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So You've Been Preempted—What Are You Going to Do Now?: Solutions for States Following Federal Preemption of State Predatory Lending Statutes

I. INTRODUCTION

Home ownership is the foundation upon which the “American dream” is built; the goal of owning a home remains high on the list of priorities for Americans young and old.¹ In April 2000, 70.7 million American families (67.1%) owned their homes, more than ever before in our nation’s history.² Although many factors likely contributed to those record levels, the increased availability of subprime credit was one important cause;³ the ability of individuals with blemished credit histories to obtain credit was never greater. The total dollar amount of subprime loans increased fourfold from \$40 billion in 1994 to \$160 billion in 1999,⁴ with the subprime

1. *See Predatory Mortgage Lending: The Problem, Impact and Responses: Hearings Before the Senate Committee on Banking, Housing, and Urban Affairs*, 107th Cong. 53–54 (2001) [hereinafter *Hearings*] (statement of Thomas J. Miller, Attorney General, State of Iowa).

2. *See* U.S. DEP’T OF THE TREASURY & U.S. DEP’T OF HOUS. & URBAN DEV., CURBING PREDATORY HOME MORTGAGE LENDING: A JOINT REPORT 1 (2000), available at <http://www.treas.gov/press/releases/reports/treasrpt.pdf> (last visited May 10, 2004) [hereinafter *TREASURY-HUD JOINT REPORT*].

3. Subprime lending involves lending to individuals who are unable to qualify for the best available interest rates (prime rates). “Subprime borrowers typically have weakened credit histories that include payment delinquencies, and possibly more severe problems such as charge-offs, judgments, and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories.” *BD. OF GOVERNORS OF THE FED. RESERVE SYS., FED. DEPOSIT INS. CORP., OFFICE OF THE COMPTROLLER OF THE CURRENCY & OFFICE OF THRIFT SUPERVISION, EXPANDED GUIDANCE FOR SUBPRIME LENDING PROGRAMS 2* (2001).

4. KENNETH TEMKIN ET AL., U.S. DEP’T OF HOUS. & URBAN DEV., SUBPRIME MARKETS, THE ROLE OF GSEs, AND RISK-BASED PRICING vii (2000) (“A number of factors accounted for this growth: federal legislation preempting state restrictions on allowable rates and loan features, the tax reform act of 1986 [sic], increased demand for and availability of consumer debt, and an increase in subprime securitization.”). Another report states that the number of subprime loans increased from 80,000 in 1993 to over 790,000 in 1998, with subprime loans increasing from a \$20 billion portion of the overall mortgage market to a \$150 billion portion over the same period. *See* U.S. DEP’T OF HOUS. & URBAN DEV., UNEQUAL BURDEN: INCOME AND RACIAL DISPARITIES IN SUBPRIME LENDING IN AMERICA (2000), available at <http://www.hud.gov/library/bookshelf18/pressrel/subprime.html> (last visited May 10, 2004) [hereinafter *UNEQUAL BURDEN*].

market comprising “a little more than ten percent of the [overall] mortgage market.”⁵ Although increased subprime lending contributed to that encouraging increase in home ownership, not all the consequences have been positive. As subprime loan originations have increased, so too have “predatory” loan practices.⁶

While individuals, consumer groups, state and federal government agencies, and state and federal politicians have become increasingly concerned about such practices and have called for changes in the way mortgage lending is regulated, they do not agree on the shape such changes should take.⁷ In particular, state and federal government approaches to the problem are not in accord. State and local governments have enacted laws that combat predatory loan practices by regulating banks and banking subsidiaries

5. AMY CREWS CUTTS & ROBERT A. VAN ORDER, FREDDIE MAC, ON THE ECONOMICS OF SUBPRIME LENDING 1 (Freddie Mac, Office of the Chief Economist, 2003).

6. See *infra* Part II.A (explaining what predatory lending is and providing examples of such practices).

7. See, e.g., *Hearings, supra* note 1 (discussing the predatory lending problem and various responses to it); Letter from Neil A. Milner, President and Chief Executive Officer, Conference of State Bank Supervisors, to the Honorable John D. Hawke, Jr., Comptroller of the Currency, Office of the Comptroller of the Currency 1–11 (March 28, 2003) (opposing federal preemption of state predatory lending laws, specifically the Georgia Fair Lending Act, and arguing that states have the power to regulate national and state banks); Notice, National City Bank, 68 Fed. Reg. 46264 (Aug. 5, 2003) [hereinafter GFLA Preemption Determination] (preempting the Georgia Fair Lending Act as it applies to federally chartered banks and concluding that Georgia’s act interferes with national bank real estate lending powers).

One major difficulty in regulating the subprime market is that the subprime market, while fertile ground for predatory and unfair lending practices, is also a vital source of credit. Regulating the subprime lending market without cutting off access to its credit resources is not an easy task. As explained by a witness at congressional hearings held regarding the predatory lending issue, “[d]rying up productive credit would be of grave concern; drying up destructive debt is sound economic and public policy.” *Hearings, supra* note 1, at 54 (statement of Thomas J. Miller, Attorney General, State of Iowa). A recent Department of Housing and Urban Development report described the value of subprime lending, illustrating the importance of not damaging or eliminating it through overly intrusive regulation, as follows:

By providing loans to borrowers who do not meet the credit standards for borrowers in the prime market, subprime lending can and does serve a critical role in the Nation’s economy. These borrowers may have blemishes in their credit record, insufficient credit history or non-traditional credit sources. Through the subprime loan market, they can buy a new home, improve their existing home, or refinance their mortgage to increase their cash on hand.

UNEQUAL BURDEN, *supra* note 4, at 1.

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operating within their borders,⁸ only to have their efforts preempted by the Office of Thrift Supervision (“OTS”) and the Office of the Comptroller of the Currency (“OCC”).⁹ For instance, the OCC recently issued a preemption order and determination that the substantive provisions of the Georgia Fair Lending Act (“GFLA”), which prohibits various loan terms and features that the Georgia legislature deemed undesirable,¹⁰ does not apply to nationally chartered banks and their subsidiaries.¹¹ The OCC determination, combined with the GFLA’s parity provision (which makes the GFLA inapplicable to state banks if a federal regulatory agency determines that the GFLA does not apply to nationally chartered banks),¹² makes the GFLA ineffective against all bank lenders in Georgia.¹³ These federal regulatory agencies have expressed concern that state predatory lending regulations, such as the GFLA, interfere with the ability of national financial institutions to regulate real estate finance.¹⁴ State and local policymakers, however, insist that federal laws and regulations are not strict enough.¹⁵ As the problem of

8. *See, e.g.*, GFLA Preemption Determination, *supra* note 7 (preempting the Georgia Fair Lending Act as it applies to federally chartered banks); Georgia Fair Lending Act, GA. CODE ANN. §§ 7-6A-1 to -13 (2002) (amended 2003).

9. *See* GFLA Preemption Determination, *supra* note 7; Letter from Carolyn J. Buck, Chief Counsel, Office of Thrift Supervision, Department of the Treasury (Jan. 21, 2003) (concluding that federal law preempts application of various provisions of the Georgia Fair Lending Act to federal savings associations and their operating subsidiaries), *at* <http://www.ots.treas.gov/docs/56301.pdf> (last visited May 10, 2004) [hereinafter OTS GFLA Preemption Letter]; Letter from Carolyn J. Buck, Chief Counsel, Office of Thrift Supervision, Department of the Treasury (July 22, 2003) (concluding that federal law preempts application of various provisions of the New Jersey Home Ownership Security Act of 2002 to federal savings associations and their operating subsidiaries), *at* <http://www.ots.treas.gov/docs/56305.pdf> (last visited May 10, 2004) [hereinafter OTS NJHOSA Preemption Letter].

10. GA. CODE ANN. §§ 7-6A-1 to -13.

11. *See* GFLA Preemption Determination, *supra* note 7; *see also infra* Part III.

12. *See* GA. CODE ANN. § 7-6A-12 (stating that the provisions of the GFLA will not apply to state-chartered financial institutions to the “extent federal law precludes or preempts or has been determined to preclude or preempt the application of the provisions of this chapter to any federally chartered bank”).

13. *See* Memorandum from Bo Fears, Assistant Attorney General, State of Georgia, to David Sorrell, Commissioner, Department of Banking and Finance, State of Georgia (Aug. 4, 2003) (explaining that the OCC’s preemption order is a preemption determination within the meaning of the GFLA’s parity provision, which, according to the GFLA’s parity provision, leads to the conclusion that the GFLA does not apply to state banks).

14. *See infra* Parts III.A–B.

