other public and quasi-public agencies are thinking of following suit. To this point, efforts to extend consumer financial education into high schools have proven very disappointing, but there have been some successes with stock market simulation exercises. Perhaps some of these efforts could be extended to predatory lending issues.

especially chairman Alan Greenspan.\footnote{Edmund L. Andrews, \textit{Fed and Regulators Shrugged As the Subprime Crisis Worsened}, N.Y. TIMES, December 18, 2007, at A1.} In part this was due to the view that the overall benefits of risky loan practices outweighed possible risks\footnote{Id. (officials, including Alan Greenspan, enthusiastically praised subprime lenders for helping millions of families buy homes even while they recognized that the loosening of mortgage credit terms increased financial risk).} -- a net societal benefits test being used as the determinant for government intervention. Further evidence of the Federal Reserve’s free market viewpoint is contained in the analysis of its net societal benefits standard, discussed below.

Finally, in 2008 the Federal Reserve Board significantly expanded consumer protection through increased regulation of the mortgage market. All this was done without any Congressional Amendments to HOEPA, indicating the Federal Reserve had more regulatory power and discretion than it had exercised in the past.

The 2008 amendments to the HOEPA regulations, effective October 1, 2009, significantly broadened the reach of new regulatory prohibitions. It established a category of loans called “high-priced mortgage loans” in order to subject such loans to additional prohibitions and other consumer protections.\footnote{Truth in Lending, 73 Fed. Reg. 44522 (July 30, 2008). The Federal Reserve Board will publish the “average prime offer rate,” based on a survey currently published by Freddie Mac. A loan is higher-priced if it is a first-lien mortgage and has an annual percentage rate that exceeds this index by 1.5 percentage points or 3.5 percentage points if it is a subordinate-lien mortgage.} Its definition of that new term causes its new regulations to apply to all subprime mortgages.

The Federal Reserve also rejected its earlier reliance on issuing “guidances”. In doing so it admitted the shortcomings of a reliance on guidances:

\begin{quote}
Guidance . . . is not necessarily implemented uniformly by all originators. Originators who are not subject to routine
\end{quote}
examination and supervision may not adhere to guidance as closely as originators who are. Guidance also does not provide individual consumers who have suffered harm because of abusive lending practices an opportunity for redress. The new and expanded consumer protections that the Board is adopting apply uniformly to all creditors and are enforceable by federal and state supervisory and enforcement agencies and in many cases by borrowers.  

The Federal Reserve issued regulations that add four additional protections, in the form of regulatory prohibitions or requirements, for borrowers with such “higher-priced mortgage loans.” Namely under the new regulations: (a) lenders are prohibited from making a loan without regard to borrowers’ ability to repay the loan from income and assets other than the home’s value, and a lender must assess repayment ability based on the highest scheduled payment in the first seven years of the loan; (b) creditors must verify the income and assets they rely upon to determine repayment ability; (c) any prepayment penalty is banned if the payment can change in the initial four years, and for other higher-priced loans, a prepayment penalty period cannot last for more than two years; and (d) creditors must establish escrow accounts for property taxes and homeowner’s insurance for all first-lien mortgage loans.  

In addition, the regulations add protections for all loans secured by a consumer’s principal dwelling, even if the loan is not a “higher-priced mortgage loan.” This

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85 Id. at 44539-44560. No “pattern or practice” of making loans without regard to ability to repay needs to be demonstrated, as it was in earlier regulations. Id. at 44543.
86 Id. at 44563 et seq. The protections are as follows: (a) creditors and mortgage brokers are prohibited from coercing a real estate appraiser to misstate a home’s value; (b) companies that service mortgage loans are prohibited from engaging in certain practices, such as pyramiding late fees, and servicers are required to credit consumers’ loan payments as of the date of receipt and provide a payoff statement within a reasonable time of request; and (c) creditors must provide a good faith estimate of the loan costs, including a schedule of payments, within three days after a consumer applies for any mortgage loan, including home improvement loans and refinancings.
includes home purchase loans, refinancings, and home equity loans. Earlier HOEPA protections in Federal Reserve regulations were limited to refinancings and home equity loans. All of the 2008 regulations were issued on the basis of the Federal Reserve’s authority to prohibit acts or practices that are unfair, deceptive or designed to evade the provisions of HOEPA.⁸⁷

The actions of the Federal Reserve reflect a partial change in viewpoint. On the issue of consumer self-protection the Board admits that consumers are often unable to protect themselves due to: (a) limitations on price and product transparency, (b) the complexity of products offered and the limits of any form of disclosure to provide an effective means of protection for consumers, (c) misaligned incentives among originators and the lack of transparency regarding the roles and incentives of originators, and (d) the behavioral tendency of limited shopping and limited focus on the part of consumers.⁸⁸ These limits on the ability of consumers to protect themselves are further explored in Part Two of this article.

However, what did not change in 2008 is the significant barrier to regulatory intervention in the mortgage markets arising due to its embrace of a net societal benefits test. This is explored below.

*Embracing A Net Societal Benefits Standard*

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As discussed above, in 2001 the Federal Reserve Board addressed the issue of abusive mortgage practices but failed to act to address the questionable practices it had uncovered. It relied on a net societal benefits standard to avoid regulatory intervention. For example, while identifying as abusive the practice of refinancing low-rate loans originated through mortgage assistance programs with high cost loans, it refused to regulate such activity. The Board justified its non-intervention in these terms: “(w)hile borrowers with low-rate mortgage loans could benefit from the rule, the benefits appear to be far outweighed by the potential compliance burden for all home-equity lenders.”

The net societal benefits viewpoint was the subject of a lengthy analysis of subprime mortgage lending by Federal Reserve Governor Gramlich in 2004. He explained:

> On a social level, one question is whether the gains afforded by these new market developments outweigh the losses. Another question is whether anything can be done to limit foreclosures... Despite the caveats, the net social evaluation of these trends is probably a strong positive. The 9 million new homeowners, more than half of whom are minorities and many of whom have lower incomes, suggest that credit and ownership markets are democratizing. Millions of lower-income and minority households now have a chance to own homes and to build wealth; and the vast majority of these new homeowners do not appear to be having credit problems. The rates of serious delinquencies and near-serious delinquencies do raise important warning flags and should inspire renewed efforts to prevent foreclosures, but

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89 Id. at 65613. The proposed rule would allow such refinancing only when it was in the borrower’s interest. The Board did not explain or document the “compliance burden.”

they do not seem high enough to challenge the overall positive assessment.\textsuperscript{91}

Governor Gramlich’s individual assessment did focus on equal opportunity for low-income borrowers, and the costs and benefits of increased regulation to such borrowers. By contrast, the Federal Reserve Board’s assessment of net social benefits with regard to the decision not to prohibit refinancings of low-cost mortgages balanced the benefits of regulation to the borrower against the costs to the industry. That net benefits test applied to society as a whole is the same viewpoint that finally motivated Federal Reserve intervention in 2008, as discussed below.

As discussed above, Governor Gramlich did later attempt to persuade other Federal Reserve Board members to increase oversight over risky loan practices, but was rebuffed, in part based on the view that the overall societal benefits of risky loan practices outweighed possible risks.\textsuperscript{92}

A related viewpoint voiced at times by Federal Reserve members is one that examines the need for intervention at the macro-economic level. Federal Reserve Chairman Greenspan’s remarks on the dangers of high loan to value mortgage lending illustrate this view. Justifying his conclusion that no government intervention was necessary, Greenspan noted:

\begin{quote}
. . . measures of household financial stress do not, at least to date, appear overly worrisome.

About three-fourths of all outstanding first-lien mortgages were originated with a loan-to-value ratio of 80 percent or less, and in aggregate, the current loan-to-value ratio is estimated to be around 45 percent. Even though some down payments are borrowed, it would take
\end{quote}

\textsuperscript{91} Id.
\textsuperscript{92} Supra notes 81 and 82 and accompany text.
a large, and historically most unusual, fall in home prices to wipe out a significant part of home equity. Many of those who purchased their residence more than a year ago have equity buffers in their homes adequate to withstand any price decline other than a very deep one.  

As to the size of the debt burden households are subject to, the analysis was on the same terms:

To be sure, some households are stretched to their limits. The persistently elevated bankruptcy rate remains a concern, as it indicates pockets of distress in the household sector. But the vast majority appear able to calibrate their borrowing and spending to minimize financial difficulties. Thus, short of a significant fall in overall household income or in home prices, debt servicing is unlikely to become destabilizing.

Under the Federal Reserve’s approach millions of homeowners could be unwittingly subjected to loans that they cannot repay, and therefore subjected to loss of their homes and equity as long as most homeowners were not overburdened and benefits resulted for the economy from such lending. Similarly, vulnerable groups of borrowers could be stripped of equity through excessive interest rates, excessive fees, and excessive prepayment penalties as long as the economy as a whole benefited from unregulated lending practices. In other words, under sanction of law wealth was transferred from vulnerable groups to business interests in the name of net societal benefit.

The viewpoint that net societal benefits is the determinant of regulatory intervention is one that has never changed. This is even true of the Fed’s decision to


\[94\] *Id.*
finally intervene in the mortgage market in July 2008. The Federal Reserve’s proposed rule makes it clear that it was motivated by a conclusion that the net societal costs of the current regulatory approach far outweighed its benefits. Federal Reserve Chairman Bernanke noted:

Rates of mortgage delinquencies and foreclosures have been increasing rapidly lately, imposing large costs on borrowers, their communities, and the national economy. Although the high rate of delinquency has a number of causes, it seems clear that unfair or deceptive acts and practices by lenders resulted in the extension of many loans, particularly high-cost loans, that were inappropriate for or misled the borrower.

The viewpoint was not only reflected in the motivation for the Federal Reserve’s decision to act at all. It was also reflected in its embrace of the FTC’s standard for defining unfair practices under the FTC Act as the governing standard under HOEPA as well. The Board states that it has “considered” both the standards currently applied by the FTC as well as standards applied under similar state statutes. However, when deciding whether to adopt certain regulatory prohibitions the Board employed the FTC standard, including an analysis of whether injury is outweighed by countervailing

95 The proposed rule discusses the serious levels of delinquency in subprime loans generally and even in near prime loans, the severe consequences of default for borrowers and the entire communities where they are located, the expectation that delinquencies and foreclosure will rise further, and the risks posed not only to borrowers but to creditors. Truth in Lending, Proposed Rule, 73 Fed. Reg. 1672, 1674 (Jan. 9, 2008).
97 Truth in Lending, supra, note 95 at 44529.
98 Id.at 44529. The Board notes that the Conference Report on HOEPA asks the Board to look to the standards under state law and the FTC Act. It also notes that:
   Many states also have adopted statutes prohibiting unfair or deceptive acts or practices, and these statutes employ a variety of standards, many of them different from the standards currently applied to the FTC Act. A number of states follow an unfairness standard formerly used by the FTC.
   Under this standard, an act or practice is unfair where it offends public policy; or is immoral, unethic, oppressive, or unscrupulous; and causes substantial injury to consumers.
Id.at 44530 (footnote omitted).
benefits to consumers or to competition. It did not analyze whether a practice offends public policy, is immoral, unethical, oppressive or unscrupulous – the standard employed by many states.

Thus, recent action of the Federal Reserve demonstrates it continues to adhere to the position that if an act or practice causes or is likely to cause substantial injury to consumers, and the injury is not reasonably avoidable by consumers, the Federal Reserve still will not intervene unless such injury outweighs countervailing benefits to society.

The bank regulators resort to deregulation as the means to achieve the goal of wealth maximization (net societal benefits) illustrates the emphasis on efficiency rather than morality in the evaluation of moral hazard. The view was that statutory or regulatory restrictions on mortgage practices and products might reduce risks but did not maximize wealth. The preferred approach was to lift statutory and regulatory restrictions in order to maximize wealth, and to rely on market discipline to avoid excess risk taking. The resort to deregulation did not completely ignore the aim of weeding out unfair or deceptive mortgage practices, since Congress insisted upon it over the years. However, the threshold for regulatory intervention – net societal benefits – relegated that aim to secondary importance behind wealth maximization. Moreover, market discipline was

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99 Id. at 44543 (prohibition of lending without regard to borrower’s ability to repay – Board considers substantial costs to borrowers and communities), 44554 (prepayment penalties’ injuries outweigh their benefits in case of higher-priced mortgaged and HOEPA loans with payment increases after a few years, but for other types of loans the injuries and benefits are much closer to being in equipose ), 44559 (benefits from escrows for taxes and insurance outweigh costs.)

The Board’s discussion emphasizes costs and benefits to consumers. However, this is not the Board’s only concern. For example, in making its decision regarding the scope of the prohibition on prepayment penalties the Board considered if prepayment penalties increase market liquidity by permitting creditors and investors to price directly and efficiently for prepayment risk. Id. at 44554. Similarly, when discussing its decision to require tax and insurance escrows the Board noted the potentially substantial costs to creditors in setting up or acquiring escrow capabilities, and noted that escrows can improve loan performance to the advantage of creditors, investors and consumers alike. Id. at 44559.
presumed to effectively substitute for government intervention to avoid the emergence or prevalence of unsafe and unfair mortgage products. In the case of unfair mortgage products the discipline was to be exercised by the consumers, who would presumably avoid unfair, as well as unsafe, mortgage practices and products. Did actual outcomes reflect these expectations for market discipline on the part of the industry and the public? This issue is explored below.

**Part Two – Outcomes in a Deregulated Mortgage Market**

**A. Unsafe Products and Practices and Equity Stripping**

*Unsafe Products and Practices*

The most revealing outcome in evaluating the moral hazard posed by deregulation is one examining the mortgage practices of banks and thrifts. These institutions were subject to the general prohibition against “unsafe and unsound” banking practices, as well as the uniform guidelines cautioning against unaffordable loans including loans made without regard to the borrower’s ability to repay. If these legal “constraints” coupled with market discipline did not prevent unsafe lending practices by these institutions, then it certainly would not prevent unsafe lending practices by non-affiliated and less regulated mortgage companies.

The mortgage products and practices that emerged were: (a) adjustable rate mortgages (ARMs) with low initial rates that lead to substantial increases in loan payments after expiration of the initial “teaser” rate, (b) payment option loans in which the borrower could choose an amount to pay, including a minimum payment that did not include all accrued interest, until a recast of the payments at a later point which significantly increased loan payments, (c) loans underwritten without regard to
borrowers’ ability to repay, including limited documentation or no documentation loans, and (d) loans made requiring very little or no borrower equity, including first lien mortgage loans that tolerated piggyback loans.

ARMs introduce the risk of sticker shock after the expiration of a low initial “teaser” interest rate. For example, analysis of 2/28 subprime ARMs (with a low initial interest rate in effect the first two years) made in 2006 indicated an average payment shock of 29 percent over the teaser-rate payment even if short-term interest rates remained unchanged. However, since interest rates increased in 2006 the payment shock is estimated to be 50 percent.\(^\text{100}\) Many borrowers would be unable to pay the higher payments required of them, particularly if their ability to repay was based on the low initial interest rate.\(^\text{101}\)

Payment option loans introduce the risk of another form of sticker shock, namely increase in monthly payments upon recast of the loan. In payment option loans the borrower can choose to pay a minimum payment which does not include all accrued interest and does not include payment of principal. Some industry analysts have estimated that 70 percent of payment option ARM borrowers were making only the minimum payments allowed under their mortgage loans.\(^\text{102}\) The accrued and unpaid interest is then added to the principal. However, when the outstanding balance reaches a


\(^{101}\) Lingling Wei, Washington Mutual to Stop Offering Certain Subprime Loans, July 18, 2007, http://www.marketwatch.com/news/story/washington-mutual-stop-offering-certain/story.asp (analysts at Credit Suisse examined subprime borrowers in 2006 whose loans adjust after two years, and found about one-third would not have qualified for the loans had the lender used the fully-indexed rate-not the initial “teaser” rate – in determining the borrowers’ repayment ability).

certain threshold – typically 115% of fair market value – then the payment option expires and the loan is recast to require monthly payments of both interest and principal. The Illinois Attorney General’s lawsuit against Countrywide illustrates the payment shock of recast of a payment option loan using an example from its investigation. It found the borrower’s monthly minimum payment was $751 but the fully amortizing payment required after recast was $1,824.103

No documentation or low documentation loans add the risk that the lender has no assurance that the borrower is able to afford the loan, either initially or after a reset of interest rates or recast of payments. From 2000 to 2005 the number of subprime loans made without full documentation of income climbed from 26 percent of subprime mortgages in 2000 to 44 percent in 2005.104

Finally, piggyback loans add the risk that the borrower has very little equity in the home. In the event of a significant decline in the fair market value of the property, refinancing becomes difficult or impossible. Moreover, the risk of default increases since the borrower’s equity has already been lost due to the market decline.105 By the end of 2006, 32 percent of home purchase borrowers relied on piggyback loans (junior loans) to finance their purchase.106 Moreover, an increasing number of subprime loans had loan to value ratios exceeding 90 percent. Such high loan-to-value loans were 6.32 percent of

103 The People of the State of Illinois v. Countrywide Financial Corporation, et al., 08CH 22994, Complaint for Injunctive and Other Relief at 35.
105 These risks were discussed and documented in Robert B. Avery, Kenneth B. Brevoort, and Glenn B. Canner, The 2007 HMDA Data, 94 FED. RES. BULL. A107, A117 (December 2008).
106 Furman Center for Real Estate & Urban Policy, Declining Credit & Growing Disparities: Key Findings from HMDA 2007, at 2. Data reported to the Federal Reserve revealed 1.37 million junior-lien loans used to purchase home in 2005, 1.43 million in 2006, and 600,000 in 2007 Avery, Brevoort and Canner, Id. at A113.
subprime loan originations in 1998 and jumped to 13.7, 16.91 and 13.46 percent in 2002, 2003 and 2004 respectively.\textsuperscript{107}

The widespread offering of these risky loan products was documented by research analysts at Credit Suisse.\textsuperscript{108} Focusing on the subprime market at the end of 2006, Credit Suisse found:

- Roughly 50% of all subprime borrowers in the last two years had provided limited documentation regarding their incomes.
- In 2006, 2/28 ARMS (resetting after 2 years) represented roughly 78% of all subprime purchase originations, and home buyers were primarily qualified at the introductory teaser rate rather than the fully amortizing rate.\textsuperscript{109}

Focusing on the Alt-A market at the end of 2006, Credit Suisse found:

- 55% of borrowers in Alt-A purchase originations had taken simultaneous second mortgages (piggybacks) at the time of purchase.
- Low or no-documentation loans represented 81% of total Alt-A purchase originations
- Interest only and option ARM loans represented approximately 62% of Alt-A purchase originations

\textsuperscript{109} Id. at 4-5. The subprime market constituted 20% of total originations in 2006.
• Adding to the risk, one-year hybrid ARMs represented approximately 28% of Alt-A purchase originations, setting the stage for considerable reset risk.\textsuperscript{110}

Focusing on the overall market for mortgage products, Credit Suisse found:

• Approximately 23% of total purchase originations in 2006 were interest only or negative amortization mortgages.