15. *See infra* Part III.C.

predatory lending continues and federal agencies show a willingness to preempt state regulations that affect nationally chartered financial institutions, states are left with fewer options for protecting at-risk consumers in the subprime market.

This Comment discusses this problem and suggests that states may reduce abusive subprime lending, in spite of federal orders preempting their legislative and regulatory efforts, by improving regulation of nonbank loan sellers and increasing enforcement of state deceptive and unfair trade practices acts. Part II defines predatory lending, discusses why it is a problem, and briefly recounts current federal and state remedies. Part III outlines the reasoning behind the OCC's recent order and determination, which preempts the GFLA and sets the stage for future orders preempting state predatory lending laws. It also briefly outlines OTC preemption orders that have determined that the GFLA and a similar New Jersey predatory lending law are not applicable to federally chartered savings and thrift associations or their subsidiaries.¹⁶ Part IV provides two suggested solutions for states seeking to develop effective tactics for fighting predatory lending practices without running afoul of preemption concerns: the increased regulation of nonbank sellers of loans (primarily mortgage brokers who often operate outside federal and state regulatory structures), and increased enforcement of state deceptive and unfair trade practices acts (such as mini-FTC acts). Though many approaches can be taken,¹⁷ these remedies address the problem effectively, cannot be preempted by federal regulatory agencies, and are better suited to address state predatory lending problems than blanket federal regulation. They can also be tailored to address the needs of various jurisdictions and applied to transactions that are truly predatory without restricting access to legitimate subprime credit. Part V offers a conclusion.¹⁸

16. See OTS GFLA Preemption Letter, *supra* note 9; OTS NJHOSA Preemption Letter, *supra* note 9.

17. Such approaches include heightened federal standards under such laws as the Real Estate Settlement Procedures Act (RESPA), 12 U.S.C. §§ 2601-17 (2000), the Truth in Lending Act (TILA), 15 U.S.C. § 1604 (2000), increased borrower education, and further regulation by state and local legislatures through the enactment of new predatory lending laws.

18. This Comment seeks to provide solutions to the predatory lending problem that can be followed by state legislators and regulators without fear of preemption by federal law. The suggestions made in this Comment are not exhaustive, and additional action may be necessary at both state and federal levels to combat abusive lending practices.

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II. WHAT IS PREDATORY LENDING AND WHY IS IT HARMFUL?

A. Defining Predatory Lending

Defining predatory lending is difficult.¹⁹ Any list of predatory practices is incomplete because such a “list does not consider the context in which the alleged abuse has occurred.”²⁰ Although certain lending practices may be abusive when sold as part of a high-cost subprime loan if the borrower is deceived or misled, the same practices are not abusive in other high-cost situations if the borrower understands the otherwise abusive term or practice and the loan is negotiated as part of an arms-length transaction.²¹ When determining whether a loan or its terms are predatory, all of the circumstances surrounding the transaction must be considered.²²

19. Although defining predatory lending in an objective way is not easy, it helps to recognize what predatory lending is not: legitimate subprime lending. Subprime lending is an important source of financing for those with imperfect credit and has provided a way for many people to become homeowners who would have otherwise been unable. *Hearings, supra* note 1, at 311 (statement of John A. Courson, President and CEO, Central Pacific Mortgage Company, Folsom, California, on behalf of Mortgage Bankers Association of America) (“[Subprime lending] has been extremely beneficial to thousands of families in the last couple of years. Subprime lending has opened up new markets and helped many consumers that would not have received needed funds but for the special products available in this sector of the market. The subprime market provides a legitimate and much needed source of credit for many families.”). Subprime lending

refers to entirely appropriate and legal lending to borrowers who do not qualify for prime rates, those rates reserved for borrowers with virtually blemish-free credit histories. Premiums for extending credit to these borrowers compensate lenders for the increased risk that they incur and range several percentage points over rates charged on prime loans.

Governor Edward M. Gramlich, Address at the Housing Bureau for Seniors Conference, Ann Arbor, Michigan (Jan. 18, 2002), *available at* <http://federalreserve.gov/boarddocs/speeches/2002/20020118/default.htm>.

20. *See* TREASURY-HUD JOINT REPORT, *supra* note 2, at 19.

21. *Id.* As one commentator stated,

In its reliance on a ‘I know it when I see it’ kind of test, predatory lending is similar to obscenity. Just as two observers may differ over whether a picture is obscene, they may also differ over whether a particular practice is abusive. And just as there is no end to the sources of obscene expression, there is no end to the list of lending practices that could be used in abusive fashion.

JACK GUTTENTAG, ANOTHER VIEW OF PREDATORY LENDING 5 (Wharton Sch., Univ. of Pa., Fin. Insts. Ctr., Working Paper No. 01-23-B, 2001), *available at* <http://fic.wharton.upenn.edu/fic/papers/01/0123.pdf> (last visited May 10, 2004).

22. As explained by one witness at congressional hearings about the predatory lending issue, the full context of the transaction must be analyzed to properly assess whether an abuse has occurred:

In spite of the difficulty in definitively and objectively defining predatory lending, some practices are definitely considered predatory in certain circumstances. Such practices include aggressive sales techniques, deceit, fraud, manipulation, or any number of the foregoing, “often combined with loan terms that, alone or in combination, are abusive or make the borrower more vulnerable to abusive practices.”²³ Loan terms and practices that are often considered abusive when offered in a “predatory” context include: (1) loan “flipping,”²⁴ (2) making loans without considering the borrower’s ability to repay and primarily for the purpose of obtaining the collateral,²⁵ (3) negative amortization loans,²⁶ (4) the use of

It is impossible, for example, to identify “excessive” fees without knowing the nature and difficulty of the service provided in exchange for that fee. Nor can we recognize repeat refinances that are meant to strip equity without looking at the fee structure of the transaction and the equity of the consumer. In order to determine that a consumer has been “deliberately misled,” we have to study the disclosures and the oral representations made in the context of the specific transaction at hand. Since every loan is unique and every transaction is tailored to specific needs and conditions, the answer of whether mortgage abuse has occurred in any given situation is dependent upon the totality of the circumstances of the borrower and the transaction. It is daunting, therefore, to isolate the specific “bad acts” that are employed by unscrupulous lenders in a way that allows for appropriate regulation.

Hearings, supra note 1, at 312 (statement of John A. Courson, President and CEO, Central Pacific Mortgage Company, Folsom, California, on behalf of Mortgage Bankers Association of America).

23. See TREASURY-HUD JOINT REPORT, *supra* note 2, at 1.

24. Loan “flipping” is frequent refinancing done in order to get additional fees or other lender-favorable terms that have little or no benefit, economic or otherwise, to the borrower. Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 515 (2002) (defining “flipping” as “the early or frequent refinancing of a loan, normally with each new set of loan fees financed by the loan, so that the loan amount continually rises, even while the homeowner makes her payments”). The Treasury-HUD Joint Report also states:

Loan flipping generally refers to repeated refinancing of a mortgage loan within a short period of time with little or no benefit to the borrower. Loan flipping typically occurs when borrower [sic] is unable to meet scheduled payments, or repeatedly consolidates other unsecured debts into a new, home-secured loan at the urging of a lender. Lenders who flip loans tend to charge high origination fees with each successive refinancing, and may charge these fees based on the entire amount of the new loan, not on just the incremental amount (if any) added to the loan principal through the refinancing.

TREASURY-HUD JOINT REPORT, *supra* note 2, at 73.

25. See TREASURY-HUD JOINT REPORT, *supra* note 2, at 2. This practice, also often called “asset-based lending,” was recognized as a problem and condemned by the Treasury-HUD Joint Report:

A creditor’s decision on whether to originate a mortgage loan should be guided by his/her assessment of the borrower’s ability to repay the loan from liquid sources

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excessive prepayment penalties,²⁷ (5) balloon payments,²⁸ (6) the use of mandatory arbitration clauses,²⁹ (7) fee “packing,”³⁰ and (8)

(e.g., income and non-housing assets). Other factors, such as the overall size of the loan, the borrower’s credit history and the value of the collateral play into the decision as well. There is widespread concern, however, that some unscrupulous creditors are making loans to borrowers who clearly cannot afford to repay them. . . . Lending with no reasonable expectation of repayment other than recourse to the underlying collateral is not a practice engaged in by safe and sound lenders. Similarly, responsible mortgage brokers do not broker loans to borrowers where the borrower can’t repay. Asset-based lending can have significant social implications, particularly in home-secured transactions. Borrowers not only risk losing their homes to foreclosure, but also their accumulated equity in their homes, a major source of wealth for many Americans.

Id. at 76–77. The OCC also recognizes the problem of asset-based lending, noting that such practices are a fundamental characteristic of predatory loans. Abusive loans are often “underwritten predominantly on the basis of the liquidation value of the collateral, without regard to the borrower’s ability to service and repay the loan according to its terms absent resorting to that collateral.” Advisory Letter from the Office of the Comptroller of the Currency, Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices to Chief Executive Officers of All National Banks and National Bank Operating Subsidiaries, Department & Division Heads, and All Examining Personnel 2 (Feb. 21, 2003), available at <http://www.occ.treas.gov/ftp/advisory/2003-2.pdf> [hereinafter OCC Predatory Abuses Guidelines Letter].

26. See TREASURY-HUD JOINT REPORT, *supra* note 2, at 91–92. Negative amortization loans are loans that are structured so that the borrower pays less than the amount of interest due on the loan so that the principal amount of the debt increases. *Id.* at 91. This causes the borrower to lose equity in her home, and “[t]he existence of such a schedule . . . may indicate a lack of understanding on the part of the borrower or misleading lender practices.” *Id.* at 92.

27. Prepayment penalties are “fees that are added to the amount the borrower must pay to retire a loan before it reaches full term.” Eggert, *supra* note 24, at 518. Early payment of a loan reduces the amount of interest lenders receive on a given loan, and prepayment penalties are therefore intended to reduce early payment. *Id.* “[W]hen employed by predatory lenders, prepayment penalties are designed either to trap the borrower, forcing her to remain in an inequitable loan, or to reward the lender with an unreasonable payoff when an unwitting borrower refinances the loan.” *Id.* See also TREASURY-HUD JOINT REPORT, *supra* note 2, at 92–96 (discussing prepayment penalties and their effects on borrowers).

28. Balloon payments are large payments that are due “at the end of a fixed-rate loan term when regular monthly payments do not fully amortize the loan principal.” TREASURY-HUD JOINT REPORT, *supra* note 2, at 96. Such payments “force a borrower at a set time to repay all of the remaining balance on a loan rather than continuing to make monthly payments until the entire loan has been repaid.” Eggert, *supra* note 24, at 519. When the balloon payment comes due, “borrowers are highly unlikely to be able to pay off a sizeable balloon payment without refinancing the loan, thus incurring a new round of points and fees.” *Id.*

29. TREASURY-HUD JOINT REPORT, *supra* note 2, at 98–99.

30. Fee “packing” generally refers to the inclusion of excessive or unnecessary fees and points being financed into the loan amount. Eggert, *supra* note 24, at 517. “‘Packing’ is the practice of forcing or inducing borrowers to use some of their loan proceeds to pay for unnecessary or undesired products Predatory lenders try to include as many such products as they can, such as insurance to pay off credit card debt or to service home appliances.” *Id.*

steering individuals that would otherwise qualify for low-cost prime loans into high-cost subprime loans.³¹

B. Why Is Predatory Lending a Problem?

Predatory lending is problematic because predatory lenders often seek out those who are least able to deal with the burdens that onerous loans impose, such as the elderly and minorities (due to economic constraints).³² Additionally, predatory lending, and regulatory responses to it, cause disruptions in the secondary market

Predatory lenders engage in such practices because they directly benefit from receiving higher fees and “obtain profits from selling these overpriced products.” *Id.*

One product that predatory lenders “pack” into loans and that is often harmful to borrowers is single premium credit insurance. *See* TREASURY-HUD JOINT REPORT, *supra* note 2, at 89–90. Upon death or disability of the borrower, credit insurance pays off the balance of the mortgage. *Id.* at 89. Premiums for such insurance are often paid in a lump-sum at closing and are financed as part of the loan, increasing finance charges and providing “no actuarial benefit to the consumer” since the policy is in effect for only the first few years of the loan. *Id.* at 90. In some cases,

lenders may mislead consumers into believing that credit insurance is a requirement for approval of the loan. An industry-funded report found that 18 percent of those surveyed did not remember being told that credit insurance was optional. In some instances, borrowers have been unaware that they have purchased credit insurance. Even if borrowers understand that they are purchasing the product and do so voluntarily, the lender may mislead the consumer into thinking that coverage is for the entire life of the mortgage when the policy is only in effect for the first five to seven years of the loan.

Id.

31. Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1266 (2002). Engel & McCoy would describe the practice of steering individuals into higher cost loans as “harmful rent-seeking,” which they argue is a defining characteristic of predatory lenders and lending practices. *Id.* at 1265–67 (“The practice of steering prime borrowers to high-cost lenders is an example of pricing that is designed to extract harmful rents.”).

32. TREASURY-HUD JOINT REPORT, *supra* note 2, at 22. Governor Gramlich noted that “groups that have disproportionately been prey for unscrupulous creditors are women, minorities, and lower-income households. The activities, referred to collectively as predatory lending, are a scourge on the mortgage industry.” Gramlich, *supra* note 19.

A recent HUD report concluded that subprime lending and its accompanying abuses occur much more often in low-income neighborhoods: “In low-income neighborhoods, subprime loans accounted for 26 percent of total loans in 1998—compared with only 11 percent in moderate-income neighborhoods and just 7 percent in upper-income neighborhoods. Comparable 1993 figures were 3 percent in low-income neighborhoods and 1 percent each in moderate-income and upper-income neighborhoods.” UNEQUAL BURDEN, *supra* note 4, at 2. Subprime loans are over three times more likely in low-income neighborhoods than high-income neighborhoods. *Id.*

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for home loans, which disruptions may decrease the availability of credit.

Unscrupulous lenders often target the elderly because they typically have substantial equity in their homes.³³ According to the AARP, “[n]early 80 percent of older Americans are homeowners, and 80 percent of these older homeowners own their homes free and clear [of any liens]. . . . [O]ver 60 percent of homeowners age 65 and older had at least \$50,000 in home equity.”³⁴ Elderly homeowners are often cash poor, live on fixed incomes, and have substantial medical problems, as well as “diminished faculties, and isolation that impair their ability to understand loan terms and/or make them especially vulnerable to aggressive sales tactics.”³⁵ These unique circumstances and vulnerabilities place the elderly in a particularly precarious position and often make them easier targets for predatory lenders.

Increased levels of subprime lending in minority communities suggest that such communities may be subject to increased lending abuses. The United States Department of Housing and Urban Development (“HUD”) reported that five times more subprime loans are originated in predominantly African-American neighborhoods than white neighborhoods.³⁶ While not all subprime lending is predatory, and “subprime lending is an important element of our financial system[] because it delivers credit to those that may otherwise be unable to obtain credit,” the subprime market “appears more susceptible to abusive lending practices than is the prime market. A subprime borrower may have few financial options

33. See Gramlich, *supra* note 19 (explaining that “lenders often target elderly homeowners, who tend to have the highest levels of equity in their homes”).

34. MIKE CALHOUN ET AL., AARP PUB. POLICY INST., HOME LOAN PROTECTION ACT, A MODEL STATUTE 5 (2001).

35. See TREASURY-HUD JOINT REPORT, *supra* note 2, at 72; see also James H. Carr & Lopa Kolluri, *Predatory Lending, in* FINANCIAL SERVICES IN DISTRESSED COMMUNITIES: ISSUES AND ANSWERS 32–33 (Fannie Mae Foundation ed., 2001) (explaining that predatory lenders often target elderly homeowners and “people with limited education who are not adept in financial matters and lack the financial sophistication to scrutinize loans,” and discussing fraudulent practices used against such groups).

36. “In predominantly black neighborhoods, the high-cost subprime lending accounted for 51 percent of home loans in 1998—compared with only 9 percent in predominately white areas. Comparable 1993 figures were 8 percent in black neighborhoods and 1 percent in white neighborhoods.” UNEQUAL BURDEN, *supra* note 4, at 2.

available or less information on loan terms and conditions and less opportunity to shop for the best terms and conditions available.”³⁷

In addition to the social problems predatory lending causes, predatory lending practices and the regulatory responses they have elicited have created market disruptions that may counteract efforts to increase home ownership by decreasing the availability of credit. In response to state and local regulations that impose restrictions on high-cost home loans and attempt to stop abusive practices, some lenders have withdrawn from the secondary market where securitized home loans are sold and which provides the main source of funding for the home mortgage market.³⁸ For instance, in response to the enactment of Georgia’s initial Fair Lending Act, which prohibited

37. TREASURY-HUD JOINT REPORT, *supra* note 2, at 51. The Treasury-HUD report explained further the connection between subprime lending and predatory practices as follows:

Evidence of predatory lending practices generally arises from the subprime mortgage market. While predatory lending can occur in the prime market, such practices are for the most part effectively deterred by competition among lenders, greater homogeneity in loan terms and the prime borrowers’ greater familiarity with complex financial transactions. In combination, these factors make prime borrowers more likely to shop for the best loan terms and less likely to fall victim to predatory loans. In addition, many prime lenders are banks, thrifts, and credit unions that are subject to extensive oversight and regulation by federal and state governments.