• Low or no documentation loans increased from 18% of total purchase originations in 2001 to 49% in 2006.\textsuperscript{111}

Not only were individually risky products introduced but there was also a layering of risks. Payment option ARMs are especially risky due to a layering of two sets of sticker shock, one due to the interest rate reset and another due to the recast of payments. A no documentation payment option ARM then adds a third layer of risk due to an inability to assess borrowers’ repayment ability. A pattern of engaging in risky practices by offering loan products that layered risks was evident in the industry generally. For example, about 83 percent of the payment option ARMs issued from 2004 to 2007 were underwritten without full documentation of the borrowers’ income.\textsuperscript{112}

The mortgage banking industry generally increasingly offered loan products with several layers of risk. For example the General Accountability Office examined

\textsuperscript{110} Id. at 4. The Alt-A market constituted 20% of total originations in 2006, rising from just 5% in 2002.

\textsuperscript{111} Id. at 5.

\textsuperscript{112} Bob Ivry and Linda Shen, infra note 131 (Bloomberg) (according to Fitch Ratings analysts).
payment option ARM loans securitized in the private label secondary market in the period 2001 through 2005. It found the following:

Underwriting Trends of Recent Payment-Option ARM Securitizations,

January 2001 to June 2005

<table>
<thead>
<tr>
<th>Origination Year</th>
<th>Origination amount (in millions of dollars)</th>
<th>Percentage of FICO scores below 700</th>
<th>Average DIT Ratios*</th>
<th>Percentage of Option ARM with piggyback mortgages</th>
<th>CLTV&gt;80 Percent**</th>
<th>Percentage with low documentation</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$2,210</td>
<td>32.4%</td>
<td>24.4</td>
<td>0.0%</td>
<td>1.8%</td>
<td>69.4%</td>
</tr>
<tr>
<td>2002</td>
<td>3,745</td>
<td>33.4</td>
<td>29.2</td>
<td>0.3</td>
<td>1.9</td>
<td>67.6</td>
</tr>
<tr>
<td>2003</td>
<td>2,098</td>
<td>42.4</td>
<td>28.9</td>
<td>6.3</td>
<td>10.4</td>
<td>74.4</td>
</tr>
<tr>
<td>2004</td>
<td>37,117</td>
<td>43.1</td>
<td>31.6</td>
<td>11.4</td>
<td>12.0</td>
<td>75.4</td>
</tr>
<tr>
<td>2005</td>
<td>13,572</td>
<td>48.2</td>
<td>32.6</td>
<td>25.3</td>
<td>22.2</td>
<td>74.7</td>
</tr>
</tbody>
</table>

*Ratio based on borrower’s fixed monthly expenses divided by gross monthly income.

**Combined loan to value ratio, in light of both first and second mortgage loans.

This data reveals an increasing number of loans with not two but three or even four or more layers of risk – ARM risk, payment option risk, low documentation risk and piggyback loan risk.

Focusing on banks and thrifts specifically, industry surveys reveal that banks and thrifts, either directly or through affiliates, became primary originators of payment

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option ARMS. Vague legal constraints in the form of “safety and soundness” requirements and regulatory guidelines warning against making loans without regard to ability to repay did not prevent these practices at federally regulated financial institutions. Beginning in 2005 and continuing into 2007 the mortgage industry newsletter, National Mortgage News, periodically collected data on residential payment option ARM originations.\textsuperscript{114} Such data revealed the following levels of participation by banks or thrifts and their affiliates in originations of payment option ARMs:

\textsuperscript{114} Paul Muolo, \textit{Option ARMs in Sevenfold Rise}, \textsc{National Mortgage News}, December 5, 2005, at 1 (mortgage bankers funded almost $73 billion in payment-option ARMs in the third quarter of 2005, a more than sevenfold increase from the same period last year). The figures reported payment-option ARM production disclosed to National Mortgage News by lenders. The disclosed figures are estimated to capture about 60 percent of the payment option ARM market.
The mortgage practices of four large banks and thrifts – Countrywide, Washington Mutual, Wachovia and IndyMac – illustrate the failings of a reliance on vague legal standards and market discipline to avoid unsafe mortgage lending practices.

Countrywide was the country’s largest mortgage lender as of 2008. It originated $73 billion in mortgage loans in the first quarter of 2008 alone. It was also a significant originator of subprime mortgages. By the first quarter of 2007, Countrywide had become

<table>
<thead>
<tr>
<th>Time Period</th>
<th>Market Share – Residential Payment Option Loans Originated by Banks, Thrifts or Affiliates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Second Quarter 2007</td>
<td>52.39 percent</td>
</tr>
<tr>
<td>Second Quarter 2006</td>
<td>51.1 percent</td>
</tr>
<tr>
<td>First Quarter 2006</td>
<td>55.77 percent</td>
</tr>
<tr>
<td>Fourth Quarter 2005</td>
<td>60.30 percent</td>
</tr>
</tbody>
</table>

115 Residential Option ARMs Lenders in Q2 2007, National Mortgage News, October 1, 2007, at 1. The bank or thrift lenders or their affiliates were Washington Mutual, Countrywide, Wachovia, IndyMac, Greenpoint Mortgage, Mortgage IT (a subsidiary of Deutsche Bank), Flagstar Bank, 1st National Bank of Arizona, Downey Savings and Loan, and Sun Trust Mortgage.

116 Residential Option ARM Lenders in Q2 ’06, National Mortgage News, September 15, 2006, at 1. The bank or thrift lenders or their affiliates were Countrywide, Washington Mutual, IndyMac, Greenpoint Mortgage, EMC Mortgage (a subsidiary of JP Morgan Chase), Mortgage IT (a subsidiary of Deutsche Bank), Downey Savings and Loan, 1st National Bank of Arizona, Bank of America, First Horizon, Sun Trust Mortgage, and American Mortgage Network (a subsidiary of Wachovia).

117 Residential Option ARM Lenders in Q1 ’06, National Mortgage News, July 24, 2006 at 1. The bank or thrift lenders or their affiliates were Countrywide, EMC Mortgage (a subsidiary of JP Morgan Chase), IndyMac, Goldenwest Financial, Greenpoint Mortgage, Downey Savings & Loan, Mortgage IT (a subsidiary of Deutsche Bank), 1st National Bank of Arizona, Bank of America, First Horizon, Sun Trust Mortgage, and American Mortgage Network (a subsidiary of Wachovia).

118 Residential Option ARM Lenders in Q4 ’05, National Mortgage News, March 27, 2006, at 1. The bank or thrift lenders and their affiliates were Countrywide, EMC Mortgage (a subsidiary of JP Morgan Chase), IndyMac, Greenpoint Mortgage, Downey Savings & Loan, Bank of America, American Mortgage Network (a subsidiary of Wachovia), First Horizon, Flagstar Bank, and Sun Trust Mortgage.
the largest originator of subprime loans with a total subprime loan volume of over $7.8 billion.\textsuperscript{119}

The evidence that has emerged regarding mortgage industry practices indicates layering of several types of risky loans in the industry generally as well as at Countrywide – namely, ARMs with a payment option, made with little or no documentation of income, and requiring little money down. Thus the Wall Street Journal reported in 2007:

By 2005, option ARMs accounted for $238 billion of loan volume, or about 8% of loans originated that year, according to Inside Mortgage Finance, a trade publication. At Countrywide, these loans accounted for $93 billion, or 19\%, of the company’s loan volume by 2005, making it the top option ARM lender that year. . . .

Of the option ARMs it [Countrywide] issued last year [2006], 91\% were “low-doc” mortgages in which the borrower didn’t fully document income or assets, according to UBS, compared with an industry average of 88\% that year. In 2004, 78\% of Countrywide’s option ARMs carried less than full documentation.

Countrywide also allowed borrowers to put down as little as 5\% of a home’s price and offered “piggyback mortgages,” which allow borrowers to finance more than 80\% of a home’s value without paying for private mortgage insurance. By 2006, nearly 29\% of the option ARMs originated by Countrywide and packaged into mortgage securities had a combined loan-to-value of 90\% or more, up from just 15\% in 2004, according to UBS.\textsuperscript{120}

\textsuperscript{119} The People of the State of Illinois v. Countrywide Financial Corporation et. at., 08 CH 22994. Complaint for Injunctive and Other Relief at 9-10. In 2002 Countrywide originated approximately $9 billion in subprime loans. In 2005 that number increased to over $44 billion. \textit{Id.} at 13.

Cases brought by State Attorneys General also uncovered a pattern of unsafe lending practices at Countrywide. For example, in its lawsuit against Countrywide filed by the State of Illinois, the complaint indicates:

- From 2005 through the first half of 2007, a majority of the Countrywide mortgages sold in Illinois were reduced documentation loans, often called “stated income” or “liar’s loans”. ¹²¹

- Countrywide became a leader in the profitable Option ARM loan market. Option ARMs increased from approximately 3% of the company’s loan production during the quarter ended June 30, 2004, to approximately 21% of its production during the quarter ended June 30, 2005. ¹²²

- Of the option ARMs Countrywide sold in 2007, 82% were reduced documentation mortgages in which the borrower did not fully document income or assets. ¹²³

- Countrywide offered interest-only loan products in which the interest-only payment feature existed only during the first years of the loan, usually the first 3, 5, 7 or 10 years. It became the second leading originator of interest-only loans from 2006 through the second quarter of 2007. When it qualified borrowers’ ability to

¹²¹ The People of the State of Illinois v. Countrywide Financial Corporation et al., 08 CH 22994, Complaint for Injunctive and Other Relief at 23.
¹²² Id. at 35.
¹²³ Id. at 40.
repay, such qualification was often not at the payment due on a fully amortizing mortgage. Countrywide qualified its borrowers at the minimum or the lower non-amortizing interest only payment at least part of the time during the period 2003 through 2007.\textsuperscript{124}

- Countrywide acknowledged in a May 7, 2007 letter to OTS that looking at originations in the fourth quarter of 2006, almost 60% of the borrowers who obtained subprime hybrid ARMs, including interest only loans, from Countrywide would not have qualified at the fully indexed rate.\textsuperscript{125}

Indeed, Countrywide decided to switch from a national bank to a thrift charter in 2006 precisely because the OTS applied the interagency guidelines on alternative mortgage products with “more restraint”.\textsuperscript{126}

The practice of embracing risky loan practices was equally evident at Washington Mutual. Between 2004 and 2007 it increasingly originated subprime loans, and short-term adjustable-rate mortgages especially payment option ARMs.\textsuperscript{127} In 2005 and 2006 WaMu funded a total of $107 billion in payment option adjustable rate mortgages, and by the end of 2007 WaMu held $48 billion in payment option adjustable rate mortgages that

\begin{itemize}
\item \textsuperscript{124} Id. at 30.
\item \textsuperscript{125} Id. at 32.
\item In addition almost 25 percent of the borrowers for subprime hybrid ARMs, which may include reduced documentation and high loan-to-value ratios, would not have qualified for any other Countrywide loan product.
\item Barbara A. Rehm, \textit{Countrywide to Drop Bank Charter in Favor of OTS}, \textit{AM. BANKER}, November 10, 2006, at 1.
\end{itemize}
resulted in negative amortization.\textsuperscript{128} In addition, into 2007 WaMu underwrote payment option ARM loans based on the borrower’s ability to afford the low initial teaser payment.\textsuperscript{129} It also increasingly originated loans with limited or no documentation of income or assets.\textsuperscript{130}

Wachovia was similarly in the business of making risky loans in recent years. It was the largest originator of payment option ARM loans in the second quarter of 2007, followed by WaMu, and held $122 billion of such loans.\textsuperscript{131} The biggest originators of such loans at the time were Wachovia, WaMu, Countrywide, Downey Financial Corp. (a savings and loan), and IndyMac.\textsuperscript{132} Wachovia was the largest holder of option ARMs. According to its own website such mortgages represented 73 percent of Wachovia’s loan portfolio.\textsuperscript{133} Indeed one of the very reasons Wachovia purchased Golden West Financial Corp. in 2006 was Golden West’s focus on payment option adjustable-rate mortgages that it hoped to cross-sell to Wachovia customers.\textsuperscript{134}

The same practice of making risky loans was uncovered at IndyMac. IndyMac was one of the largest holders of payment option ARM loans.\textsuperscript{135} In addition, as recently

\textsuperscript{128} Michael Hudson and Jim Overton, The Second S&L Scandal 8, Center for Responsible Lending, January 2009 (figures collected from WaMu’s filings with the SEC).

\textsuperscript{129} Id.

\textsuperscript{130} Drew De Silver, \textit{supra} note 127. For example Michael Shedlock analyzed a bundle of loans made by WaMu in May 2007 that consisted of 1765 loans totaling $519 million. In this bundle of loans, 88% did not request verification of income. By March 2008, 18 percent of the loans were in foreclosure. Mark Grimeen, \textit{Inside the Liar’s Loan}, April 24, 2008 \url{http://www.slate.com/id/2189576}.


\textsuperscript{132} Id.

\textsuperscript{133} Id.


as the first quarter of 2007 only 21% of IndyMac’s total loan production were in the form of full documentation mortgages. Finally, some of the loans that IndyMac labeled as full documentation loans may have been supported not by verification of income but only by verification of employment with no verification of income.

Equity Stripping

The greatest loss of equity for consumers results from unsafe lending practices that lead to foreclosure. Recent foreclosures have come in three waves, representing three stages of risk resulting from the mortgage practices of recent years. The first wave of foreclosures, occurring in 2007 and 2008, resulted from adjustable-rate subprime loans in which the borrowers were unable to afford the reset interest-rate and unable to refinance. The second wave is expected in 2009 and 2010 and will result from payment option ARMs that recast and five year adjustable-rate hybrid ARMs. Such loans were made in both the subprime and the Alt-A market. A third wave of foreclosures has actually overlapped with these first two causes of financial difficulty. This results from unavailability of credit in a tightened mortgage market in late-2008 and 2009, job losses resulting from a downturn in the economy triggered by mortgage loan losses of financial institutions, and a sharp drop in housing prices making refinancing of a large outstanding mortgage balance impossible.

However, loss of equity due to unsafe products and practices is not a loss experienced only in recent years. The foreclosure rate in subprime loans has exceeded

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136 Center for Responsible Lending, Indymac: What Went Wrong 3, June 30, 2008. Figures are based on filings with the SEC. One year later IndyMac had charged this reliance on limited or no documentation loans, but by March 2008, 69% of its loan volume involved full documentation mortgages, leaving almost one-third of its loan volume still in the form of limited or no documentation mortgages.