The subprime market, in contrast, provides much more fertile ground for predatory lending practices. Several factors contribute to this result.

The characteristics of many subprime borrowers make them more easily manipulated and misled by unscrupulous actors. Many subprime borrowers who have had difficulty obtaining credit in the past may underestimate their ability to obtain new sources of credit, which may make them more likely to accept the first offer of credit they receive, rather than shop for a loan with the best possible terms. In addition, subprime borrowers may be more in need of immediate funds due to the heightened challenge of meeting household and emergency expenses on their lower incomes.

Many subprime borrowers live in low-income and minority communities that are comparatively underserved by traditional prime lenders. As a result, many of these communities suffer from insufficient competition among lenders, so that better loan terms may be harder to find, or persons may be unaware of them.

The subprime mortgage and finance companies that dominate mortgage lending in many low-income and minority communities, while subject to the same consumer protection laws, are not subject to as much federal oversight as their prime market counterparts—who are largely federally-supervised banks, thrifts, and credit unions. The absence of such accountability may create an environment where predatory practices flourish because they are unlikely to be detected.

Id. at 17–18.

38. GREGORY ELLIEHAUSEN & MICHAEL STATEN, REGULATION OF SUBPRIME MORTGAGE PRODUCTS: AN ANALYSIS OF NORTH CAROLINA’S PREDATORY LENDING LAW 2 (Credit Research Center, McDonough Sch. of Bus., Working Paper No. 66, 2002).

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high-cost loans and imposed liability on lenders that made such loans and on those that purchased them, Moody's Investors Service concluded that "including GFLA-covered loans in securitizations was too risky, causing lenders to scale back loans in the state and leading issuers to remove Georgia loans from securitizations."³⁹ Standard and Poor's also announced that it would no longer rate mortgage-backed securities that included Georgia mortgage loans.⁴⁰ Government-sponsored entities Fannie Mae and Freddie Mac, both major purchasers of securitized loans and an important capital source for the credit markets, have also taken measures aimed at reducing the possibility of purchasing abusive loans and have refused to purchase loans that are considered high-cost based upon federal standards.⁴¹

III. FEDERAL PREEMPTION OF THE GFLA AND OTHER STATE LAWS: THE DOOR IS OPEN

Although both federal and state regulators and legislators have taken aim at predatory practices and attempted to stop them through various regulatory devices, controversy still exists about who should regulate such practices and to what extent.⁴² Federal agencies, particularly the OCC and the OTS,⁴³ have expressed concern that state predatory lending regulation interferes with the ability of national financial institutions to make real estate loans and have issued determinations that certain state predatory lending laws,

39. GFLA Preemption Determination, *supra* note 7, at 46278.

40. *Id.*

41. See generally FREDDIE MAC, PROTECTING BORROWERS FROM PREDATORY LENDING PRACTICES (2002), available at http://www.freddiemac.com/corporate/affordhouse/predlend/apl_fact.html; Press Release, Fannie Mae, Fannie Mae Chairman Announces New Loan Guidelines to Combat Predatory Lending Practices (Apr. 11, 2000), available at <http://www.fanniemae.com/newsreleases/2000/0710.html>.

42. See generally *Hearings*, *supra* note 1 (discussing the predatory lending problem and various responses to it); Milner, *supra* note 7 (opposing federal preemption of state predatory lending laws, specifically the Georgia Fair Lending Act, and arguing that states have the power to regulate national and state banks); GFLA Preemption Determination, *supra* note 7 (preempting the Georgia Fair Lending Act as it applies to federally chartered banks and concluding that Georgia's act interferes with national bank real estate lending powers); Robert M. Jaworski, *Legislating Against Bad Loans: The State/Local Battleground*, 58 BUS. LAW. 1228, 1242 (2003) (discussing various state and local attempts to regulate predatory loans and suggesting that such attempts make it difficult for lenders to operate efficiently).

43. The OCC and OTS are charged with regulating nationally chartered banks and nationally chartered savings and thrift associations, respectively.

notably the GFLA, do not apply to nationally chartered financial institutions.⁴⁴ State and local policymakers, on the other hand, insist that federal laws and regulations are not strict enough and have enacted new laws and regulations to address the problem.⁴⁵ Sections A and B of this Part discuss the scope of the OCC and OTS preemption decisions, respectively, demonstrating that state predatory lending legislation similar to that enacted by Georgia can no longer address the predatory lending problem effectively. Section C then outlines the reasons why exclusive federal regulation in this area would not be sufficient to stop the predatory lending problem and why, therefore, states should be allowed to regulate in the ways suggested in Part IV.⁴⁶

A. The OCC's Preemption of the GFLA

In spite of states' concerns and desire to regulate in this area, the OCC has become increasingly unwilling to allow state predatory lending laws to operate against federally chartered banks. Notably, the OCC recently released a preemption order and determination that the GFLA does not apply to nationally chartered banks or their subsidiaries that operate within Georgia.⁴⁷

44. See GFLA Preemption Determination, *supra* note 7; OTS GFLA Preemption Letter, *supra* note 9; OTS NJHOSA Preemption Letter, *supra* note 9.

45. See generally Jaworski, *supra* note 42 (discussing various state and local attempts to regulate predatory loans).

46. The purpose of this Comment is not to analyze the substantive correctness of the OCC and OTS preemption determinations. Although the propriety of those decisions is arguable, their correctness is conceded for the purposes of this Comment. This Comment simply seeks to provide solutions to the predatory lending problem that can be followed by state legislators and regulators without fear of preemption by federal law. The propositions made here allow states to continue efforts to stop predatory lending in spite of the OCC's and OTS's willingness to preempt state statutes aimed at predatory lending, even if the OCC determines, based on its recently proposed rulemaking discussed below, that it occupies the field of real estate lending regulation with respect to national banks. Because the federal government has not and arguably cannot produce a solution that will fully address the predatory lending problem, states must seek remedies for the problem, such as those suggested here, that cannot be preempted by federal regulators.

47. GFLA Preemption Determination, *supra* note 7, at 46281 (concluding that "the GFLA does not apply to National City or any other national bank or national bank operating subsidiary that engages in real estate lending activities in Georgia").

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1. Background

The GFLA was enacted in 2002 as Georgia's bid to stop predatory lending, which Georgia legislators perceived to be an increasing problem.⁴⁸ It prohibits the financing of single premium credit accident, health, or life insurance,⁴⁹ places limitations on late payment charges and fees,⁵⁰ prohibits "flipping" and provides for damages for victims of such practices,⁵¹ and places other substantial limitations on loans that are defined by the act as "high-cost."⁵²

In response to the GFLA's restrictions, National City Bank, a nationally chartered bank incorporated in Indiana that was an active lender in Georgia, sought a determination from the OCC that the

48. Georgia Fair Lending Act, GA. CODE ANN. §§ 7-6A-1 to -13 (2002) (amended 2003). The GFLA was amended in 2003 in response to criticisms from various lending interests.

49. *Id.* § 7-6A-3(1). The statute provides:

No creditor shall make a home loan that finances, directly or indirectly:

(A) Any credit life, credit accident, credit health, credit personal property, or credit loss-of-income insurance, debt suspension coverage, or debt cancellation coverage, whether or not such coverage is insurance under applicable law, that provides for cancellation of all or part of a borrower's liability in the event of loss of life, health, personal property, or income or in the case of accident written in connection with a home loan; or

(B) Any life, accident, health, or loss-of-income insurance without regard to the identity of the ultimate beneficiary of such insurance; provided, however, that for the purposes of this Code section, any premiums or charges calculated and paid on a monthly basis shall not be considered financed directly or indirectly by the creditor.

Id.

50. *Id.* § 7-6A-3(3).

51. *Id.* § 7-6A-4. Subpart (a) of §7-6A-4 provides:

No creditor may knowingly or intentionally engage in the unfair act or practice of "flipping" a home loan. Flipping a home loan is the consummating of a high cost home loan to a borrower that refinances an existing home loan that was consummated within the prior five years when the new loan does not provide reasonable, tangible net benefit to the borrower considering all of the circumstances including, but not limited to, the terms of both the new and refinanced loans, the cost of the new loan, and the borrower's circumstances.

Id. § 7-6A-4(a). Also, damages are available for violations. *Id.* § 7-6A-4(c).