137 Id. at 8.
5% in the period 2001 through 2003 and then again in the first quarter of 2007, and has never dropped below 3% in the 2001 to 2007 period.\textsuperscript{138}

Total loans in foreclosure averaged 455,000 annually in the period 2002 to 2006, and then more than doubled to nearly 940,000 by the fourth quarter of 2007.\textsuperscript{139} This was a jump from less than 1 percent of all loans outstanding in the earlier period to more than 2 percent by the end of 2007.

Defaults and foreclosures increased in 2008 and will continue to do so in 2009. In October 2007 the Joint Economic Committee reported that in the 2007-09 period subprime foreclosures would total 2 million, causing $71 billion in housing wealth to be directly destroyed through the process of foreclosure and another $32 billion indirectly destroyed by the spillover effects of foreclosures.\textsuperscript{140} In fact, the number of foreclosure filings has been greater than expected. Thus, during 2008 foreclosure filings actually

\begin{flushleft}
\textsuperscript{138} Congressional Research Service, Understanding Mortgage Foreclosures: Recent Events, the Process and the Costs 3, November 5, 2007. The foreclosure rate exceeded 7% in the period 2001 through the second quarter of 2003. \textit{See also} Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest, \textit{Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners} at 11, Center for Responsible Lending (December 2006) (foreclosures rates for subprime loans originated in 1998 were 9.7\%, were 12.0\% for loans originated in 1999, 12.9\% for loans originated in 2000, 8.2\% for loans originated in 2001, and 4.1\% for loans originated in 2002).

\textsuperscript{139} Joint Center for Housing Studies of Harvard University, The State of the Nation’s Housing 2008 at 20 (data from the Mortgage Bankers Association).

\textsuperscript{140} Report and Recommendations by the Majority Staff of the Joint Economic Committee, the Subprime Lending Crisis 1, October 2007 (estimated aggregate cumulative subprime foreclosure rate of 18 percent during the 2007-09 period). Not all foreclosure filings lead to the loss of the property by the borrower. However, a 2008 report from Barclays Capital estimated there were 721,000 bank-owned homes in the U.S., up from 112,000 two years ago, and estimated that the total will rise 60 percent before peaking in late 2009. James R. Hagerty and Jonathan Karp, \textit{Banks Incur Housing Pain – Foreclosures in U.S. Are Sold at Big Losses; Clearing the Backlog}, WALL ST. J. EUROPE, August 14, 2008, at 25.
\end{flushleft}
occurred against 2,330,483 U.S. properties. In addition, it is now expected there will be 2.4 million new foreclosure filings in 2009.

Two troubling characteristics have become apparent, regarding the incidence of foreclosures in recent years. Namely, foreclosures are heavily concentrated in low-income communities and in communities that are predominantly black or Hispanic. This is understandable because lower-income borrowers are least likely to be able to afford the payment shocks triggered by recent “innovative” mortgage products.

Studies and reports concerning foreclosures in the New York City region, Boston, Chicago, Baltimore, Minneapolis-St. Paul, Cleveland, San Diego

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142 Center for Responsible Lending, United States Foreclosures: Impact & Opportunities, January 2009. More than 8 million foreclosures are expected during the next four years based on Credit Suisse analysts’ forecasts. Id.
143 New York State Senator Jeffrey D. Klein, Survey of Subprime Mortgages in New York 17-23, August 2007 (demographic breakdown of foreclosure filings in neighborhoods located in New York City, Westchester, and Nassau); Testimony of Vicki Been, House Committee on Oversight and Government Reform, Subcommittee on Domestic Policy, May 21, 2008, Figure 2 (lis pendens rate and median household income for New York City), http://domesticpolicy.oversight.house.gov/documents/20080522105505.pdf.edu. As Professor Been testified
Foreclosures in New York City are highly concentrated in specific neighborhoods. . . High-exposure neighborhoods tend to have a greater proportion of Black and Hispanic residents, lower median incomes, lower median sales prices and higher rates of subprime lending than low-exposure neighborhoods.

See also experience in Minneapolis and St. Paul, Jennifer Bjorhus, Foreclosure Threat Reaches the Burbs, ST. PAUL PIONEER PRESS, December 3, 2006, at 1A (Twin Cities foreclosures have been most concentrated in lower-income urban neighborhoods such as North Minneapolis and St. Paul’s East Side, although they are rapidly becoming a suburban problem); Jackie Crosby, Pam Louwagie, Kara McGuire, Twin Cities Troubled by Multiplying Foreclosures, STAR TRIBUNE, November 26, 2006, at 1A (disproportionate number of foreclosures in Minneapolis are in low-income neighborhoods on the city’s North Side and in St. Paul’s East Side and other central city neighborhoods).
144 Id. and infra, notes 146 to 153.
145 Supra note 143.
146 Kristopher S. Gerardi and Paul S. Willen, Subprime Mortgages, Foreclosures, and Urban Neighborhoods at 14, Public Policy Discussion Paper No. 08-6, Federal Reserve Bank of Boston
and Durham County, North Carolina\textsuperscript{152}, for example, all document that foreclosures are highly concentrated in minority neighborhoods and lower-income neighborhoods. Moreover, the adverse impact of a foreclosure is more pronounced for low-income residents since housing wealth constitutes a very large component of total family wealth – approaching or exceeding 50 percent of total family wealth.\textsuperscript{153}

\footnotesize{(December 22, 2008), available at \url{http://ssrn.com/abstract=1324323} (in the current housing crisis, foreclosures are highly concentrated in minority neighborhoods, even relative to past foreclosure booms, such as the crisis of the early 1990s).}

\footnotesize{147 Woodstock Institute, \textit{Foreclosures in the Chicago Region Continue to Grow At An Alarming Rate} at 4 and 6 (March 2008) (census tracts in Chicago that are 80 percent or greater minority had foreclosure levels 2.5 times greater than the six county region in 2007).}

\footnotesize{148 Complaint for Declaratory and Injunctive Relief and Damages, Mayor and City Council of Baltimore v. Wells Fargo Bank, 2008 cv 00062. Maryland Federal District Court, January 8, 2008, at 2:

Defendant Wells Fargo Bank, N.A., is one of the largest mortgage lenders in Baltimore and the country at large. Together with Defendant Wells Fargo Financial Leasing, Inc. (collectively “Wells Fargo”), it is also one of the leading causes of the disproportionately high rate of foreclosures in Baltimore’s African-American neighborhoods. In 2005 and 2006, for example, two thirds of Wells Fargo’s foreclosures were in Baltimore City census tracts that are more than 60% African-American, while only 15.6% were in tracts that are less than 20% African-American. Wells Fargo’s foreclosure rate for loans in African-American neighborhoods is nearly double the overall city average, while the rate for its loans in white neighborhoods is less than half of the average.}

\footnotesize{149 \textit{Supra} note 143.}

\footnotesize{150 Vikas Bajaj and Ron Nixon, \textit{For Minorities, Signs of Trouble in Foreclosures}, N.Y. TIMES, February 22, 2006 (in the eastern part of Cuyahoga County, which includes Cleveland, which is 52 percent black and 7 percent Hispanic, the ratio of foreclosure auctions to regular sales was 23 per 100 last year, up from 9 in 1995, while in the west, which is 82 percent white, the ratio was 11 per 100, up from 2.5).}

\footnotesize{151 San Diego Reinvestment Task Force, Analysis and Response to Foreclosures in Low-Moderate Income Communities of San Diego at 5 (September 2007), \url{http://www.co.san-diego.ca.us/rtf/docs/response-to-foreclosure.pdf} (there is an ongoing increase in foreclosures of single-family homes with highest concentrations in low-income and ethnic dominant census tracts and predominantly subprime products).}

\footnotesize{152 Adam Rust and Peter Skillern, \textit{Empty Houses and Broken Dreams} 5, The Community Reinvestment Association of North Carolina (February 25, 2008) (approximately 78 percent of all homes in foreclosure in Durham County were resided in by African Americans).}

\footnotesize{153}

\begin{table}[h]
\centering
\begin{tabular}{|l|c|}
\hline
Family characteristic & House value as a percentage of all assets of group \\
& 2007 (percent) \\
\hline
All families & 31.8 \\
Percentile of income & \\
Less than 20 & 47.1 \\
20-39.9 & 51.8 \\
40-59.9 & 48.4 \\
60-79.9 & 45.3 \\
\hline
\end{tabular}
\end{table}
The comparison of this recent foreclosure experience with experience in earlier periods, before the introduction of “innovative” and risky loan products and the increased offering of subprime loans, is revealing. Studies revealed that lower income households are more likely to miss payments and default on their mortgages. However, overall foreclosure was a rare event for low-income borrowers in the early and mid-1990s, with the rate of foreclosures being only slightly higher than for high-income borrowers.  

Recent comparative studies of default and foreclosure rates among borrowers holding innovative mortgage loan products compared with traditional mortgage products have similarly found a low default and foreclosure rate even among low-income borrowers who received traditional mortgage loans. 

<table>
<thead>
<tr>
<th>Income Range</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>80-89.9</td>
<td>44.5</td>
</tr>
<tr>
<td>90-100</td>
<td>19.8</td>
</tr>
</tbody>
</table>


Christopher E. Herbert and Eric S. Belsky, *The Homeownership Experience of Low-Income and Minority Households: A Review and Synthesis of the Literature*, CITYSCAPE 10:2 at 5 (2008). The findings of the most recent report on mortgage foreclosure and low-income borrowers performed before the surge of innovative loan products in recent years can be summarized as follows:

Van Order and Zorn (2002) study the performance of mortgages purchased by Freddie Mac that were originated between 1993 and 1995 and then tracked through 1999. Even after controlling for a variety of loan characteristics, they find that lower income groups consistently have higher default probabilities than higher income groups do. . . The data that Van Order and Zorn present indicate that, even for low-income borrowers, foreclosure is a rare event. Among their cohort of low-income borrowers from the first half of the 1990s, only 0.8 percent of buyers with incomes of less than 80 percent of area median income experienced a foreclosure in the 4 to 6 years following origination. This rate was only slightly higher than the 0.6 percent of high-income borrowers who experienced foreclosure over the same time period.

*Id.* at 15–16.

E.g. Gretchen Morgenson, *Blame the Borrowers? Not So Fast*, N.Y. TIMES, November 25, 2007, section 3 at 31 (comparison of loans made by Neighborhood Housing Services of America (NHSA), in which borrowers’ income averaged less than two-thirds of the national median income, with subprime loans found that as of June 30, 2007, 3.34 percent of NHSA borrowers were at least 30 days delinquent on their loans, a rate only slightly higher than the 2.63 percent delinquency rate on prime loans and far lower than the 14.54 percent delinquency rate on subprime loans nationwide. With regard to foreclosures, NHSA loans that went into foreclosure during the second quarter of 2007 totaled 0.56 percent, compared with an 0.25 percent rate for prime loans and 2.45 percent rate for subprime loans. The NHSA borrowers did not meet conventional credit standards in addition to being of low or moderate income).
The argument that has been made in favor of “innovative” mortgage products is that they increased rates of homeownership and thus provided a net societal benefit. Even if a net increase in homeownership was the outcome, it is a troubling ethical viewpoint to claim that losses suffered by many homeowners due to the high-risk nature of the products they were offered, especially low-income homeowners, are justified because of a net overall gain in levels of homeownership nationwide. This ethical argument is explored in Part Three of this article. However, the evidence has actually revealed that there were no net societal benefits in the form of increased levels of homeownership in the long-term.

The Center for Responsible Lending analyzed the claimed net gain in homeownership resulting from subprime lending during the period 1998 to 2006. It’s conclusion was:

Subprime loans made during 1998-2006 have led or will lead to a net loss of homeownership for almost one million families. In fact, a net homeownership loss occurs in subprime loans made in every one of the past nine years.156

This conclusion was due to the fact that between 1998 and 2006 about 1.4 million first-time home buyers purchased homes using subprime loans but an estimated 2.2 million borrowers who obtained subprime loans will lose or already have lost their home to foreclosure.157 The calculations made by the Center for Responsible

157 Id. 2 and 3. A majority of subprime loans were refinances and not for purchase of a home. Moreover, a significant proportion of subprime purchase mortgages are obtained by existing homeowners buying another home, and not first-time home-buyers, and therefore do not increase homeownership levels. There is evidence in the literature that a substantial number of first-time homeowners return to renter status within
Lending do not take into account the even greater number of foreclosures that occurred after 2006 and are now expected for 2009 and 2010. This will further increase the net loss in homeownership produced by “innovative” loan products.

The Center for Responsible Lending’s data focused on the net effect on homeownership of subprime loans. More generally, The Joint Center for Housing Studies of Harvard University examined the overall rates of homeownership in the United States and found the following:\footnote{Joint Center for Housing Studies of Harvard University, The State of the Nation’s Housing 2008 Table A-5.}

<table>
<thead>
<tr>
<th>Homeownership Rates 1994-2007</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td><strong>All Households</strong></td>
</tr>
<tr>
<td>-------</td>
</tr>
<tr>
<td>64.0</td>
</tr>
<tr>
<td><strong>Race/Ethnicity</strong></td>
</tr>
<tr>
<td><strong>White</strong></td>
</tr>
<tr>
<td>-------</td>
</tr>
<tr>
<td>70.0</td>
</tr>
<tr>
<td><strong>Hispanic</strong></td>
</tr>
<tr>
<td>-------</td>
</tr>
<tr>
<td>41.2</td>
</tr>
<tr>
<td><strong>Black</strong></td>
</tr>
<tr>
<td>-------</td>
</tr>
<tr>
<td>42.5</td>
</tr>
<tr>
<td><strong>Asian/Other</strong></td>
</tr>
<tr>
<td>-------</td>
</tr>
<tr>
<td>50.8</td>
</tr>
<tr>
<td><strong>All Minority</strong></td>
</tr>
<tr>
<td>-------</td>
</tr>
<tr>
<td>43.2</td>
</tr>
</tbody>
</table>

This data reveals that overall homeownership levels have declined to the levels prior to 2003, before most “innovative” loan products became prevalent. This is true without yet accounting for further losses due to foreclosures in 2008 and subsequent 5 years of homeownership. Christopher E. Herbert and Eric S. Belsky, *The Homeownership Experience of Low-Income and Minority Households: A Review and Synthesis of the Literature*, CITY SCAPE 10:2 at 5 and 18-19 (2008) (data from the period 1976 to 2000 reveals roughly one-half of low-income first-time homebuyers exit homeownership within 5 years of purchase, compared with one-fourth to one-third of high-income buyers). However, this would only lead to the conclusion that total gains in homeownership should be about one-half of the initial gains in the long-term. It does not lead to a significant net loss in homeownership, which resulted from recent innovative loan products.
years. More recent analysis which includes losses due to foreclosures in 2008 found the overall homeownership rate had fallen to a level below that of 2002.\footnote{Paul S. Calem, Marsha J. Courchane, and Susan M. Wacher, Sustainable Homeownership at 2 and 5 (March 19, 2009), available at http://ssrn.com/abstract=1365436.}

Moreover, overall levels of homeownership among minority homeowners have similarly declined to the levels prior to 2004, and for black homeowners to levels prior to 2001. Considered in unison with the Center for Responsible Lending’s analysis of the substantial net decline in homeownership produced by subprime loans, which are also more commonly characterized by “innovations” such as ARMs and payment option terms\footnote{Keith S. Ernst and Deborah Goldstein, The Foreclosure Crisis and its Challenge to Community Economic Development, 17 J. AFFORDABLE HOUS. & COMMUNITY DEV. L. 273, 275 (2008) (by 2007 ARMs accounted for 49 percent of outstanding subprime loans compared with 18 percent of outstanding prime loans, and by 2004 more than 40 percent of subprime loans were made with low or no documentation of borrowers’ income, assets or both).}, the reasonable conclusion is that such innovations produced far more harm than good. The Joint Center for Housing Studies came to the same conclusion. It noted:

The expansion of mortgage credit in the 1990s was therefore accomplished with traditional products and without adding much to risk. The growth in mortgage credit after 2003, in contrast, came largely from gains in much riskier subprime, interest-only, and payment-option loans. These novel mortgage products provided only a temporary lift to homeownership. Indeed, the national homeownership rate peaked in 2004 and has since retreated below its 2003 level.

For the rate to fall below its 2000 level, the number of homeowners would have to dip by another million—a real possibility given the rising tide of foreclosures.\footnote{\textit{Supra} note 158 at 4.}
B. Unfair Products and Practices and Equity Stripping

Unfair Mortgage Products

Unfair mortgage products and practices are defined, for purposes of this article, as products and practices that (a) cause a significant loss to consumers, (b) against which consumers are unable to protect themselves. Thus, the unsafe mortgage products and practices of recent years, discussed above, are also unfair products and practices from the consumers’ perspective. The substantial losses arising due to foreclosures have been documented above. The consumers’ inability to protect themselves is documented in Part Three of this article.