52. *Id.* § 7-6A-5. Some of the limitations this section places on high-cost loans include limitations on prepayment fees (§7-6A-5(1)), on loan terms that call for an increase in interest rates after default (§7-6A-5(4)), and on the ability of a lender to make a loan before the borrower has received counseling from an approved, independent third-party (§7-6A-5(7)). The section also prohibits a creditor from making a high-cost home loan "unless a reasonable creditor would believe at the time the loan is consummated that the borrower residing in the home will be able to make the scheduled payments" based upon the borrower's financial situation. *Id.* § 7-6A-5(8).

GFLA did not apply to it or its operating subsidiaries.⁵³ In its request, National City Bank asserted “that the GFLA is preempted under various provisions of federal law and that, accordingly, the OCC should conclude that the Georgia law does not apply to it.”⁵⁴ After notice to the public and an opportunity for comment on the issue, the OCC handed down an order which concluded that the substantive provisions of the GFLA do not apply to any nationally chartered banking institution operating within Georgia or any subsidiary of such a nationally chartered bank.⁵⁵

2. Rationale for the OCC’s decision

The OCC found authority to issue the preemption order from 12 U.S.C. § 371(a), which gives national banks the ability to “make, arrange, purchase or sell loans or extensions of credit secured by liens on interests in real estate, subject to section 1828(o) of [the Federal Deposit Insurance Act] and such restrictions and requirements as the Comptroller of the Currency may prescribe by regulation or order.”⁵⁶ The OCC interpreted this grant of power very broadly, stating that “[i]n no respect does the statute express or imply that the power granted is limited, to some variable degree, by application of fifty different state laws.”⁵⁷ Federal preemption principles and the Supremacy Clause do not allow states to “modify a Congressional grant of power to national banks by limiting, conditioning, or otherwise impermissibly affecting a national bank’s exercise of that power.”⁵⁸

3. Scope of the OCC’s determination

Based on regulations that the OCC had already properly enacted pursuant to § 371, the OCC reasoned further that various types of state rules regulating national bank real estate lending do not apply to national banks. Specifically, 12 C.F.R. § 34.4(a) lists five areas of

53. GFLA Preemption Determination, *supra* note 7, at 46265–66.

54. *Id.* at 46264.

55. *See id.*

56. 12 U.S.C. §371(a) (2000). The OCC’s order states that “[t]he Federal statute that authorizes national banks’ real estate lending activities, 12 U.S.C. 371, precludes application of many provisions of the GFLA to national banks.” GFLA Preemption Determination, *supra* note 7, at 46266.

57. GFLA Preemption Determination, *supra* note 7, at 46276.

58. *Id.* at 46266.

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state laws and limitations that do not apply to national banks in the area of mortgage lending, two of which covered GFLA provisions.⁵⁹ First, under § 34.4(a)(2),⁶⁰ GFLA restrictions on balloon payments, negative amortization provisions, advance payment provisions, and provisions against late fees, regulation of prepayment fees, and provisions limiting default rates of interest were all preempted and not applicable to national banks.⁶¹ Second, § 34.4(a)(3)⁶² expressly preempted GFLA provisions governing limitations on prepayment fees, prohibitions on the ability of a lender to accelerate the loan absent default by the borrower, and provisions giving borrowers a right to cure any default that occurred over the term of the loan.⁶³

The OCC's order also determined that additional GFLA provisions were preempted under the broader preemption principle stated in 12 C.F.R. § 34.4(b).⁶⁴ Under this provision, the OCC applied a traditional preemption analysis based upon the United States Supreme Court's preemption jurisprudence.⁶⁵ Because the GFLA conditioned the exercise of § 371 "upon the approval of the states," provisions of the GFLA were preempted.⁶⁶ The following

59. 12 C.F.R. § 34.4(a) (2003); *see also* GFLA Preemption Determination, *supra* note 7, at 46276 ("Section 34.4(a) expressly preempts state laws concerning five areas of fixed-rate mortgage lending Two of the five types of state laws expressly preempted by § 34.4(a)—state laws concerning the schedule for the repayment of principal and interest (§ 34.4(a)(2)) and the term to maturity of the loan (§ 34.4(a)(3))—are relevant here.").

60. 12 C.F.R. § 34.4(a)(2) (providing that a state cannot regulate the "schedule for the repayment to principal and interest").

61. *See* GFLA Preemption Determination, *supra* note 7, at 46276.

62. 12 C.F.R. § 34.4(a)(3) (prohibiting states from regulating the "term to maturity of the loan").

63. GFLA Preemption Determination, *supra* note 7, at 46276–77.

64. 12 C.F.R. § 34.4(b) (proclaiming that "[t]he OCC will apply recognized principles of Federal preemption in considering whether State laws apply to other aspects of real estate lending by national banks").

65. A federal law preempts state law (1) where Congress has expressly preempted state law, *Schneidewind v. ANR Pipeline Co.*, 485 U.S. 293, 299–300 (1988); (2) where Congress has occupied the field the state seeks to regulate, leaving no room for state legislation; or (3) where state law "actually conflicts with federal law," *id.*; *see also* *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947).

A state law conflicts with federal law when (1) it is impossible to comply with both laws, or (2) when the state law produces "an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941); *Fla. Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142–43 (1963).

66. In coming to this conclusion, the OCC relied on the Supreme Court's reasoning in *Barnett Bank of Marion County v. Nelson*, 517 U.S. 25, 34–35 (1996), which interpreted 12 U.S.C. § 92, a statute that gives national banks the power to act as agents for insurance sales.

GFLA provisions impose requirements that a national bank must satisfy before exercising lending powers granted to it by Congress and are therefore preempted under the § 34.4(b) preemption principle: the “financing of credit insurance and debt suspension and debt cancellation fees,” “restrictions on refinancings,” the requirement that borrowers receive counseling prior to receiving a loan, restrictions on underwriting standards, limits on home improvement loans, and certain notice requirements.⁶⁷ Additional provisions are preempted because they interfere with the power of national banks to make real estate loans, including a provision discouraging the use of mandatory arbitration, a provision imposing liability on assignees of loans, a requirement that lenders not encourage default by borrowers, and a requirement that contractors be liable for the loans they produce.⁶⁸

Finally, the OCC determined that some GFLA provisions are preempted under 12 U.S.C. § 24 (Seventh) and 12 C.F.R. § 7.1004.⁶⁹ These sections preempt GFLA provisions prohibiting payoff balance and release fees, provisions providing the borrower

See GFLA Preemption Determination, *supra* note 7, at 46277. The OCC reasoned that “as recognized by the Supreme Court in *Barnett*, the history of national bank powers is one of ‘interpreting grants of both enumerated and incidental “powers” to national banks as grants of authority not normally limited by, but rather ordinarily pre-empting, contrary state law.’” *Id.* at 46274 (quoting *Barnett*, 517 U.S. at 32). “[W]here Congress has not expressly conditioned the grant of ‘power’ upon a grant of state permission, the Court has ordinarily found that no such condition applies.” *Id.* at 46275 (quoting *Barnett*, 517 U.S. at 34).

The OCC further explained that state laws do not normally apply when they alter or condition a national bank’s ability to exercise a power that federal law grants to it. States are allowed to regulate areas of contract, debt collection, acquisition and transfer of property, taxation, zoning, criminal, and tort law. These types of laws regulate the “legal infrastructure that surrounds and supports the conduct of that business. They promote a national bank’s ability to conduct business; they do not obstruct a national bank’s exercise of powers granted under Federal law.” *Id.* at 46274–75. The GFLA, on the other hand, regulates the manner and content of national bank’s lending activities, which is prohibited under § 371 and recognized principles of federal preemption. *Id.*

67. GFLA Preemption Determination, *supra* note 7, at 46277.

68. *Id.* at 46278.

69. *Id.* at 46279. The preemption determination also noted that section 24 (Seventh) authorizes a national bank to engage in activities that are part of, or incidental to, the business of banking as well as to engage in certain specified activities listed in the statute. A bank’s authority to provide these services to its customers necessarily encompasses the ability to charge a fee for them, and this ability to charge a fee for the bank’s services is expressly affirmed in 12 CFR 7.4002(a).

Id.

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the right to cure default, and provisions limiting the rate of interest a national bank can charge.⁷⁰

B. The OTS Preemption Determinations

In an action similar to but preceding the OCC's determination that the GFLA does not apply to national banks or their operating subsidiaries, the OTS also decided that the GFLA does not apply to federally regulated savings and thrift associations.⁷¹ The OTS followed a line of reasoning similar to that of the OCC, explaining that, under the Home Owners' Loan Act ("HOLA"), Congress required the OTS "to provide for the organization, incorporation, examination, operation, and regulation of federal savings associations."⁷² Based on this language, the

OTS has made clear in its lending regulations its intent to carry out this congressional objective by giving federal savings associations maximum flexibility to exercise their lending powers in accordance with a uniform federal scheme of regulation. That uniform federal scheme occupies the field of regulation for lending activities. The comprehensiveness of the HOLA language demonstrates that Congress intended the federal scheme to be exclusive, leaving no room for state regulation, conflicting or complimentary.⁷³

OTS regulations promulgated under HOLA give federal savings associations the ability to make loans under federal law without approval or interference from state laws or regulators.⁷⁴ Thus, "GFLA provisions purporting to regulate the terms of credit, loan-related fees, disclosures, or the ability of a creditor to originate or refinance a loan, are preempted by federal law from applying to federal savings associations."⁷⁵

70. *Id.*

71. OTS GFLA Preemption Letter, *supra* note 9, at 1 ("We conclude that GFLA provisions purporting to regulate the terms of credit, loan-related fees, disclosures, or the ability of a creditor to originate or refinance a loan, are preempted by federal law from applying to federal savings associations and their operating subsidies."). As noted briefly above, the OCC has regulatory power over federally chartered banking institutions while the OTS is charged with regulating federally chartered savings and thrift associations. Thus, the OCC's preemption determination has application only to federally chartered banks, while the OTS's decision applies to federally chartered savings and thrift associations.

72. *Id.* at 2.

73. *Id.* at 2 (footnote omitted).

74. *Id.* at 2-3.

75. *Id.* at 2.

Just a few months after the issuance of the letter preempting the GFLA, the OTS issued a second preemption letter regarding New Jersey's abusive lending practices legislation, the New Jersey Home Ownership Security Act.⁷⁶ Following its reasoning in the GFLA preemption order and using identical language, the OTS reaffirmed its conclusion that it alone is authorized to impose conditions upon federal savings associations' lending activities.⁷⁷

*C. Why Exclusive Federal Regulation of Predatory
Lending Is Insufficient*

Because of the broad preemptive scope of these OCC and OTS determinations, it is unlikely that state restrictions on predatory practices will ever be effective against federal savings and thrift associations, thus underscoring the importance of finding ways to regulate such practices without interfering with the powers of the OCC and OTS to regulate in this area. In addition to these preemption determinations, the OCC has also recently released a proposed rule that may allow it to completely preempt the field of regulation of national bank real estate lending, therefore making it impossible for states to take any kind of action against national banks operating within their borders.⁷⁸ While it is true that the OCC and OTS preemption determinations do not serve to remove the enacted statutes from the states' books, they do substantially limit the ability of states to effectively legislate against abusive lending practices in two ways.

First, the GFLA contains a parity provision that serves to place state-chartered banks on the same level as federally chartered banks with regard to regulatory strictures.⁷⁹ If the GFLA provisions are

76. See N.J. STAT. ANN § 46.10B-22 (West 2002); OTS NJHOSA Preemption Letter, *supra* note 9.

77. OTS NJHOSA Preemption Letter, *supra* note 9, at 4–5.

78. Bank Activities and Operations; Real Estate Lending and Appraisals, 68 Fed. Reg. 46119 (proposed Aug. 5, 2003) (to be codified at 12 C.F.R. pts. 7 & 34) (proposing to amend C.F.R. parts 7 and 34 “to add provisions clarifying the applicability of state law to national banks[,] provisions [which] would identify types of state laws that are preempted, as well as types of state laws that generally are not preempted, in the context of national bank lending, deposit-taking, and other authorized activities”).

79. GA. CODE ANN. § 7-6A-12 (2002) (stating that the provisions of the GFLA will not apply to state-chartered financial institutions to the “extent federal law precludes or preempts or has been determined to preclude or preempt the application of the provisions of this chapter to any federally chartered bank”).

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preempted on a federal level so that they no longer apply to nationally chartered banks, those provisions also do not apply to state institutions, which nullifies the law's effect against state lenders as well as national lenders.⁸⁰ The Georgia Attorney General has issued an opinion that the parity provision has taken effect as a result of the OCC's decision; the GFLA, therefore, no longer applies to state banks or federal banks, which leaves regulation of abusive lending practices unchanged from the way they were prior to GFLA's enactment.⁸¹ Similar results may follow for states that enact predatory lending statutes with parity provisions that resemble the one contained in the GFLA.

Second, even in situations where state predatory lending laws do not contain parity provisions like Georgia's, and the law remains in effect against state banks, OCC preemption means that state regulation cannot reach nationally chartered financial institutions. OCC preemption and its recent proposed rulemaking, mentioned above, which could potentially allow the OCC to occupy the field of national bank real estate lending and totally preempt the states from regulating national bank real estate lending, it is becoming increasingly unlikely that federally chartered financial institutions will be subject to state predatory lending measures in the future.⁸² As the problem of predatory lending continues, and federal agencies show a willingness to preempt state regulations that affect nationally chartered financial institutions, states that have enacted legislation similar to Georgia's are left with fewer options for protecting at-risk consumers in the subprime market.

Furthermore, increased regulation of predatory lending practices on the federal level will not adequately protect consumers. Although it is possible that federal regulatory agencies and Congress could enact additional legislation that applies to nationally chartered lending institutions and heighten existing standards under federal laws such as HOEPA, TILA, and RESPA,⁸³ significant changes to the federal regulatory structure that address predatory lending

80. *See generally* Memorandum from Bo Fears, *supra* note 13.

81. *See id.* (explaining that the OCC's preemption order is a preemption determination within the meaning of the GFLA's parity provision, which, according to that provision, leads to the conclusion that the GFLA does not apply to state banks).

82. *See* Bank Activities and Operations, *supra* note 78.

83. TREASURY-HUD JOINT REPORT, *supra* note 2, at 53-54 (outlining HOEPA's, TILA's, and RESPA's provisions).

practices have not yet been put in place. As noted by the Departments of Treasury and HUD throughout their report on the topic, the federal scheme for regulating predatory practices contains gaps and could be adjusted significantly to provide adequate protection.⁸⁴ States enacted their laws, at least in part, to fill the federal gaps, and to date the federal government has made no significant changes to address the predatory lending problem.

Even if the federal scheme is changed significantly, the problem is complicated by the fact that many federal regulations would not apply to state banks. The American dual banking system gives the authority to regulate a bank to the government that chartered it.⁸⁵ Although many of the federal laws apply to state and federal banks alike (such as HOEPA, TILA, and RESPA), the “day-to-day” oversight of state-chartered banks is performed by state regulatory agencies, while federal banks and other financial institutions are regulated solely by the OCC and the OTS.⁸⁶ If Congress fails to enact additional protections or amend existing laws that are applicable to both state and federal banks, and if states do not find solutions to the predatory problem that are effective against both state and federal lenders, such as those suggested in Part IV, predatory practices may remain largely unregulated.

However, additional action by Congress in this area may not be desirable and, at any rate, would not be a panacea. A blanket federal solution is not adequate or necessary to solve the problem; each jurisdiction requires a distinct response that is tailored to fit the situation. The Treasury-HUD Joint Report notes that “the exact nature of abusive lending practices often varies from community to community,” and concludes that “[s]tate regulators and enforcement agencies . . . may be best equipped to understand the roots of the problems that exist within their own borders.”⁸⁷ For instance, empirical evidence suggests that the predatory lending problem in urban areas with large minority communities is different than the problem that exists in areas where such communities do not

84. *Id.* at 69–71, 75, 77, 82, 84–88 (recommending that changes be made to HOEPA, TILA, and RESPA to better combat predatory lending abuses).

85. Henry N. Butler & Jonathan R. Macey, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677, 677 (1988).

86. *Id.*

87. TREASURY-HUD JOINT REPORT, *supra* note 2, at 83.

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exist.⁸⁸ The predatory lending problem in urban, minority communities results from the higher rate of subprime lending that occurs in those areas.⁸⁹ By contrast, the problem in Utah, for example, is much different. Although many borrowers in Utah are being saddled with loans they cannot handle—a common practice among predatory lenders—the fraud in that jurisdiction often includes participation by the borrowers themselves, who assist mortgage brokers in the inflation of incomes and other such practices in order to be approved for a home they could not otherwise afford.⁹⁰ Problems faced in various jurisdictions require a distinct regulatory response.

IV. SOLUTIONS FOR STATES IN THE FACE OF FEDERAL PREEMPTION

Because federal regulatory agencies are prone to preempt state efforts, because federal regulation is incomplete, and because blanket federal regulation will not fully address the problem, it is important that states develop solutions that are effective in stopping predatory lending abuses, that do not interfere with federal financial institutions' lending powers, and that do not restrict regulations promulgated by federal regulatory agencies pursuant to their perceived regulatory powers. This Part provides two suggestions for states to curb predatory lending abuses in spite of these obstacles: the regulation of mortgage loan sellers and increased prosecution through state unfair and deceptive trade practices acts. Although other solutions to the predatory lending problem exist, these suggestions effectively address the problem and cannot be preempted by federal regulatory agencies.