In addition to unsafe mortgage loans, there are additional unfair mortgage products and practices of lending institutions that have stripped equity from consumers, particularly low-income and minority consumers. These products and practices have stripped equity from consumers not only in recent years but for more than a decade. This article will focus on three unfair products and practices: (a) charging consumers excessive interest rates, (b) charging consumers excessive fees and prepayment penalties, and (c) forced refinancings and loan flipping. For purposes of this article, interest rates, fees, and prepayment penalties are “excessive” when the amounts are not justified based on credit risk and underwriting costs.

1. Excessive Interest Rates

Substantial Number of Consumers Affected

Evidence of excessive interest rates and fees has been available for many years. The practice at issue is providing subprime loans to borrowers that would qualify for prime loans. Freddie Mac discovered this phenomena in 1996 when it analyzed subprime
loans for the purpose of testing a proposed automated underwriting program. It found that between 10 and 35 percent of borrowers who obtained mortgages in the subprime market could have qualified for a conventional loan.  

This conclusion was confirmed soon thereafter through a poll of the 50 most active subprime lenders, which concluded that up to 50 percent of borrowers receiving subprime mortgages could qualify for investment-grade mortgages (prime mortgages). Fannie Mae came to the same conclusion in its analysis of subprime loans – estimating that as many as 50 percent of borrowers in the subprime market could qualify for prime market loans. 

The introduction of automated underwriting programs could have helped institutions better identify such borrowers and minimize the frequency of excessive interest rates being paid. It did not. More recent analysis of the subprime mortgage market uncovered the same phenomena – indeed, the number of borrowers subjected to this unfair lending practice has arguably increased. In an analysis of more than $2.5 trillion subprime loans made since 2000 the Wall Street Journal reported the continuation of this unfair loan practice. In 2005 its conclusion was that 55 percent of borrowers with

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162 FREDDIE MAC, AUTOMATED UNDERWRITING REPORT, Chapter 5 (September 1996), available at http://www.freddiemac.com/corporate/reports/moseley/chap5.htm (results based on a pilot program to evaluate automated underwriting initiated in October 1995 which evaluated a sample of 15,000 subprime mortgages originated by four financial institutions). A later study by Freddie Mac similarly concluded that more than 1 in 5 borrowers who received subprime loans could have qualified for less expensive prime loans. This study of hundreds of thousands of subprime loans over a two year period took into account factors such as credit history, home value and the borrowers’ ability to pay. Mike Hudson and E. Scott Reckard, The Nation; More Homeowners with Good Credit Getting Stuck with Higher-Rate Loan, L.A. TIMES, October 24, 2005 at A1.  


credit scores that qualify for prime mortgages received subprime mortgages instead. This percentage was 41 percent in 2000, and it rose to 65 percent in 2006.\footnote{Rick Brooks and Ruth Simon, \textit{Subprime Debacle Traps Even Very Credit-Worthy}, WALL ST. J., December 3, 2007 at A1.}

Another mortgage practice has emerged that creates a second group of loans subject to unfair loan pricing – borrowers with weaker credit histories who relied on mortgage brokers. In recent years mortgage brokers have originated more than half of all mortgage loans, prime and subprime.\footnote{Joint HUD/Treasury Task Force on Predatory Lending, Curbing Predatory Home Mortgage Lending 39 notes 43 and 44 (2000) (brokers originate over half of all mortgage loans), available at \url{http://www.huduser.org/publications/pdf/treasrpt.pdf}.} However, brokers cause bona fide subprime borrowers to pay excessive interest rates.

The Center for Responsible Lending analyzed 1.7 million mortgages originated between 2004 and 2006. It then analyzed the interest rates received by the pool of borrowers with weaker credit histories – i.e. borrowers who would indeed qualify for subprime and not prime loans. The comparison was between interest rates received by such borrowers if they obtained their loan through a mortgage broker as opposed to directly from the lender. It found that individuals with higher credit scores who received prime loans paid about the same interest rate regardless of whether their loans were brokered. However, individuals with weaker credit histories who received subprime loans were consistently charged higher interest rates when they received a loan through a mortgage broker. Over the life of the loan the extra payments required were equivalent to an interest rate 1.3 percentage points higher than a similar borrower who received a loan directly from the lender.\footnote{Keith Ernst, Debbie Bocian, and Wei Li, Steered Wrong: Brokers, Borrowers, and Subprime Loans at 14, Center for Responsible Lending (April 8, 2008) (a typical subprime borrower with a $166,000}
Substantial Consumer Losses – Equity Stripping

As early as 1996 Freddie Mac reported that subprime borrowers who would have qualified for prime loans pay mortgage rates on the order of one to two-and-one half percentage points higher in the subprime market.\textsuperscript{168} Thereafter, an additional study by Freddie Mac found that 100 bases points (1 percent) in the interest rates charged on such subprime loans could not be explained by credit risk.\textsuperscript{169}

Based on such evidence of rate risk disparity in subprime lending the Center for Responsible Lending calculated the loss to consumers from excess interest charges. Based on subprime originations in 2000, the cost would be $2.9 billion per year.\textsuperscript{170} This is the cost to subprime borrowers who would have qualified for prime loans. As noted above, subprime borrowers who would not likely qualify for prime loans also pay higher interest rates when they receive their loan through a broker. Thus, a similarly large annual loss in the form of excess interest payments would exist due to rate disparities in subprime brokered loans.

Even more troubling than the unfair practice of charging excessive interest to consumers is evidence that certain vulnerable groups were targeted for risky or unfair loan products. The groups found to be targeted are the elderly, minority borrowers and low-income borrowers. Thus AARP reported that borrowers age 65 or older were three times more likely to hold subprime mortgages than borrowers less than 35 years of age.

\textsuperscript{168} Freddie Mac, \textit{supra} note 162.
\textsuperscript{169} Peter Zorn, \textit{Subprime Lending: An Investigation of Economic Efficiency}, Freddie Mac (December 21, 2000).
\textsuperscript{170} Eric Stein, \textit{Quantifying the Economic Cost of Predatory Lending} at 16-17 (July 25, 2001, revised October 30, 2001). This conservatively assumes 20\% of subprime borrowers would qualify for prime loans.
Based on data from 2002 researchers at the University of Pennsylvania and the Federal Reserve studied lending patterns for minority borrowers and less financially sophisticated borrowers. They found:

“minority status, in particular, percentage of African-American household continues to be strongly associated with subprime lending in 2002, holding other variables constant . . . Finally . . . lack of education, holding other variables constant, is a consistently significant factor in explaining the market share of subprime lending in 2002 . . .”

Similarly, researchers have reported that subprime loans are three times more likely in low-income neighborhoods than in high-income areas, and five times more likely in black neighborhoods than in white neighborhoods. Moreover, the differences are not justified by differences in credit risk. Thus, researchers at Fannie Mae explained:

[T]he rationale for disproportionately high levels of subprime lending to lower income and minority households is that those borrowers represent substantially greater risk than borrowers in the prime mortgage market. Unfortunately, there is little available public data on the credit quality of households that would allow for an examination of the reasonableness of the growth of subprime lending to lower-income minority households. Data that are

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171 Sharon Hermanson, AARP Public Policy Institute, The Subprime Market: Wealth Building or Wealth Stripping for Older Persons (June 2007).
172 Jonathan Hershaff, Susan Wachter and Karl Russo, Subprime Lending: Neighborhood Patterns Over Time, at 16, April, 2005. The study also found:
Hispanic, percent college-educated, and log of median family income have strong effects on subprime growth rates. An increase in the Hispanic population from 10% to 20% is associated with an approximately 70% higher subprime growth rate in a zip code. Subprime lending growth is also lower in highly educated areas. A one standard deviation increase (20-percentage points) in the percentage of individuals with a bachelor’s degree is associated with a nearly 200-percentage point reduction in the growth rate of subprime lending.
Id. at 13-14.
available, however, do not support the recent explosive growth of this segment of the mortgage market.

First, several financial institutions in the past decade have confirmed that lower-income status is not synonymous with higher credit risk. Stated otherwise, lower-income consumers who receive mainstream credit perform roughly the same as middle-and upper-income households receiving similar credit. As a result, the much greater level of subprime lending to lower-income households relative to higher-income households is not immediately justified by available information on credit quality of these two groups. Second, although black households have been shown in studies to have greater credit problems than non-Hispanic white households, the level of subprime lending to black households and communities far exceeds the measured level of credit problems experienced by those households. 174

2. Excessive Fees and Prepayment Penalties

Excessive charges have been imposed on consumers in two forms. First, fees charged at loan origination may be excessive in relation to underwriting costs or returns based on interest rates charged. Second, excessive prepayment penalties may be imposed.

As documented above, a substantial number of borrowers who may qualify for prime mortgages are given subprime mortgages instead by originators. The cost of such subprime loans is not only higher interest rates, documented above, but also higher origination fees. Thus, in 1999, for example, total points and fees for conventional loans

174 Id. at 6-7. See also Debbie Guenenstein Bocian, Keith S. Ernst and Wei Li, Unfair Lending, The Effect of Race and Ethnicity on the Price of Subprime Mortgages, at 3 (May 31, 2006), available at http://www.responsiblelending.org/mortgage-lending//research-analysis/rroll-Unfair-Lending-0506.pdf. (analysis of 2004 HMDA data, supplemented with proprietary subprime loan dataset, found that African-American and Latino borrowers are at greater risk of receiving higher-rate loans than white borrowers, even after controlling for legitimate risk factors. The disparities are large and statistically significant).
were, on average, 1.1%. However, points and fees on subprime loans were considerably higher, and in some cases were 7% or higher. On average upfront charges known as points were 1% or less of the loan amount on prime mortgage loans in 2005 but were 3% on subprime loans. The Center for Responsible Lending estimated that in 1999 excess up-front fees of 2 percent paid by subprime borrowers would total $800 million per year and affect 600,000 borrowers. This figure is based on subprime mortgage loan volume in 1999. As such volume increased in later years the total excess cost imposed on consumers also increased.

Excessive prepayment penalties are another source of excessive fees imposed on borrowers. Prepayment penalties were imposed on less than 2 percent of prime mortgages but up to 50 percent of subprime mortgages in the period 2001 and 2002. The frequency with which prepayment penalties were imposed increased in later years and were still disproportionately imposed in subprime loans. In the period 2003 to mid-

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175 Eric Stein, Quantifying the Economic Cost of Predatory Lending at 7 footnote 17, Center for Responsible Lending (October 30, 2001) (reporting data collected by Freddie Mac).
176 Id. at 14-15 (a review of mortgage loans made by Household Finance reveals a standard charge on first mortgages of 7.25%).
178 Stein, supra note 175 at 15. This figure is based on 25% of subprime loans made in 1999 and unnecessary upfront fees of 2%.
179 Goldstein and Son, infra note 185 at 2 (based on data reported by Standard and Poor in 2001 and 2002 and by Freddie Mac). See also Wei Li and Keith S. Ernst, Do State Predatory Lending Laws Work? A Panel Analysis of Market Reforms, 18:2 HOUS. POLICY DEBATE 347, 361 (2007). Based on analysis of the Loan Performance Subprime Asset-Backed Securities Database for 7 million subprime loans originated between January 1998 and March 2005 the authors found the following percentage of such loans contained prepayment penalties:

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<th>Year</th>
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<td>54.37</td>
<td>66.08</td>
<td>68.63</td>
<td>68.41</td>
<td>71.70</td>
<td>68.74</td>
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2007 just 6 percent of prime loans contained prepayment penalties while close to 75 percent of subprime loans contained prepayment penalties.\textsuperscript{180} Lenders have argued that prepayment penalties are charged in exchange for lower interest rates granted to consumers and therefore justified by such lower rates. However, the Center for Responsible Lending found that in subprime purchase loans borrowers with prepayment penalties actually paid higher interest rates than similarly situated borrowers without prepayment penalties.\textsuperscript{181} In subprime refinance loans imposition of prepayment penalties produced no statistically significant difference in interest rates.\textsuperscript{182} A later study conducted by Barr, Dokko and Keys similarly found that interest rates on mortgages with prepayment penalties are higher than those without.\textsuperscript{183} Thus, such prepayment penalties were not justified in economic terms as an exchange for lower interest rates.

The Center for Responsible Lending then calculated the costs to consumers. Two calculations were made. One calculation was a quantification of the higher interest rate charged in loan originations to borrowers who also were subjected to prepayment penalties. It found the lifetime cost in excess interest would be $881 million and affect 380,000 borrowers in 2003.\textsuperscript{184} A second calculation was the cost of the prepayment penalties.

\begin{footnotesize}
\begin{enumerate}
\item Data calculated by the Federal Reserve Board, Truth-In Lending, 73 Fed. Reg. 44522, 44553 (July 30, 2008).
\item Keith S. Ernst, Borrowers Gain No Interest Rate Benefits from Prepayment Penalties on Subprime Mortgages at 1, Center for Responsible Lending (January 2005).
\item Id.
\item Michael S. Barr, Jane K. Dokko and Benjamin J. Keys, Who Gets Lost in the Subprime Mortgage Fallout? Homeowners in Low-and Moderate Income Neighborhoods at 11, April 2008, \texttt{http://ssrn.com/abstract = 1121215}. The authors found a median APR of 7 percent for loans with prepayment penalties vs. 6.5 percent for loans without prepayment penalties. Various additional studies concerning the rate reduction, if any, generated by imposition of prepayment penalties are discussed by the Federal Reserve Board in Truth in Lending, 73 Fed. Reg. 44522, 44554 (2008).
\item Keith S. Ernst, \textit{supra} note 181 at 5.
\end{enumerate}
\end{footnotesize}
penalty itself, which amounted to a loss of $2.3 billion each year and affected approximately 850,000 families.185

One final troubling finding associated with prepayment penalties is that they increase the likelihood of foreclosure. After controlling for other factors researchers found that loans with prepayment penalties are 20 percent more likely to experience foreclosure than other loans.186 This is because prepayments may preclude the ability to cure a default through refinancing. Thus borrowers who may have qualified for prime loans but were given subprime loans bear the costs of higher interest rates, higher fees, and prepayment penalties, as well as a higher risk of foreclosure due to such excessive charges.

Similar to the situation facing borrowers who are charged excessive interest on their loans, researchers have also confirmed that certain groups seem to be targeted for excessive fees and prepayment penalties, or at least are disproportionately impacted by such practices. Thus, research has confirmed the correlation between minority status and unfair credit terms. Based on data from 2006, researchers at the University of Michigan and the Federal Reserve concluded:

. . . even within similar low-income neighborhoods, black homeowners are significantly more likely to have prepayment penalties or balloon payments attached to their mortgages than non-black homeowners, even

185 Debbie Goldstein and Stacy Strohauer Son, Why Prepayment Penalties are Abusive in Subprime Home Loans at 3, Center for Responsible Lending Policy Brief (April 2, 2003). These figures are based on the number of subprime loans made in 1999 and the incidence of prepayment penalties.
after controlling for age, income, gender and credit worthiness.\textsuperscript{187} The researchers also found that borrowers who are black pay more than twice the amount in fees or points than white borrowers.\textsuperscript{188} This is not a new issue. In 2000 the Joint HUD-Treasury Task Force on Predatory Lending, warned: “In some low-income and minority communities, especially where competition is limited, predatory lenders may make loans with interest rates and fees significantly higher than the prevailing market rates, unrelated to the credit risk posed by the borrower.”\textsuperscript{189}

Recent Federal Reserve Board regulations will forbid prepayment penalties for future subprime and Alt-A mortgage loans.\textsuperscript{190} However, for purposes of this article it is troubling from an ethical perspective that the law tolerated this abusive practice for more than a decade. The recent Federal Reserve Board regulations do not, however, address the issue of excessive interest rates and fees imposed on borrowers.

3. Refinancings and Loan Flipping

Equity stripping arises in two situations in connection with refinancings of mortgage loans: (a) refinancing forced upon borrowers due to ARMs or the recast of payment option loans, and (b) refinancings in the form of loan flipping.

Refinancing required by “innovative” mortgage products, such as ARMs and payment option loans, take a toll on homeowner equity. Each refinancing strips equity from the homeowner due to the fees and costs incurred. These include points paid on the


\textsuperscript{188} Id. at 9-10.

\textsuperscript{189} Joint HUD-Treasury Task Force on Predatory Lending, Curbing Predatory Home Mortgage Lending at 72 (June 2000), available at \url{www.huduser.org/publications/pdf/treasrpt.pdf}.

\textsuperscript{190} See discussion \textit{supra} note 85 and accompanying text.
new loan, fees charged by the lender to complete each refinancing such as appraisal fees and lender attorney’s fees, fees charged by third-parties necessitated by the refinancing such as title insurance searches and fees in connection with the mortgage title insurance policy, and in some states mortgage recording taxes.

At times lenders may offer refinancing of loans with “no closing costs.” However, at Countrywide, for example, consumers that received refinancings with “no closing costs” were charged higher interest rates, thus similarly stripping additional equity from the consumer.

Loan flipping is another form of refinancing and is abusive when the refinancing is not in the borrowers’ interest and arises in several distinct situations. A review of thousands of subprime loan documents by the Center for Responsible Lending led to the conclusion that approximately 15 percent of all subprime refinances do not benefit the borrower in economic terms. The most onerous example is when a borrower is convinced to substitute a high-priced mortgage loan for a low-priced mortgage loan that might be guaranteed or subsidized by federal or state government. For example researchers in North Carolina found that lenders convinced one in ten Habitat for Humanity borrowers to refinance their zero percent first mortgages into high interest subprime loans.

The Center for Responsible Lending estimated the costs to borrowers in the form of closing costs and fees imposed in refinancings that were not in the borrowers’ best

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191 The People of the State of Illinois v. Countrywide Financial Corporation et al., 08CH22994, Complaint for Injunctive and other Relief at 61.
interest in that they did not benefit the borrower in economic terms. This amounted to $960 million per year in excess fees paid by 150,000 borrowers.\footnote{Eric Stein, Quantifying the Economic Cost of Predatory Lending at 15, Center for Responsible Lending (June 25, 2001, revised October 30, 2001).} These calculations were based on subprime refinancings in 1999. Since then they have increased substantially, resulting in an even greater cost to consumers. Of course, this calculation does not measure the additional costs of higher interest rates that may be generated by such refinancings.

C. The Failure of Market Discipline

In the period following the lifting of statutory requirements on real estate lending practices, the industry was largely faced with a regulatory scheme relying on market forces to avoid unsafe and unfair lending practices. This deregulated market relied on the mortgage originator’s self-interest to lead it to underwrite only safe loans. It relied on consumers, exercising their judgment and motivated by self-interest, to avoid both unsafe and unfair loans. Was the reliance on market discipline justified?

1. The Industry’s Market Evaluation

Whether market discipline resulting from self-interest leads mortgage lenders to avoid originating of unsafe and unfair loans depends on the originator’s evaluation of the benefits and risks of unsafe and unfair mortgage practices.

*Industry Benefits From Unfair and Unsafe Mortgage Products*

Unfair mortgage practices in the form of excessive interest charges, fees and prepayment penalties, as well as unfair refinancings and loan flipping, are rather easily evaluated. All of these practices generate significant profits for the originators. For
example, Countrywide discouraged its sales force from offering fixed rate FHA loans to borrowers, which may be well-suited for low-income or first-time homeowners. One Countrywide salesman noted that a recent applicant for a $275,000 loan could have been offered an FHA loan with a 7 percent fixed interest rate and 0.125 percentage points. Instead the borrower was granted a subprime loan with an interest rate of 9.875 percent and three additional points. The monthly payment would have been $1,829 on the FHA loan, while Countrywide’s subprime loan led to a monthly payment of $2,387 - a difference of $558 a month or $6,698 per year. This additional monthly payment is a burden placed on a low-income homeowner but is additional profit generated for the originator or investor, who also received the additional $7,906 profit generated by the higher points charged at origination. In addition to extra profits from higher interest rates and fees, prepayment penalties generated $268 million in revenue for Countrywide in 2006 and $212 million in 2005. If the loans were sold, investors paid more for loans with higher interest rates and prepayment penalties. Thus the profits from excessive interest rates, fees and prepayment penalties accrue to the originator either as holder of the loans or as recipient of funds from secondary market investors upon sale of the loans as part of a mortgage pool. Unfair refinancings and loan flipping by definition multiply the incidence of imposition of excessive charges and prepayment penalties, to the benefit of the originator.

196 Id.
197 See e.g. The People of the State of Illinois v. Countrywide Financial Corporation et al., 08CH 022994, Complaint for Injunctive and Other Relief at 38 (investors would pay more for loans with prepayment penalties, and brokers were paid more for loans with prepayment penalties).
Additional comment is necessary on the practice of relying on mortgage brokers to generate loan volume. Brokers received higher compensation for loans generated with higher interest rates and prepayment penalties, as well as payment-option ARMS. For example, according to the March 2007 “rate sheet” distributed by New Century Financial, brokers could earn a yield spread premium of 2 percent of the loan amount if a borrower’s interest rate was an extra 1.25 percentage points higher than the lender’s listed rates. This practice compensated brokers for convincing borrowers to accept a loan at an interest rate higher than that for which they would qualify at most lending institutions. In fact, industry-wide mortgage brokers collected an average 1.88% of the loan amount for originating a subprime loan, which carried higher interest rates, compared with 1.48% for originating a conforming loan.

Brokers also received higher compensation by imposing prepayment penalties. At Countrywide, for example, brokers would receive an extra 1 percent of a loan’s value by adding a three-year prepayment penalty to the mortgage loan. All of these compensation formulas were the result of the higher profits that the unfair loan products in question would generate for the loan originators and/or investors.

This analysis of compensation incentives has focused on unfair mortgage products, namely loans that unfairly burdened borrowers with excessive interest, fees and prepayment penalties, as well as refinancings and loan flipping. Turning to unsafe mortgage practices, the mortgage market evolved to create significant benefits for originators of unsafe mortgage practices that overshadowed possible risks. As a result,

199 Id.
originating unsafe mortgage loans was deemed to be a reasonable business practice based on industry cost-benefit evaluations. This is the same conclusion reached in my earlier research into the business practices of the securities industry.\textsuperscript{201}

The innovative mortgage products discussed above that led to substantial numbers of foreclosures in recent years were: (a) adjustable rate mortgages, especially those in which the borrower’s ability to repay was based on the initial interest rate, (b) payment option loans and similar loans that led to negative amortization and a later recast of payments (c) reduced documentation loans, and (d) piggyback loans. The business practices that emerged in recent years caused these loans to be very profitable for originators.

For example, the compensation scheme system for brokers acting on behalf of Countrywide was based on a yield spread premium. The amount of the yield spread premium was greatest for brokers using payment option ARMs. Why? The low initial interest rate on ARMs hid from borrowers’ scrutiny the actual interest rate to be charged after reset, including the amount of the margin to be added to the index for calculating the adjusted interest rate. In addition, the minimum payment option hid the eventual true monthly payment required of the borrower. Thus the broker would maximize compensation not only by convincing the borrower to accept a payment option ARM but also to accept one with (a) a slightly higher initial teaser rate, (b) the maximum margin permitted by Countrywide’s product offerings, and (c) a prepayment penalty.\textsuperscript{202} Nationwide broker commissions were, on average, up to 2.5% for payment

\textsuperscript{202} The People of the State of Illinois, \textit{supra} note 197 at 45-47.
option ARMS compared with 1.88% for subprime loans, and 1.48% for standard fixed rate mortgages.\textsuperscript{203}

Payment option ARMs were profitable for originators and holders of such mortgage loans, which is the reason for the higher compensation structure for brokers initiating such loans. It is estimated that as much as $389 billion in payment option ARMs were originated in 2004 and 2005, and some $182 billion were sold to investors through mortgage backed securities in each of these years.\textsuperscript{204} Investors paid higher prices for such loans that would reset at high interest rates and often contained prepayment penalties. Moreover, the payment option ARMs that remained in the lenders’ portfolios generated substantial phantom profits. This is because under generally accepted accounting principles banks can count as revenue the highest amount of an option ARM payment – i.e. the fully amortized amount – even when the borrowers make a minimum payment.\textsuperscript{205} Thus, the banks claimed future revenue immediately, inflating their earnings per share.

At First Fed Financial such phantom profits made up 67% of second-quarter pretax profit in 2006, and at Golden West Financial it made up 59.6% of the bank’s earnings in the first half of 2006.\textsuperscript{206} At Countrywide such income totaled $654 million in 2006, and $1.2 billion in 2007.\textsuperscript{207}

As a result, originators promoted payment option loans. For example, investigation of Wachovia’s loan practices uncovered that for mortgage consultants

\begin{footnotes}
\item[204] \textit{Nightmare Mortgages}, BUS. Wk., September 11, 2006.
\item[205] \textit{Id}. This is based on so-called accrual accounting.
\item[206] \textit{Id}.
\item[207] The People of the State of Illinois, \textit{supra} note 197 at 44.
\end{footnotes}
working in Wachovia’s branches, sales commissions on payment option loans were double the rates for conventional loans, and, at least in some offices, such employees were required, as late as July 2007, to make sure nearly half of the loans they originated were payment option loans.\textsuperscript{208}

Overall, the many higher sources of compensation for originators of subprime mortgage loans, including higher prices paid by investors for the higher interest rates on such loans as well as ARMs that would reset at higher levels and mortgages with prepayment penalties, generated higher profit margins. At Countrywide, for example, profit margins were 3.64 percent on subprime mortgages compared with 0.93 percent on prime mortgages in 2004, 2 percent on subprime mortgages compared with 0.82 percent on prime mortgages in 2005, and 1.84 percent on subprime mortgages compared with 1.07 percent on prime mortgages in 2006.\textsuperscript{209}

In addition to higher profits generated by ARMs and by payment option loans, as well as subprime loans generally, the piggyback loan structure was also profitable for originators and investors because a higher interest rate was applied to loans in the second lien position. This resulted in a higher income stream for holders of such loans or investors.\textsuperscript{210}

Finally, the no documentation or low documentation loan was also favored by originators as a source of profit. At first this seems counterintuitive because of the obvious, potential hidden risk of default. However, the demand for loans to be sold to the secondary market was very strong in the middle years of this decade. Investors in

\textsuperscript{208} John W. Schoen, ‘\textit{Pay option’ loans could swell foreclosures} (December 10, 2008), http://www.msnbc.msn.com/id/28035238.

\textsuperscript{209} Gretchen Morgenson, \textit{Inside the Countrywide Lending Spree}, N.Y. TIMES, August 26, 2008, at 31.

\textsuperscript{210} The People of the State of Illinois, \textit{supra} note 197 at 53 (discussing piggyback loans at Countrywide).
mortgage-backed securities did not refuse to accept low documentation or no documentation loans, perhaps based on the belief that diversification of loans in the portfolio reduced risk as did the borrowers’ option to refinance in the event of difficulty. Low documentation or no documentation in that context became profitable for originators because (a) borrowers were charged higher fees for such loans in the origination process, and (b) such loans could be approved more quickly thereby generating greater loan volume.\textsuperscript{211}

\textit{Industry Risks from Unfair and Unsafe Mortgage Products}

Theoretically, the market discipline that was relied upon to constrain unfair and unsafe practices would be the risk of loss suffered by the industry from such practices, and the ethical duty to comply with legal directives. Too often predictions regarding the effects of market discipline are based on theoretical decisions that will be reached by rational decision makers evaluating risks and benefits in a static environment. I have never embraced such an evaluative approach. Theories from non-linear dynamics, sometimes referred to as complexity or chaos theory, are more useful in evaluating outcomes.

Non-linear dynamics views one change – i.e. deregulation of the mortgage market – as one factor that is introduced into a business environment to interact with all other factors that influence business decisions in that environment, which themselves change over time. As a result, in the long-term outcomes are unpredictable.\textsuperscript{212} We must examine actual outcomes to ascertain how the one initial change interacts with all

\textsuperscript{211} The People of the State of Illinois, supra note 197 at 28 (at Countrywide, in addition to higher fees, it took as little as 30 minutes to underwrite some reduced documentation loans, and some loans closed the same day the application was taken from the borrower).

other influences in the business environment to produce an outcome. As documented above the actual outcome in the U.S. mortgage market was the increased offerings of both unfair and unsafe mortgage products in recent years. Why did the industry conclude that the benefits of unsafe and unfair mortgage products outweighed their risks?

Risk of loss in the form of legal sanctions is one type of loss that may influence corporate behavior. With respect to unfair mortgage practices—namely, excessive interest rates, fees and prepayment penalties, as well as unfair refinancings and loan flipping—there was no specific federal prohibition against such practices. The only federal prohibition is the general duty to avoid “unfair” practices contained in the FTC Act.213 None of the unfair practices enumerated in this article were specifically defined as unfair mortgage practices in any regulations issued under the FTC Act and therefore prohibited for all originators.214 Agencies can bring individual enforcement actions against particular practices of individual banks. However, they did not do so with respect to the four types of unfair mortgage practices that are the subject of this article.215 The actions that have been brought were based on misrepresentations of the terms of loans of (deceptive practices) or for HOEPA violations.216 This was the conclusion of the General Accounting Office’s review of the enforcement activities of


214 See discussion supra, notes 29-40, 46 and 52-63 and accompanying text.


216 Id., and discussion of actions taken by the FTC, Id. at 37-38 and Appendix I.
the federal agencies with regard to predatory lending practices as of January 2004—a
time as of which unfair mortgage practices had existed for some time and unsafe
mortgage practices were about to be offered with greater and greater frequency.
Subsequent analysis of enforcement actions on the part of federal bank regulators
uncovered additional actions in 2005 and 2006 but relatively few actions.217 This
conclusion is also true with respect to the FTC218, which has jurisdiction to bring
actions against independent mortgage companies and mortgage affiliates of banks and
thrifts.

With respect to unsafe mortgage practices, the federal prohibition for banks and
thrifts is the general federal prohibition against “unsafe and unsound” banking
practices219, as well as the guidances on subprime and nontraditional loan products.220
Enforcement actions have, however, rarely been brought for originating or purchasing
loans without regard to ability to repay. In addition, if such actions were to be taken
typically the only sanction would be an agreement or order against an individual bank
to stop such practices.221

217 Greg IP and Damian Paletta, *Lending Oversight: Regulators Scrutinized in Mortgage Meltdown –
(in the past two years the FDIC has issued four cease and desist orders against subprime lenders, the Fed
has issued one and the OTS has issued none. The OCC has sanctioned one subprime lender in that time).
218 “Civil Rights Issues Emerging from the Mortgage Crisis,” Statement of the Federal Trade Commission
before the United States Commission on Civil Rights, at 3-6 (March 20, 2009) (FTC has brought 26
actions, 8 since January 2004, alleging deceptive or unfair practices against companies in the mortgage
lending industry, but the actions largely involve deceptive or illegal marketing). The FTC enforces the
FTC Act against non-bank financial companies, mortgage brokers, and subsidiaries of bank holding
companies. The bank regulatory agencies enforce the FTC Act against banks, thrifts, federal credit unions
and their subsidiaries. However, the Federal Reserve and Office of Thrift Supervision also have
jurisdiction over bank holding company subsidiaries with respect to “safety and soundness” issues.
219 *Supra* note 9.
220 *Supra* notes 29-40, 46, and 52-63.
221 Todd Davenport, *OCC’s New Predator Rule; Are Violations a Safety-and-Soundness Issue?*, WALL ST.
J, February 3, 2005, at 1 (OCC defines anti-predatory lending standards as a safety and soundness issue,
and enforces violations through a deficiency letter or in an examination report first, followed by a safety-
and-soundness order, the equivalent of a cease and desist order, and lastly, for failure to comply, possible
As to mortgage originators not affiliated with a bank or thrift, even these
general federal legal constraints and limited potential sanctions were unavailable.
Thus, only state laws may impose constraints or sanctions for making unsafe loans, and
also, possibly unfair loans. Examination of the limited coverage and limited
enforcement actions taken by state authorities is beyond the scope of this article,
although others have addressed these topics.\(^{222}\) Thus, originators viewed the risk of
such enforcement action on the part of state regulators as either nonexistent or small.

Setting aside legal sanctions, we are left with actual or expected market losses
serving to discipline mortgage practices that may lead to default and foreclosure. This
is because in the event of foreclosure the lender or holder of the loan is likely to suffer a
substantial loss.\(^{223}\) However, originators and investors convinced themselves that long-
term default was unlikely. As a result the U. S. General Accounting Office concluded

\(^{222}\) E.g. Greg Ip and Damian Paletta, *supra* note 217 (many state regulators lack the resources and mandates
of their federal counterparts. For example, the California Department of Corporations has 25 examiners to
oversee more than 4,800 state licensed lenders, including many of the country’s largest subprime
companies).