88. *See supra* Part II.B.

89. U.S. DEP'T OF HOUS. & URBAN DEV., *UNEQUAL BURDEN IN CHICAGO: INCOME AND RACIAL DISPARITIES IN SUBPRIME LENDING* 3, 5 (2000) (finding a higher rate of subprime loans being made in certain minority communities than in white communities of Chicago and suggesting that these higher rates may lead to an increase in predatory lending abuses such as "excessive mortgage fees, interest rates, penalties and insurance charges that raise the cost of refinancing by thousands of dollars for individual families"). For other regional analyses making similar conclusions, see U.S. DEP'T OF HOUS. & URBAN DEV., *UNEQUAL BURDEN IN ATLANTA: INCOME AND RACIAL DISPARITIES IN SUBPRIME LENDING* (2000); U.S. DEP'T OF HOUS. & URBAN DEV., *UNEQUAL BURDEN IN BALTIMORE: INCOME AND RACIAL DISPARITIES IN SUBPRIME LENDING* (2000); U.S. DEP'T OF HOUS. & URBAN DEV., *UNEQUAL BURDEN IN LOS ANGELES: INCOME AND RACIAL DISPARITIES IN SUBPRIME LENDING* (2000); U.S. DEP'T OF HOUS. & URBAN DEV., *UNEQUAL BURDEN IN NEW YORK: INCOME AND RACIAL DISPARITIES IN SUBPRIME LENDING* (2000).

90. Lesley Mitchell, *Home Loan Fraud Soaring*, SALT LAKE TRIB., Oct. 23, 2003, at E1.

A. Increased Regulation of Nonbank Loan Sales

As explained in Part II, the problem of predatory lending arises primarily because of unscrupulous, deceptive, and fraudulent sales tactics. Sellers of loans, just like any salesperson, have obvious incentives to sell loans—namely, they stand to profit. Because of this, unregulated nonbank sellers of loans—primarily mortgage brokers—are a significant part of the predatory lending problem. Inadequate or nonexistent regulation, pricing structures that give mortgage brokers incentives to sell loans that may not be appropriate for particular borrowers, and the facts that brokers do not actually back the loan financially and do not take on the credit risk themselves, create a significant risk that some mortgage brokers will be tempted to engage in predatory lending practices. States can remedy this problem, at least partly, by increasing mortgage broker licensing and registration requirements and by providing better oversight and additional guidance through a regulatory agency.

1. Nonbank loan sellers are the main source of the predatory lending problem

Mortgage brokers—nonbank loan sellers—facilitate as many as two-thirds of all home loans⁹¹ and originate fifty percent of subprime loans.⁹² “[T]he growth of this industry has brought with it increasing complaints of mortgage fraud and predatory lending.”⁹³ Although brokers process and originate most home loans, regulation of brokers, which is done at the state level, is uneven or nonexistent in some cases. A group of state attorneys general, writing as amicus curiae in a recent case regarding an OTS rulemaking, claimed that

[b]ased on consumer complaints received, as well as investigations and enforcement actions undertaken by the Attorneys General, predatory lending abuses are largely confined to the subprime mortgage lending market and to nondepository institutions.

91. GUTTENTAG, *supra* note 21, at 7 (“Brokers today touch about 2/3 or more of all home loans.”).

92. TREASURY-HUD JOINT REPORT, *supra* note 2, at 39–40 (“According to the National Association of Mortgage Brokers, mortgage brokers arrange financing for well over half of all home mortgages today. The National Home Equity Mortgage Association also reports that about 50 percent of subprime loans are originated through mortgage brokers.”).

93. V. Lynne Windham, *Alabama’s New Mortgage Brokers Licensing Act*, 64 ALA. LAW. 52, 53 (2003).

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Almost all of the leading subprime lenders are mortgage companies and finance companies, not banks or direct bank subsidiaries.⁹⁴

Not only do mortgage brokers facilitate most home mortgage loans and most subprime loans, the role of a mortgage broker in a loan transaction is extensive, giving unscrupulous mortgage brokers ample opportunity to engage in predatory practices. Mortgage brokers provide a service to those seeking a home loan by counseling with them, helping them select and qualify for a loan, shopping for the best rate among various lenders, and locking in the terms of the loan with the lender.⁹⁵ Mortgage brokers also provide federally mandated disclosures, gather all documentation necessary to get the loan through the lender's underwriting process, order property appraisals and borrower credit reports, verify the borrower's source of income, facilitate the loan closing, and see the loan through until it is later given over completely to the lender.⁹⁶ The broker usually provides all the necessary services required to generate the loan, with the exception of providing the loan funds.⁹⁷ Typically, once the loan is closed and the broker is paid, his relationship with the borrower ceases and the lender is involved exclusively with servicing the borrower's loan.⁹⁸

Because of their extensive involvement in the lending process and the relationship of trust and counseling they often have with their clients, mortgage brokers are also in a unique position that may allow them to take advantage of unwary borrowers. Brokers

94. OCC Preemption Determination and Order Concerning the Georgia Fair Lending Act, Questions and Answers, July 31, 2003, at 1–2 (citing Brief for Amicus Curiae State Attorneys General, Nat'l Home Equity Mortgage Ass'n v. OTS, Civil Action No. 02-2506 (GK) (D.D.C. 2003) (regarding predatory lending filed in a litigation concerning an OTS rulemaking)). Also,

predatory lending generally does not occur in a vacuum. Rather, it breeds in an environment characterized by little competition for traditional financial services. Specifically, a community flush with 'fringe lenders'—check cashing outlets, pawnshops, rent-to-own stores, title lenders, and similar operations—as well as excessive subprime lending, is the environment in which predatory lending activities often flourish.

Carr & Kolluri, *supra* note 35, at 32.

95. GUTTENTAG, *supra* note 21, at 7.

96. *Id.*

97. *Id.*

98. *Id.*

may hide disclosures from borrowers, begin work on a borrower's home and then "bait and switch" with new loan terms before the loan is closed, finance fees without borrowers' knowledge, or lead them to believe that they must purchase products such as credit insurance in order to close the loan.⁹⁹

Many third party brokers engage in "aggressive marketing and solicitation tactics" that sometimes "rise to the level of fraud or illegal deception."¹⁰⁰

Mortgage brokers engage in such practices because of the real potential for financial gain. The broker compensation system is such that "brokers are paid by borrowers and in many cases, by lenders The total from both sources is their gross profit from a transaction."¹⁰¹ While the amount of the borrower-paid portion of the fee is typically ascertainable before or at the closing of the loan, the amount the lender pays to the broker is often paid in the form of a confusing and nontransparent "yield-spread premium," which, in the end, comes out of the borrower's pocket as well. A yield-spread premium—a fee kicked back from the lender to the broker— "is inflated interest on a loan that is used to cover the cost of the broker's fee."¹⁰² One study of such premiums determined that, in the prime market,

[brokers] added an average cost of over \$1,100 on each transaction in which they were charged. The author found that the most likely explanation for the added cost was not added value, nor added services. Rather, it is a system which lends itself to price discrimination: extra broker-compensation can be extracted from less sophisticated consumers, while it can be waived for the few who are savvy about the complex pricing practices in today's mortgage market.¹⁰³

99. See TREASURY-HUD JOINT REPORT, *supra* note 2, at 24.

100. *Id.* at 79.

101. GUTTENTAG, *supra* note 21, at 7.

102. Anna Beth Ferguson, Note, *Predatory Lending: Practices, Remedies and Lack of Adequate Protection for Ohio Consumers*, 48 CLEV. ST. L. REV. 607, 614 (2000) ("For example, a borrower may qualify for a loan at a 10% annual percentage rate The broker negotiates the loan at a higher rate of 10.25% and then splits the interest premium with the lender.").

103. *Hearings*, *supra* note 1, at 57 n.17 (statement of Thomas J. Miller, Attorney General, State of Iowa).

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Because of the potential of collecting yield-spread premiums from unwary borrowers, some mortgage brokers seek out lenders that serve their own interests by offering the broker the best compensation package rather than looking out for their client's best interests.¹⁰⁴

Even when yield-spread premiums are not involved, broker compensation is based upon the amount of the loan. In order to increase fees and commissions, "brokers have an incentive to encourage the borrowers to take out as large a loan as possible."¹⁰⁵ "The use of brokers has hastened the growth of subprime lending, given that brokers have placed some borrowers who would otherwise qualify for conventional loans into subprime loans because of the greater broker fees from subprime loans."¹⁰⁶ These compensation features cause divided loyalties, since the broker should be looking out for the interests of her client. "As with most other transactions in our increasingly complex society, these borrowers rely on the good faith and honesty of the 'specialist' to help provide full, accurate, and complete information and explanations. Unfortunately, much predatory lending is a function of misplaced trust."¹⁰⁷ Although mortgage brokers act in many ways as agents for their clients and stand in relationships of trust with them, the compensation system can lead to unfavorable results for borrowers.¹⁰⁸

104. Eggert, *supra* note 24, at 553 (2002) (noting that the "use of brokers may lead to higher fees charged to borrowers, as brokers could be tempted to seek out the lenders that provide the greatest payments to brokers rather than the best rates to borrowers").