(foreclosure costs a lender as much as 40% or 50% of the unpaid balance).
in its discussion of that the overall market risk evaluation made by investors was as follows:

Loans with predatory features may carry very high interest rates and have barriers to prepayment, which may more than compensate for the increased credit risks associated with subprime loans.\textsuperscript{224}

That conclusion is consistent with my earlier research into the actions of the securities industry and the skewed risk perception of individuals, including corporate actors.\textsuperscript{225} Namely, there is an inverse relationship in individuals’ perceptions of risks versus benefits. When a high benefit is perceived (i.e. high profits produced by a course of action), then any risk posed by the activity is viewed as a low risk. In fact, legal sanctions were in fact a low risk. Market losses were potentially a greater risk, but were perceived to be a low risk – a perception brought about by the rising value of real estate prices in recent years\textsuperscript{226}, refinancing of potentially unsafe loans, allowed due to rising real estate values, which avoided many losses in the short-term\textsuperscript{227}, the alleged diversification of risk produced by bundling loans into mortgage backed securities\textsuperscript{228},

\begin{flushright}
\textsuperscript{224}GAO-04-280, \textit{supra} note 215, at 76. \\
\textsuperscript{226}Jack Guttentag \textit{Shortsighted About the Subprime Disaster}, \textit{WASH. POST}, May 26, 2007 at F2 (housing prices had been rising for a long period of time and it was assumed that they would continue to rise). \\
\textsuperscript{227}Testimony of Sheila C. Bair, Chair, Federal Deposit Insurance Corporation, before the House Financial Services Committee, December 6, 2007, reprinted in 2007 FDIC QUARTERLY 1:3 at 23,25 (despite the steep “payment shock” built into two-and three-year adjustable rate subprime hybrid loans, they performed reasonably well until last year because rapid rates of home price appreciation in many areas of the country allowed even highly leveraged borrowers to refinance or sell their home when the loan reset, masking the underlying weakness of the structure and underwriting of these loan products). \\
\textsuperscript{228}See Emilio Augoulias, \textit{What Future for Disclosure as a Regulatory Technique? Lessons from the Global Financial Crisis and Beyond} at 17-18 (March 26, 2009), available at \url{http://ssrn.com/abstract=1369004} (rational actors’ cognitive limitations and focus on short-term profit forced sophisticated investors to ignore warning signals and place an incredible amount of trust on the ratings of credit rating agencies); Schwarcz, \textit{Id.} at 381-383.
\end{flushright}
the favorable credit ratings granted to such securities by credit agencies\textsuperscript{229}, and, perhaps most importantly, the skewed perception of the likelihood of risk of loss due to the substantial profits that were being generated by both unsafe and unfair mortgage practices.

Skewed risk perception in the banking industry was not evidenced only in the recent residential mortgage boom and bust. It also occurred in the 1980’s and was one factor that led to the savings and loan crisis of the 1980’s. Failure of market discipline due to skewed risk perception led to risky loan practices in the 1980’s that were very similar to recent risky loan practices. The difference is that in the 1980’s such practices occurred with respect to mortgage loans secured by commercial real estate.

The actions documented in the 1980’s on the part of the banking industry include the following:

(a) savings and loan associations in need of immediate profits had an incentive for risk taking with respect to construction loans because they could charge high upfront loan fees, which they often paid themselves by adding the fees to the loan principal, and earn a high interest rate on the construction loan, which they also often paid themselves in the form of interest reserves funded by adding the sums to principal\textsuperscript{230};

\begin{itemize}
  \item MARTIN LOWY, HIGH ROLLERS: INSIDE THE SAVINGS AND LOAN DEBACLE at 73 (1991) [Lowey]. This is similar to immediate income generated by high fees on subprime loans and phantom income generated by payment option loans. In the 1980’s this generated immediate income of approximately $4 billion in 1983 alone. Id. at 83. See also FEDERAL DEPOSIT INSURANCE CORPORATION, HISTORY OF THE EIGHTIES—LESSONS FOR THE FUTURE, the Savings and Loan Crisis and its Relationship to Banking, chapter 4 at 184. www.fdic.gov/hetoucal/history/167-188.pdf (interest rates in construction loans are much higher than on other forms of lending and regulatory accounting practices allowed S&Ls to book loan origination fees as current income, even though these amounts were actually included in the loan to the borrower).
\end{itemize}
(b) loans made at 100 percent of appraised value;\(^{231}\)

(c) incentives created to lend up to 100 percent of loan to value because developers would agree to pay higher upfront loan fees for higher loan to value loans\(^{232}\)

(d) poor underwriting standards including “window dressing” appraisals based on estimates of future value as well as developers’ expectations\(^{233}\);

(e) the terms of construction loans, such as interest reserves funded by the bank itself and added to principal, delayed recognition of bad loans, i.e. loans made for buildings for which there was no market, for a period of two to five years after the banks or savings and loans decided to make the loan\(^{234}\);

(f) establishing no loan loss reserves for commercial real estate loans made at 100 percent of appraised value because auditors relied on historical results of almost no losses at savings and loans on traditional single family mortgage loans\(^{235}\);

(g) real estate developers leveraged their developments as never before, with syndicators putting up any equity a bank might require and therefore developers having no money in a project but retaining rights to 20 to 50 percent of profits.\(^{236}\)

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231 Lowey at 75.
232 Id. at 77.
233 Id. at 83 and 73-75. See also FDIC, supra note 230, at 185 (lending was based on overly optimistic appraisals and S&Ls used lax underwriting standards to lure customers away from commercial banks). Similar practices were uncovered in the recent residential mortgage loan boom. E.g. N.Y. Attorney General Sues First American and its Subsidiary for Conspiring with Washington Mutual to Inflate Real Estate Appraisals, available at [http://www.oag.state.ny.us/media_center/2007/nov/novla_07.html](http://www.oag.state.ny.us/media_center/2007/nov/novla_07.html) (in a scheme detailed in numerous e-mails a subsidiary of First American Corporation caved to pressure from Washington Mutual to use a list of preferred appraisers who provided inflated appraisals on homes).
234 Lowey at 72. This is similar to the delay in recognizing defaults likely to occur in payment option loans and some ARMs.
235 Id. at 83; LAWRENCE J. WHITE, THE S & L DEBACLE at 76 (1991) (defaults in home mortgage loans were rare and in the rising real estate markets of the 1950s, 1960s and 1970s, thrift losses on defaulted mortgages were rarer still). This is similar to reliance of rating agencies for mortgage backed securities on only recent evidence of no loan losses in real estate lending – evidence based on a period of steadily rising real estate values.
With little constraint imposed by fear of sanctions or market losses, we are left with the vague legal standard itself, and the more specific cautionary directions in regulatory guidances, as an ethical standard which should constrain industry action.\textsuperscript{237} Namely, the banking laws prohibit “unsafe and unsound” practices, and the FTC Act prohibits “unfair” practices. However, my earlier research into the ethical conduct of corporate actors found that a vague legal standard was ineffective in inducing compliance. This was especially true when substantial enforcement risks and substantial sanctions for noncompliance were absent.\textsuperscript{238}

2. The Consumers’ Market Behavior

A free-market approach on the part of regulatory agencies relied on consumers to avoid accepting possible offers of unsafe or unfair products. The theory was that self-interest would bring about this outcome. Unfortunately, actual market outcomes have been far different than predicted outcomes, as demonstrated by the prevalence of both unsafe and unfair mortgage practices and products documented in Part Two of this article. Why?

Studies over the past ten years have confirmed that many consumers are unable to protect themselves in the mortgage market that emerged in this period. The Federal

\textsuperscript{236} Lowey at 87. This is similar to residential homeowners receiving piggyback loans, leaving them with little or no equity in the property but the prospect of retaining all “profits” due to future expected appreciation in value.

\textsuperscript{237} \textit{American Law Institute, Principles of Corporate Governance} §2.01 (1994) The ALI Principles require corporations to act within the boundaries set by law and in determining such boundaries corporations should not base their actions on an unduly literal reading of statutes and regulations but give weight to policies and legislative purposes.

\textsuperscript{238} Vincent Di Lorenzo, \textit{Business Ethics: Law as a Determinant of Business Conduct}, 71 J. BUS. ETHICS 275, 288-289 (2007) (a study of the securities, automobile, pharmaceutical and mortgage banking industries). \textit{See also} Lawrence J. White, \textit{supra} note 235 at 115-117 (during the 1980’s the opportunities – capabilities-incentives nexus gave use to expanded risk taking in multiple dimensions. For some thrift managements, this expansion included deliberate violations of laws, and regulations. There is no question that rules violations did occur in many thrifts).
Reserve Board finally recognized this state of affairs as it modified real estate lending regulations in July 2008. The inability of consumers to protect themselves results from the cumulative effect of five characteristics of the mortgage market that emerged. These barriers to self-protection are: (1) little useful information is and can be made available on non-prime loan products to allow to comparison shopping, in other words the market is one that can only provide limited transparency, (2) innovative mortgage products are too complex to be understood and properly evaluated by consumers, (3) these first two factors plus the cost of shopping for alternatives in turn cause limited shopping to be possible on the part of consumers, (4) in addition, persistent negative beliefs concerning credit availability and qualification prevent some consumers from shopping for more favorable terms, and (5) even if consumers received more information on mortgage products they would still be unable to properly evaluate such information in part due to its complexity, as previously noted, but also due to decision-making heuristics, primarily limited focus and optimism bias, that prevent proper evaluations.

The Federal Reserve Board summarized the limited transparency that characterizes the non-prime mortgage market. It noted:

price information for the subprime market is not widely and readily available to consumers. A consumer reading a newspaper, telephoning brokers or lenders, or searching the Internet can easily obtain current prime interest rate quotes for free. In contrast, subprime rates, which can vary significantly based on the individual borrower’s risk profile, are not broadly advertised and are usually obtainable only

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after application and paying a fee. Subprime rate quotes may not even be reliable if the originator engages in a “bait and switch” strategy. Price opacity is exacerbated because the subprime consumer often does not know her own credit score. Even if she knows her score, the prevailing interest rate for someone with that score and other credit risk characteristics is not generally publicly available.

The Department of Housing and Urban Development came to the same conclusion after reviewing various studies on the issue.

Complexity in the terms of innovative loan products are the second reason many consumers are unable to protect themselves against unfair or unsafe products. Most consumers either do not understand or cannot properly evaluate the terms and risks presented. As the Federal Reserve Board concluded:

products in the subprime market tend to be complex, both relative to the prime market and in absolute terms, as well as less standardized than in the prime market. . . .

subprime originations have much more often been ARMs than fixed rate mortgages. ARMs require consumers to make judgments about the future direction of interest rates and translate expected rate changes into changes in their payment amounts. Subprime loans are also far more likely to have prepayment penalties. Because the annual percentage rate (APR) does not reflect the price of the penalty, the consumer must both calculate the size of the penalty from a formula and assess the likelihood of moving or refinancing during

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240 Id. at 44524.
the penalty period. In these and other ways, subprime products tend to be complex for consumers.242

The FTC also focused on complexity as a cause of limited shopping opportunity in 2002, in these terms:

Currently, shopping for a mortgage can be a complicated process. The mortgage and settlement service options for consumers are diverse, and, in response to demand, new alternatives become available relatively often. The mortgage and settlement service field can also involve complex terminology, with which some consumers may not be familiar. Consumers do not purchase or refinance homes with the regularity that they may purchase other products and therefore they may deal with these issues infrequently. In addition, the loan and origination costs in mortgage transactions can involve various types of charges, with the loan price consisting of an interest rate, possibly points, and possibly a number of contingency prices, such as adjustable interest rates and prepayment penalties. Loan originators may charge different types of fees, such as those for underwriting, document preparation, and document review, which also do not have standardized (let alone simple) terminology.243

This conclusion was reconfirmed by the Federal Trade Commission in 2007 in its study of both prime and subprime loans.244

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242 Truth in Lending: Final Rule, supra note 239 at 44524-44525 (footnote omitted). [move current quote 44526]
244 James M. Lacko and Janis K. Pappalardo, Federal Trade Commission, Bureau of Economics Staff Report, Improving Consumer Mortgage Disclosures at 27 and 31 (June 2007), available at http://www.ftc.gov/be/workshops/mortgage/articles/lackopappalardo2007.pdf (although most respondents understood many of the key features of their loans, many were either unaware of, did not understand, or misunderstood some important cost or feature of their loans that had substantial impact on the overall cost of the loans, the future payments, or the ability to refinance. In addition, many of the respondents who said they understood the disclosures reported that had not been able to understand the disclosures on their own, but had relied on originators or closing agents to explain them, which can leave borrowers susceptible to incomplete explanations and, at worst, deceptive lenders).
The U.S. Department of Housing and Urban Development has embraced the view that complexity in non-prime mortgage products prevents consumer self-protection, relying in part on the analysis of Professor Jack Guttentag of The Wharton School. Professor Guttentag explained the reasons for the limited, effective comparison shopping uncovered with respect to non-prime include market nichification and float abuse.245 The former is the specialization of mortgage products and services based on a wide variety of borrower, property, loan and documentation characteristics making it difficult to determine comparative prices for the specific product a particular borrower is to receive. The latter is the practice of understating the interest rate when quoting it to shoppers and then overstating the interest rate on the date it is locked by the consumer, after the consumer has invested considerable time and money and may be planning to close within a few days.

The U.S. General Accountability Office came to the same conclusion in 2004, finding that due to complexity in the terms of non-prime mortgages and borrowers’ lack of financial education and sophistication, greater consumer education and even clear and transparent disclosures would be of limited effectiveness in decreasing the incidence of predatory lending practices.246

Chairman Bernanke of the Federal Reserve Board reached the same conclusion based on testing on the part of the Federal Reserve. He noted:

We have . . . learned from consumer testing . . . that not even the best disclosures are always adequate. According

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245 Professor Guttentag’s findings are summarized in U.S. Department of Housing and Urban Development, supra note 241, at 2-53 to 2-55.
to our testing, some aspects of increasingly complex products simply cannot be adequately understood or evaluated by most consumers, no matter how clear the disclosure. 247

Indeed, lack of knowledge of and familiarity with mortgage loan products is more pronounced among subprime borrowers248 and among low-income borrowers who were therefore unlikely to be able to assess the risks presented by non-traditional loan products.249

Consumer self-protection in an unregulated market requires, at a minimum, comparison shopping. However, limited transparency and complexity prevent comparison shopping in the non-prime mortgage market. An additional important barrier is cost. As the Federal Reserve Board concluded:

In this environment of limited transparency, consumers--particularly those in the subprime market—may reasonably decide not to shop further among originators or among loan options once an originator has told them they will receive a loan, because further shopping can be very costly. Shopping may require additional applications and application fees, and may delay the consumer’s receipt of funds. This delay creates a potentially significant cost for the many subprime borrowers seeking to refinance their obligations to lower their debt payments at least temporarily, to extract equity in the form of cash, or both. In recent years, nearly 90 percent of

subprime ARMs used for refinancings were “cash out.”

While shopping costs are likely clear, the benefits may not be obvious or may appear minimal.250

The fourth and fifth identified barriers to effective consumer self-protection involve borrowers’ beliefs and decision-making strategies. One belief is that lenders are required by law to provide the best possible rate on loans. The Fannie Mae National Housing Survey found that more than 40 percent of borrowers generally, almost two-thirds of African-American borrowers and 75 percent of Spanish speaking Hispanic borrowers did not know that this statement was false.251 This leads to limited comparison shopping or no comparison shopping.

A second belief is borrowers’ pessimism concerning their credit quality. A FreddieMac Consumer Credit Survey found that thirty percent of white borrowers, approximately one-third of Latino borrowers, and approximately fifty percent of African-American borrowers who had good credit believed they had poor credit.252 As a result consumers will accept a subprime mortgage, at a higher interest rate, carrying higher fees and a prepayment penalty, because they believe they would not qualify for a prime mortgage or would not qualify for a non-prime mortgage with a lower interest rate and fee structure.

A third belief preventing consumer self-protection, by furthering undermining comparison shopping, is the belief among low-income borrowers and subprime

250 Truth in Lending, supra note 239, at 44525 (footnotes omitted). See also Patricia A. McCoy Rethinking Disclosures in a World of Risk-Based Pricing, 44 HARV. J. LEGIS. 123, 137 (2007) (fees and interest rates are disclosed after the consumer pays a nonrefundable application fee).
borrowers that there are few alternatives available to them either due to fewer lenders willing to make loans in their communities or due to the lower, actual quality of their credit history. All of these beliefs undermine self-protection by serving as barriers to comparison shopping.

A final barrier to consumer self-protection is the manner in which consumers make decisions in the mortgage market. There has been a great deal of research concerning decision-making heuristics, and Professor Lauren Willis has recently applied this research to decision-making in the mortgage loan process. I will focus on two decision-making heuristics: limited focus and optimism bias.

The issue of limited focus was recognized by the Federal Reserve Board when it noted:

Consumers considering obtaining a typically complex subprime mortgage loan may simplify their decision by focusing on a few attributes of the product or service that seem most important. A consumer may focus on loan attributes that have the most obvious and immediate consequence such as loan amount, down payment, initial monthly payment, initial interest rate, and up-front fees (though up-front fees may be more obscure when added to the loan amount, and “discount points” in particular may be difficult for consumers to understand). These consumers, therefore, may not focus on terms that may seem less immediately important to them such as future increases in payment amounts or interest rates, prepayment penalties, and negative amortization. They are also not likely to focus on underwriting practices such as income verification, and on features such as escrows for future tax and insurance obligations. Consumers who do not fully understand such terms and features, however, are less

253 The evidence is summarized in U.S. Department of Housing and Urban Development, supra note 241, at 2-105.
able to appreciate their risks, which can be significant. For example, the payment may increase sharply and a prepayment penalty may hinder the consumer from refinancing to avoid the payment increase. Thus, consumers may unwittingly accept loans that they will have difficulty repaying.\footnote{Truth in Lending, \textit{supra} note 239, at 44525-44526 (footnotes omitted). Research on the part of the Federal Reserve staff has found, for example, that 40 percent of borrowers with income less than $50,000—corresponding to the bottom half of the income distribution of ARM borrowers— are unaware of their per-period caps on their ARM mortgages, 53 percent are unaware of their lifetime cap, and 40 percent are unaware of the index of their ARM. By contrast, 13 percent of borrowers with income exceeding $150,000 – the top income decile of ARM borrowers – are unaware of their per period caps, while 21 percent are unaware of their lifetime cap, and 8 percent are unaware of the index. Brian Bucks and Karen Pence, Do Homeowners Know Their House Values and Mortgage Terms at 20 and Table 5, Federal Reserve Board, Finance and Economics Discussion Series 2006-3 (January 2006), available at \url{http://www.federalreserve.gov/pubs/feds/2006/200603/200603abs.html}.}

In turn, the Federal Reserve Board recognized that this prevents disclosure from serving as a tool for consumer self-protection. Indeed, additional disclosures may be counterproductive. As the Federal Reserve concluded:

Disclosures describing the multiplicity of features of a complex loan could help some consumers in the subprime market, but may not be sufficient to protect them against unfair loan terms or lending practices. Obtaining widespread consumer understanding of the many potentially significant features of a typical subprime product is a major challenge. If consumers do not have a certain minimum level understanding of the market and products, disclosures for complex and infrequent transactions may not effectively provide that minimum understanding. Moreover, even if all of a loan’s features are disclosed clearly to consumers, they may continue to focus on a few features that appear most significant. Alternatively, disclosing all features may “overload” consumers and make it more difficult for them to discern which features are most important.\footnote{\textit{Id.} at 44526 (footnote omitted). \textit{See also} Lauren E. Willis, \textit{supra} note 254 at 767 (discussing cognitive responses to information overload).}
Finally, optimism bias causes consumers to overestimate the amount by which their income will increase in future years and overestimate the availability and attractiveness of refinancing options. The combination of limited focus and optimism bias will lead consumers to embrace ARM loans with low introductory interest rates and payment option loans with low minimum payment options.

Part Three – Ethical Standards and Moral Hazard – The View of the Congress

Part One of this article revealed that federal regulators embraced a deregulatory agenda in the period after 1982. They relied on market discipline to police unsafe and unfair mortgage practices, and would consider intervening in the mortgage market only when and if the costs of non-intervention outweighed its benefits to society generally, including industry members. The result was a largely unregulated mortgage market. Part two of this article documented the losses suffered by consumers in the form of equity stripping due to unsafe and unfair mortgage products and practices that became prevalent. Part two of this article revealed the reason market discipline did not restrain the industry from offering unfair and unsafe mortgage loans. It also revealed that many consumers were unable to protect themselves against such unsafe and unfair practices. Consumer losses and the failure of market discipline was particularly evident among low-income communities and residents. However, under the decision making model for government intervention adopted by the regulators, they would not intervene upon proof of (a) significant consumer losses, and (b) losses against which consumers could not protect

themselves. Rather, intervention would occur only upon evidence of net societal benefits. This creates a legal environment in which the law permits financial exploitation of vulnerable individuals for the benefit of business interests.

The issue raised is whether U.S. society embraces such an ethical viewpoint. In this portion of the article I examine the relationship between the viewpoint of bank regulatory agencies and that of the Congress. On one level this is an analysis of whether regulators have properly effectuated the intentions of Congress. If not, then on that basis alone the regulatory viewpoint and regulatory actions are subject to criticism. On another level it is also a recognition of the dual meaning of the concept of moral hazard as it was originally formulated. Namely, I embrace the view that the actions and viewpoints of Congress taken and recognized repeatedly over an extended period of time are a reflection of the ethical standards accepted by U.S. society.258 This article examines Congressional actions and viewpoints toward abusive mortgage practices over a period of more than thirty years. The conclusion drawn is that Congress repeatedly prohibited mortgage practices and products that subjected consumers to significant financial injury (loss) when it found that consumers were effectively unable to protect themselves against such injury. This reflected an ethical viewpoint in U.S. society, namely that business entities should not profit by inflicting significant financial injury on vulnerable individuals. A regulatory approach that allows and therefore sanctions such conduct

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258 The relationship between law on the one hand and ethics or morality on the other hand has been the subject of a great deal of debate. There has nonetheless been a recognition of a frequent intersection, what even Austin characterized as a “frequent coincidence” of positive law and morality. See H.L.A. Hart, *Positivism and the Separation of Law and Morals*, 71 Harv. L. Rev. 593, 598-599 (1958). Moreover, this article relies on the common motivation or viewpoint that led to particular statutory enactments over a period of more than three decades, rather than the particulars of the individual statutes (positive law) to discover the ethical perspective accepted by U.S. society.
raises moral hazard concerns – i.e. it is an approach that has encouraged unethical behavior.

**Goals Embraced By Congress**

To assess Congress’ viewpoint on mortgage market deregulation we must also understand the goals Congress wished to accomplish in the mortgage market. Congress has embraced three distinct goals for mortgage market operations in the United States. They are: (a) safety and soundness of insured financial institutions, (b) access to credit by the general public, and (c) equal opportunity for low-income communities and borrowers.

The first goal focuses on the financial condition of the institution. The second goal includes fairness in the terms of credit provided.

The first goal is ensuring the safety and soundness of federally insured financial institutions in the conduct of all of their operations. Competitiveness and efficiency are often also voiced as concerns but they are means to achieve the goal of safety and soundness.

Safety and soundness is undoubtedly an important goal embraced by Congress. It is one criteria repeatedly voiced as a basis for regulatory sanctions, for example.\(^{259}\)

Safety and soundness refers to financial soundness, and not the fairness of the transaction to the consumer. It forbids “…any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk of loss or damage to an institution, its shareholders, or the agencies administering the insurance funds.”\(^{260}\) The legislative history of the relevant

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statute employing the safety and soundness criteria list as an example “disregarding a borrower’s ability to repay” loans made by the institution.\textsuperscript{261}

A second goal of mortgage market operations is access to credit by the general public. Numerous Congressional enactments have sought to ensure access to mortgage credit.\textsuperscript{262} Congress has been concerned with and repeatedly addressed conditions that restrict credit availability. However, it has also sought to ensure that customers are not subjected to abusive practices in the extension of mortgage credit. Fairness becomes an important subsidiary goal. This is a goal to be realized through all mortgage providers and not just federally insured institutions.

A third goal of mortgage market operations for all lending institutions is equal opportunity for low-income residents and communities. Congress has responded to evidence of discriminatory practices aimed particular borrowers, as well as reverse

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\textsuperscript{261} See also Matter of Seidman, 37 F. 3d 911, 928-9 (3rd Cir. 1994) (obligating an institution to a loan that might be illegal is not in accord with generally accepted standards of prudent operations, but imprudence alone in insufficient to constitute an unsafe or unsound practice); Northwest National Bank, Fayetteville, Arkansas v. U.S., 917 F.2d 1111, 1115 (8th Cir. 1990) (finding bank’s loan practices were unsafe and unsound practices, i.e. might result in abnormal risk or loss).


The Senate Report on DIDMCA identifies the purpose of Title V as “easing the severity of the mortgage credit crunches of recent years...” S. Rep. No. 96-368, at 18 (1979). The Congressional statement of findings regarding the Title VIII of the Garn-St. Germain Act, which authorized alternative mortgage transactions for non-federally chartered institutions, were that such action was “essential to the provision of an adequate supply of credit secured by residential property necessary to meet the demand expected during the 1980’s...” 12 U.S.C.§3801 (a)(2). The Congressional findings regarding the Federal Housing Enterprises Act, which sought to ensure the financial soundness of Fannie Mae and Freddie Mac, included a finding that such agencies “...have an affirmative obligation to facilitate the financing of affordable housing for low-and moderate-income families in a manner consistent with their overall public purposes...” 12 U.S.C.§4501.
redlining aimed at both particular borrowers and communities. For example, HOEPA addressed the problem of “reverse redlining” and in doing so was concerned about “targeting of residents of [certain geographic boundaries, often based on income, race or ethnicity] for credit on unfair terms.”\textsuperscript{263} Earlier the Equal Credit Opportunity Act and the Community Reinvestment Act had embraced the goal of equal opportunity.

\textit{Congressional Viewpoints: Free Markets and Net Societal Benefits?}

A distinct question is whether Congress has embraced not only the goal of access to credit, on equal and fair terms, but also embraced a free market approach as the means to achieve that goal. The evidence does not support such a conclusion.

Congress did embrace a free market approach in one limited sense. In 1980 it preempted state usury limits on first-lien residential mortgage loans.\textsuperscript{264} This was done to address the “…adverse effects of usury ceilings on credit availability….” and ensure the stability and continued viability of the financial system.\textsuperscript{265} However, Congress did not embrace a free market approach in other legislative enactments as the sole or primary means to achieve consumer protections, i.e. fairness and equal opportunity, in the mortgage loan market. Even the legislative history of the 1980 DIDMCA cautioned that “[i]t is not the intent of section 302 to repeal existing consumer safeguards that the Federal Home Loan Bank Board has adopted with respect to real estate loans, or prevent the Board from enacting consumer safeguards in the future.”\textsuperscript{266}

\textsuperscript{264} DIDMCA, Title V, codified at 12 U.S.C.§1735f-7.
\textsuperscript{266} Id. at 18. The Senate report specifically noted that only state limits that are included in the annual percentage rate are preempted and not other limits such as “….limitations on prepayment charges, attorney fees, late charges or similar limitations designed to protect borrowers.” Id. at 19.
A second legislative enactment frequently used as an example of Congressional embrace of a free market approach is the 1982 Garn-St. Germain Act. This is a misunderstanding of the Act. The Act lifted statutory requirements for real estate loans on the part of insured institutions, such as required loan-to-value ratios. However, there is a distinction between lifting statutory requirements for mortgage loans and embracing a free market approach, i.e. relying only, or primarily, on a market forces to protect consumers against unfair practices and protect the financial system against unsound practices.

Titles 3 and 4 of the Garn-St. Germain Act lifted the rigid statutory requirements for mortgage loans originated by federally chartered banks and thrifts, such as stipulated maximum loan to value ratios.\textsuperscript{267} It substituted a general authorization to make real estate loans, and this authorization was subject to the “restrictions and requirements” the federal regulators may prescribe by regulation or order.\textsuperscript{268} The change was made to permit banks greater flexibility in order to meet the needs of first-time homebuyers and effectively compete with less regulated competitors.\textsuperscript{269} Congress did not require a free market approach as a substitute. This was recognized by the federal regulators in 1983 when they issued new regulations pursuant to the Garn-St. Germain Act, as discussed in

\textsuperscript{267} For example, prior to its amendment in 1982 12 U.S.C.\$371, governing the real estate lending powers of national banks, required a maximum loan to value ratio of 90 percent when the collateral was improved real estate, and required any loan secured by a one to four family residence with a loan to value ratio in excess of 75 percent to contain installment payments sufficient to amortize the entire principle of the loan within a period of not more than thirty years.

\textsuperscript{268} 12 U.S.C.\$371 (a) (Comptroller of the Currency); 12 U.S.C.\$1464 (c) (previously Federal Home Loan Bank Board, and later Office of Thrift Supervision).

\textsuperscript{269} S. Rep. No. 97-536, at 25-26 (1982). \textit{See also Id. at} 13-15 (additional asset flexibility and earnings opportunities are provided to thrift institutions in order to compete effectively in a marketplace characterized by payment of market interest rates), and S. Conf. Rep. No. 97-641, at 88 (1982) (liberalized provisions in the bill are intended to strengthen the thrift industry so that it may maintain its place as the nation’s primary home lender).
Part One of this article. It was the federal and state regulators that used this amendment to embrace a free market approach.

Title 8 of the Garn-St. Germain Act, otherwise known as the Alternative Mortgage Transactions Parity Act of 1982, allowed nonfederally chartered housing creditors to offer alternative mortgage transactions to the extent such transactions were authorized by federal regulators and subject to the federal regulations governing such instruments. Congress concluded that alternative mortgage transactions were “…essential to the provision of an adequate supply of credit secured by residential property necessary to meet the demand expected during the 1980’s…” However, it never required that a free market approach would be used to determine the terms of such transactions.

This conclusion was confirmed when Congress revisited its decision to lift statutory mortgage lending rules. This was done in 1991. The Federal Deposit Insurance Corporation Improvement Act of 1991 responded to losses suffered by insured institutions due to risky practices, including risky real estate lending practices. Congress was concerned that banks responded to their eroding market position by putting more funds into higher risk real estate deals, highly leveraged transactions and loans to less developed countries. These investments carried higher yields but caused many institutions to lose money. Congress responded by cautioning banks that deposits must be invested wisely and to accomplish this result stated that banks must be “closely

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supervised”. In addition, in the statute Congress provided that: “[t]he appropriate Federal banking agencies are required to jointly adopt uniform regulations prescribing standards for real estate lending by insured depository institutions.” Thus, an approach characterized by government constraints in the form of regulatory standards was embraced by Congress.

When formulating new standards for real estate lending the regulators were also directed that they were to consider three factors: “the risks presented to the insurance funds, the safety and soundness of the institution, and the availability of credit.” As in earlier statutory directions concerning safety and soundness requirements, the decision to intervene and type of intervention chosen was not based on a net societal benefits standard. Indeed, such a standard has never been mentioned by the Congress in its consideration of safety and soundness issues.

Access to mortgage credit is an important goal embraced by Congress and it motivated the actions of the Congress in 1980 and 1982. It is often overlooked that Congress also embraced a subsidiary goal. In numerous enactments over the last three decades Congress has embraced the view that when providing access to credit lending institutions must avoid abusive practices, including unfair practices. This is a restraint imposed for all institutions providing mortgage credit and not just for federally chartered or insured institutions. Moreover, in achieving this goal Congress has endorsed government intervention when necessary, including outright prohibitions against

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274 Id. at 95.
275 Id. at 136. This requirement was manifest in section 304 of the Act, Pub. L. No. 102-242, §304, codified in 12 U.S.C. §1828 (o) (emphasis added).
particular abusive practices. It has not endorsed a net societal benefits standard as the
determinant of its decision to intervene in the mortgage market.

It is often assumed that the Real Estate Settlement Procedures Act of 1974
(RESPA) is the primary federal response to possible deceptive and abusive practices in
the field of mortgage lending and that its response was only disclosure. This leads to the
mistaken conclusion that Congress was embracing a free market approach, namely full
disclosure as a means to ensure that consumers protect themselves. This is only half the
story. RESPA is not the only federal enactment addressing abusive mortgage practices,
and disclosure was not its only response. When enacting RESPA in 1974 Congress
identified two major problems:

(1) Abusive and unreasonable practices within the real estate settlement
process that increase settlement costs to home buyers without providing
any real benefits to them;

(2) The lack of understanding on the part of most home buyers about the
settlement process and its costs, which lack of understanding makes it
difficult for a free market for settlement services to function at maximum
efficiency.… 277

Thus, it was (a) significant consumer losses, plus (b) the inability of consumers to
protect themselves, that justified government intervention, including prohibitions against
kickbacks and referral fee arrangements as business practices. Net societal benefits was

complexities and inefficiencies in the present system for recording land titles. See also the Congressional
not an additional prerequisite to government intervention. Indeed, Congress noted “while the making of such payments may heretofore have been necessary from a competitive standpoint in order to obtain or retain business, and in some areas may even be permitted by state law, it is the intention of section 7 to prohibit such payments, kickbacks, rebates or unearned commissions.”278 Thus, there was a recognition of benefits to the industry of existing practices, but a decision to prohibit such practices nonetheless without any weighing of costs to consumers versus benefits to the industry.

The response of the Congress in RESPA was also twofold. One response was disclosure279, but a second response was prohibition of kickback or referral fee arrangements.280 This second response addressed the problem of abusive practices that increased settlement costs. Thus direct government intervention was employed to stop abusive practices in addition to disclosure.281

Subsequent Congressional responses occurred in 1988 and 1994. Both subsequent responses were similarly two-fold - both disclosure and prohibition of particular abusive practices.

In 1988 Congress addressed consumer concerns regarding home equity loans that had increased five fold between 1981 and 1986. The response was two-fold. First, disclosure and advertising requirements were imposed for home equity loans, and second home equity protections were legislated. The latter required lenders to base variable rate loans on an index that is publicly available and not under the control of the creditor, prohibited unilateral termination of a home equity credit plan and acceleration of the outstanding balance (except on the basis of three criteria specified in the statute), and prohibited lenders from unilaterally changing the terms of the home equity credit plan.

Congress wanted to “assure that consumers get necessary and important disclosures before they open home equity loan accounts…[so as to] enable consumers to understand fully the conditions of this new form of consumer borrowing.” This was not, however, Congress’ only response. The bill’s main sponsor explained that: “H.R. 3011 basically embodies a disclosure approach. However, there are a few areas where restrictions on certain contractual practices used by lenders are warranted.” Thus, in 1988 as in 1974 disclosure was not the exclusive response and market discipline on the part of consumers was not the only form of protection embraced. Instead, government intervention was embraced in the form of prohibition of specific abusive practices that had been uncovered.

Congress again addressed abusive lending practices in 1994 with enactment of the Home Ownership and Equity Protection Act. Here, the complete terms of the goal embraced by Congress –not only access to credit but access to credit without abusive...
terms – was again witnessed. In addition, its rejection of a free market approach was also made clear. The Senate Report on the Act explains that “[t]he legislation generally prevents lenders from including certain potentially abusive terms, . . . in high cost mortgages.”286

Congress had uncovered evidence that some home improvement contractors, second mortgage brokers and other lenders acted in a “predatory fashion, targeting unsophisticated, low-income homeowners and “skimming” equity from the neighborhoods through high-rate, high fee loans.”287 Congress’ response to these problems it had uncovered was, once again, two-fold. One response was disclosure – a new streamlined disclosure form that provided additional information regarding the risks of high cost loans.288 However, the second response was a prohibition of identified abusive practices. As the Senate Report on the Act explained:

The Committee finds that certain loan terms are particularly problematic and often mislead borrowers about the true cost of a loan. Consequently, the legislation prohibits High Cost Mortgages from containing the following terms: prepayment penalties, points on loan amounts refinanced, default interest rates above the rate prior to the default, balloon payments, negative amortization, or prepayment of more than two of the periodic payments.289

The motivation for Congressional intervention was (a) losses suffered by residents targeted by reverse redlining, and (b) which they could not avoid because they were misled, were unaware of the terms, or were unsophisticated concerning the

287 Id. at 22.
mortgage market, and were, therefore, taken advantage of by lenders.\textsuperscript{290} Once again, net societal benefits was not the determinant of the decision to intervene or not intervene. Rather the determinant was significant consumer losses that consumers could not avoid.

To say that net societal benefits has not determined the decision to intervene, is not to say that Congress has not considered the costs and benefits of a proposed action. Thus, the Senate Report cited testimony from the Comptroller of the Currency that the legislation would not impose unreasonable compliance costs or interfere with legitimate financial transactions.\textsuperscript{291} In addition, the Senate Committee considered whether the bill would restrict the flow of credit.\textsuperscript{292} To avoid this adverse effect, it focused the Act’s prohibitions “... on the segment of the home equity loan market most vulnerable to abuse.”\textsuperscript{293} Similarly, the Committee recognized that prepayment penalties may compensate a lender if the borrower repays the loan before the date specified by the loan terms – a benefit to the lender. Nonetheless, “[i]n the case of High Cost Mortgages ... the broader public interest is served by eliminating barriers that might prevent a borrower from repaying the loan.”\textsuperscript{294}

Thus, while costs and benefits of proposed government intervention were considered, they were not used to establish a net societal benefits standard as the determinant of a decision to intervene or not to intervene in the mortgage market.

\textsuperscript{290} \textit{Id.} at 22. \textit{See also Id.} at 24 (the Committee is seeking to prevent unscrupulous lenders from taking advantage of unwitting consumers) and 25 (certain loan terms are particularly problematic and often mislead consumers).

\textsuperscript{291} \textit{Id.} at 23.

\textsuperscript{292} \textit{Id.} at 24.

\textsuperscript{293} \textit{Id.} This was the justification for the annual percentage rate trigger in the definition of high cost mortgages subject to the Act’s prohibitions.

\textsuperscript{294} \textit{Id.} at 26.
Rather, the possible adverse effects to the industry or to consumers of intervention were at times addressed by minimizing such adverse effects. At other times, they were ignored because of the public interest in halting abusive loan practices.

In 1994 Congress not only prohibited certain abusive practices it had identified. It also granted the Federal Reserve Board the power to prohibit other unfair, deceptive or abusive practices that it may uncover in the future.\textsuperscript{295} The legislative history explains the approach embraced to address additional abusive practices:

the Committee also realizes that new products and practices may emerge that facilitate reverse redlining. For this reason, the legislation requires the Federal Reserve Board to prohibit acts or practices in connection with High Cost Mortgages that it finds to be unfair, deceptive, or designed to evade the provisions of this section, It is the Committee’s intention that the Federal Reserve will examine complaints and utilize this legislation to provide adequate protections for consumers under Truth in lending.\textsuperscript{296}

There is one possible exception to the conclusion that Congress, in its legislative enactments over the years, clearly embraced the view that governmental intervention was justified and preferred to prevent abusive lending practices. This is found in Congress’ other action in 1994. This action relates only to unfair mortgage practices. No contrary evidence exists as to unsafe mortgage practices.

Regulatory power over unfair lending practices, as opposed to unsafe and unsound lending practices, depends HOEPA and Section 5 of the FTC Act. HOEPA

\textsuperscript{295} “(2) PROHIBITIONS. - The Board, by regulation or order, shall prohibit acts or practices in connection with-
(A) mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section; and (B) refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower.” 15 U.S.C. § 1639 (l)(2).
permits the Federal Reserve Board to prohibit acts or practices in connection with
“mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the
provisions of this section.”297 The Conference Report on the Act explains that “[i]n
making any determination, the Board should look to the standards employed for
interpreting state unfair and deceptive trade practices acts and the Federal Unfair and
Deceptive Practices Act (15 U.S.C. § 45 (a) (1)).”298

The Congress that adopted HOEPA and included this explanation in the
Conference Report, is the same Congress that amended the Federal Unfair and Deceptive
Practices Act, otherwise known as the FTC Act. The 1994 Amendment provided that:

The Commission shall have no authority under
this section or section 18 to declare unlawful an
act or practice on the grounds that such act or
practice is unfair unless the act or practice
causes or is likely to cause substantial injury to
consumers which is not reasonably avoidable by
consumers themselves and not outweighed by
countervailing benefits to consumers or to
competition. In determining whether an act or
practice is unfair, the Commission may consider
established public policies as evidence to be
considered with all other evidence. Such public
policy considerations may not serve as a
primary basis for such determination.”299

This permitted the regulators to claim that to determine if regulatory intervention
is justified, as opposed to Congressional intervention, there should be a preference for

297 15 U.S.C. 1639 (l) (2). This is broader than the scope of other provisions in HOEPA, such as the
explicit prohibitions on certain abusive practices, that apply to “a mortgage referred to in section 103 (aa)”. Section 103 (aa) employs the interest rate trigger of greater than 10 percentage points above the Treasury yield on comparable Treasury securities or the fee trigger of points and fees in excess of 8 percent of the total loan or $400, whichever is greater, and excludes home purchase loans. Such section 103 (aa) mortgage loans are typically referred to as HOEPA loans.
consumer self-protection. In addition, the regulators could claim that even in the mortgage markets the threshold for governmental intervention is based on net societal benefits, and an evaluation that examines the costs and benefits not only to consumers, but to the economy as a whole.

This was the agencies’ interpretation of Congress’ 1994 enactment. The Federal Reserve Board in its July 2008 rule on unfair mortgage practices noted that state deceptive practices law could be the standard used to determine whether to intervene in the mortgage market. However, it chose to adopt the net societal benefits test imposed for non-mortgage transactions as the standard for intervention.300 Similarly, the other bank regulatory agencies in regulatory guidances on unfair mortgage practices chose to employ the FTC’s net societal benefits test.301

There is an alternative view. The direction in the Conference Report that the Federal Reserve should “look to” the standards contained in the FTC Act does not compel the conclusion that mortgage market regulation through HOEPA must be subject to exactly the same standards and basis for regulatory intervention as is used in the FTC Act.

Indeed the FTC Act provides expressly that the FTC’s power to prevent unfair or deceptive practices does not apply to savings associations, banks, or federal credit unions among others.302 Rather such authority is explicitly granted to the federal banking

300 Truth in Lending, 73 Fed. Reg. 44522, 44529 (July 30, 2008). The Board stated it “considered” both the FTC standard and state standards, but in fact its analysis is based on the FTC standard, including a net societal benefits test.
agencies, including the power to issue regulations governing unfair mortgage acts and practices that are applicable to independent mortgage companies, which is granted to the Federal Reserve Board. One could view the mortgage markets as different than the wide range of consumer practices covered by the FTC Act, and therefore favor regulatory intervention more readily. In addition, the agencies’ interpretation ignores the direction in the Conference report to also “look to” state law, which often differs from the basis for regulatory intervention under the FTC Act discussed above.

Most states have not adopted the FTC’s current standard for defining unfairness and instead embrace a more liberal standard for defining unfairness that does not include a net societal benefits test. The Federal Reserve Board admitted this was an alternative basis for intervention available to it, but chose the net societal benefits test. Earlier other federal banking agencies had made the same admission.

Congress responds to particular situations presented to it and typically tailors its response to the narrow situation at hand. In limiting the power of the FTC it was responding to earlier overly-broad FTC rules and vagueness in FTC authority to promulgate such rules, especially rules aimed at commercial advertising. However, the

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305 Matthew A. Edwards, The Law, Marketing and Behavioral Economics of Consumer Rebates, 12 STAN. J. L. BUS. & FIN. 362, 404 note 223 (227); Truth in Lending, 73 Fed. Reg. 44522, 44529 (July 30, 2008) (a number of states follow an unfairness standard formerly used by the FTC, in which an act or practice is unfair where it offends public policy, or is immoral, unethical, oppressive or unscrupulous and causes substantial injury to consumers).
306 Id. The Federal Reserve stated it “considered” both the FTC standard and the state standards, but in its analysis of the justification for the rules adopted it in fact followed the FTC standard.
307 E.g. Department of the Treasury, Office of Thrift Supervision, Unfair or Deceptive Acts or Practices, Advance Notice of Proposed Rulemaking, 72 Fed. Reg. 43570, 43573-43574 (August 6, 2007) (OTS notes it has the option of adopting the FTC standard as its principle for regulatory intervention or it could follow the direction of state law models, among others).
same Congress responded differently to abusive mortgage practices when it adopted HOEPA. It is a reasonable view that Congress viewed the appropriate threshold for regulatory intervention in the mortgage markets to be different. Absent that conclusion, we can only say that Congress provided a legislative signal that lacked sufficient clarity. However, this still places responsibility on the federal regulatory agencies for choosing the option – i.e. the net societal benefits test – that caused the agencies to refrain from intervention even when (a) significant injury to consumers was documented, (b) which they could not avoid.

In summary, Congress over the years has embraced three goals for the mortgage markets. It has also signaled a willingness, perhaps a preference, to employing government intervention to ensure safety and soundness, fairness when providing access to mortgage credit, and equal opportunity. Current regulatory policy toward unfair mortgage practices undermines these goals embraced by Congress. The net societal benefits test leaves consumers with no protection even when faced with practices against which they are effectively unable to protect themselves. The disparate impact of such a scenario is one disproportionately stripping equity from low income as well as minority residents and communities.

This brings us back to the issue of moral hazard – moral hazard in its original sense. Does the current regulatory viewpoint encourage unethical conduct on the part of mortgage bankers?

The ethical viewpoint embraced by a society is reflected in its laws. The best evidence is a series of statutory or case law developments over a prolonged period of time, rather than an individual enactment that may be motivated by a unique, perceived need for action or a compromise reached to avoid complete inaction. The question is whether U.S. society views as ethical business practices in which profit is based on taking advantage, financially, of individuals who are unable to protect themselves? More narrowly drawn, the issue is whether U.S. society views as ethical a business practice involving an essential public good—namely a home—in which business entities profit while imposing significant risks and costs on consumers in a situation in which they are unable to protect themselves?

The evidence presented in Part Three of this article points to a conclusion reached by the U.S. Congress—namely, that the answer to that question is No. As a result, regulatory viewpoints that permit and therefore sanction practices in which the mortgage industry imposes significant risks of default on helpless consumers due to unsafe mortgage products and practices, and strips substantial equity from consumers, especially low-income homeowners, due to unfair mortgage practices, are promoting unethical business practices. They are creating moral hazard issues.

What is interesting about this conclusion concerning the ethical viewpoint reflected in U.S. law is that the same evidence exists with respect to other transactions involving consumers’ homes. Thus over the last 30 years the warranty of habitability has been embraced by state legislators and judges. The embrace of a warranty of habitability is a decision to intervene in the free market to protect individuals against substandard housing conditions (significant injury) because the legislators or courts have concluded
that most tenants cannot effectively protect themselves\textsuperscript{309} against exploitation by unscrupulous landlords. Similarly, over the last 20 years the warranty of quality has been imposed on builders of new homes by state legislators and courts. Again, intervention in the free market has been justified due to the significant injury that would be suffered by homebuyers against which they are unable to protect themselves.\textsuperscript{310} The ethical viewpoint reflected in all of these developments, including Congressional decisions to prohibit particular abusive mortgage practices, as documented above, is that business entities should not be permitted to profit by imposing significant financial costs and burdens on consumers of homes (whether homeowners or tenants) when it is found that such consumers are effectively unable to protect themselves.

**CONCLUSION**

Since 1982 the federal banking agencies have embraced a deregulation viewpoint that prefers a free market approach to address both safety and soundness issues and unfairness issues. This paper demonstrates that Congress did not share this viewpoint for safety and soundness issues. It did deregulate the banking industry by lifting statutory requirements but it intended and preferred government regulatory intervention to prevent unsafe and unsound banking practices – not a reliance on free market forces. As to unfairness issues, the long list of Congressional acts of direct prohibition of abusive lending practices leads to the conclusion that, at least in the mortgage market, Congress

\textsuperscript{309} See Restatement Property 2d §5.1, comment b. The courts have imposed an implied obligation on landlord’s part that the premises are suitable for residential occupancy. They have rejected the doctrine of caveat emptor due to the complexity of residential housing systems, the expense of making repairs and the lack of bargaining power on the part of most residential tenants.

\textsuperscript{310} E.g. Albrecht v. Clifford, 767 N.E. 2d 42 (Mass. 2002) (warranty protects purchasers from defects that are nearly impossible to ascertain to inspection and imposes burden on the person who has the opportunity to notice, avoid, or correct latent defects).
similarly intended and preferred regulatory intervention to prevent unfair banking practices.

The federal bank regulatory agencies have also embraced a viewpoint that shuns government intervention based on a net societal benefits test when dealing with unfairness issues in mortgage lending. This article demonstrates that Congress did not share that viewpoint. Rather, it endorsed government intervention when mortgage business practices caused significant financial losses to consumers against which consumers were unable to protect themselves.

The regulatory viewpoints have led to a proliferation of both unsafe and unfair mortgage products and practices. This raises the moral hazard issue. In recent decades moral hazard has been used to refer solely to incentives to excessive risk taking created by guarantees or protections against loss. The general failure of regulatory intervention has created a form of “guarantee” against loss – in the form of legal sanction. Moreover, corporate analysis of risks versus benefits has led to a failure of market discipline since corporate actors, based in part on decision making heuristics, have concluded that the offering of unfair and even unsafe mortgage loans were reasonable business practices based on expected profits. In other words, deregulation has provided incentives for increased risk taking by mortgage loan originators.

This article explored an additional moral hazard issues with respect to unsafe and unfair mortgage loans, namely, whether the regulatory viewpoint has encouraged unethical conduct. It calls for a return to a second concept that was originally embraced as a form of moral hazard, namely business practices or government mandates that lead others to act unethically by effectively sanctioning such activity. Ethical conduct is
defined, for purposes of this article, as compliance with the legal standard that Congress, state legislatures and/or the courts have generally embraced, including actions taken to further the policies the legislature or the judiciary has embraced. This article focuses on the regulatory adoption of a net societal benefits test as the legal threshold for intervention in the mortgage market. The conclusion drawn is that the free market viewpoint embraced by the regulators, especially the embrace of a net societal benefits test, was a viewpoint rejected by the U.S. Congress. As a result, the regulatory perspective which refrained from government intervention in the face of significant financial injury to consumers against which they could not protect themselves promoted unethical business practices, practices that exploited vulnerable groups.

As to the concrete implications of this finding, at a minimum Congress must make it clear that the bank regulatory agencies are to prohibit abusive mortgage practices whenever there is a finding that (a) significant injury results from such practices, and against (b) which consumers are not effectively able to protect themselves. Congress must make clear that the regulatory agencies’ embrace of a net societal benefits test as a threshold for government intervention in the mortgage market is rejected.