105. *Id.*

106. *Id.* at 553–54. One source notes that

A 5 percent fee from a borrower who needs—and wants—just \$5000 for a roof repair is only \$250. But if the broker turns that into a refinance loan, of \$40,000, further padded with another \$10,000 of financed points, fees, and insurance premiums, his 5 percent, now \$2,500, looks a lot better.

Hearings, supra note 1, at 57–58 (2001) (statement of Thomas J. Miller, Attorney General, State of Iowa).

107. *Hearings, supra* note 1, at 57–58 (statement of Thomas J. Miller, Attorney General, State of Iowa).

108. Guttentag describes the relationship between a mortgage broker and her client and the problems that can arise from that relationship as follows:

Mortgage brokers can shop lenders much more effectively than consumers, because this is what they do. They are in the market every day. Knowledge of market niches is part of their stock in trade. They have relationships with multiple lenders, and are therefore positioned to find and shop among the lenders offering particular features. And they know the lenders who take 10 days to underwrite a loan and those who take one day.

In addition to these structural problems, it is often the case that, unlike banks and other savings institutions that originate mortgage loans, mortgage brokers are not subject to regulation by state or federal agencies.¹⁰⁹ Regulation of mortgage brokers, which occurs on the state level, is often uneven or nonexistent.¹¹⁰ Often, even if brokers must be licensed, they are not regulated.¹¹¹ As of June 2000, although thirty-nine states had some mortgage broker registration requirement and twenty-nine required proof of net worth, only six states required mortgage brokers to pass a competency test.¹¹² Brokers are often undercapitalized and sometimes simply move from state to state after declaring bankruptcy or otherwise facing consequences for making abusive loans.¹¹³

Furthermore, the mere fact that a broker is licensed does not mean that sellers of unfair loans are caught, prosecuted, or held accountable for engaging in deceptive and unfair sales tactics. In most states, the licensing and enforcement divisions are ineffective when it comes to stopping predatory sales tactics employed by mortgage brokers. As noted in the Treasury-HUD Joint Report,

[t]he subprime mortgage and finance companies that dominate mortgage lending in many low-income and minority communities, while subject to the same consumer protection laws, are not subject to as much federal oversight as their prime market counterparts—who are largely federally-supervised banks, thrifts, and credit unions. The absence of such accountability may create an

Lenders know that brokers are careful and knowledgeable shoppers while most consumers are not. That's why price differences between lenders are smaller in the wholesale market than in the retail market.

But mortgage brokers now shop for themselves. Acting as independent contractors, they have been a major part of the problem.

The key to effective reform of the home loan market is to mandate that mortgage brokers act as agents of borrowers, and that the fees for their services be explicit.

GUTTENTAG, *supra* note 21, at 24–25.

109. Eggert, *supra* note 24, at 554 (“Even in the majority of states that regulate mortgage brokers, the scope and intensiveness of that regulation is often modest compared to that directed at other lending institutions.”).

110. *Id.* (“The amount of regulation of mortgage brokers varies dramatically by state Some states have virtually no regulation.”).

111. TREASURY-HUD JOINT REPORT, *supra* note 2, at 18.

112. *See id.* at 79, Table 6.1.

113. *See id.* at 81 (citing evidence of “thinly capitalized brokers, contractors and lenders who abused consumers, declared bankruptcy, moved to new states and began operating there under different names”).

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environment where predatory practices flourish because they are unlikely to be detected.¹¹⁴

2. What form should state regulation of mortgage brokers take?

The inadequacy of state regulation of mortgage brokers and other loan sellers demonstrates that state policymakers should take thoughtful measures to combat predatory practices. This section suggests some practical solutions that states should consider when enacting regulation targeted at predatory mortgage brokers and other predatory loan sellers.¹¹⁵ States can decrease the rate of abusive lending occurrences among loan brokers by heightening licensing and registration standards for mortgage brokers (including increasing loan officer/originator fitness and competency requirements, requiring proof of adequate capitalization, and increasing or implementing bonding and insurance requirements) and by creating an agency that outlines prohibited acts and contract provisions and enforces violations of such guidelines.¹¹⁶

114. *Id.* at 18. As demonstrated in this section, mortgage brokers and other nonbank loan originators have the opportunity and motive to commit predatory lending abuses. They are also not subject to extensive oversight, which makes it unlikely that such abuses, when they occur, will be detected or stopped. However, it is true that mortgage brokers are not the only source of the predatory lending problem and that there is no way to prove or determine exactly what percentage of predatory lending mortgage brokers account for. Rather than suggesting that all predatory lending is promulgated by mortgage brokers (which suggestion would be untrue and unfair to legitimate mortgage brokers), this Comment merely attempts to show that it is highly likely that a significant number of predatory lending abuses come from the subprime mortgage broker market and that better regulation of mortgage broker sales practices will, therefore, help reduce the occurrence of such lending abuses. As explained, a vast number of mortgages go through the hands of unregulated mortgage brokers, many of whom may have powerful incentives to engage in lending abuses.

115. Each state should carefully analyze the breadth and depth of the abusive lending problem faced by consumers in their state and develop a solution that is tailored to address the problem.

116. Because every form of regulation imposes costs upon the regulator and upon the actors subject to it, the costs and benefits of any action must be weighed. Actions taken to regulate mortgage brokers should be clearly directed at the problem and impose as few costs upon brokers as possible. As stated in the HUD-Treasury report, “[i]mposing additional regulations on brokers, contractors and appraisers will impose costs on all of these parties, not just those who engage in abusive practices. New regulations should seek to protect vulnerable consumers, while not imposing undue compliance burdens on honest market participants.” TREASURY-HUD JOINT REPORT, *supra* note 2, at 81. Also, although it is true that many states have laws in place, aimed at regulating mortgage brokers, that accomplish one or more of the tasks suggested in this part, most states can work to regulate mortgage broker activity more efficiently and in a way that better protects consumers.

a. Licensing and registration of mortgage brokers. Although several states require that mortgage brokers and other loan sellers obtain a license or register with the state before originating loans, many do not.¹¹⁷ Aware of this problem in his state, the President of the Illinois Mortgage Bankers Association commented, "It's too easy to get into this business. . . . It's not good that you could be selling paint at Sears one week and originating loans the next."¹¹⁸ Because of the importance of this issue, and the substantial investment borrowers make when purchasing a home, it is imperative that "[r]esidential mortgage loan originators who work directly with the public . . . be educated, honest, and professional."¹¹⁹ Laws must seek to ensure moral and professional competence among those applying to become mortgage brokers. To be effective, licensing laws should require that every mortgage seller be individually licensed and registered.¹²⁰ States should conduct background investigations to test the ethical fitness of loan originators.¹²¹ Licenses should not be issued to loan officers

117. GOODWIN PROCTER, LLP, STATE LAWS PROTECTING CONSUMERS FROM ABUSIVE AND PREDATORY LENDING PRACTICES 24 (2001), available at http://www.mbaa.org/industry/reports/01/goodwin_0720.pdf (last visited May 10, 2004) (noting that only ten states require loan officers to be licensed or registered with the state, including California, Florida, Hawaii, Indiana, Louisiana, Nevada, New Jersey, Texas, Utah, and Wisconsin). Alabama also enacted mortgage broker licensing legislation in 2001. ALA. CODE § 5-25-1 et seq. (2002).

118. *Loan Battle Brews Anew: Subprime Lenders, Activists Set to Spar Again in Springfield*, CRAIN'S CHI. BUS., Dec. 11, 2000, at 4, available at 2000 WL 8130226 (quoting Ben Israel, president of the Illinois Mortgage Bankers Association).

119. NAT'L ASS'N OF MORTGAGE BROKERS, MODEL STATE STATUTE INITIATIVE: LICENSING, PRE-LICENSURE EDUCATION AND CONTINUING EDUCATION FOR ALL ORIGINATORS 6 (2002) [hereinafter NAMB INITIATIVE]. The National Association of Mortgage Brokers (NAMB) noted the importance of licensing and education requirements and cited such as a goal behind its recent Model State Statute Initiative on the topic. *Id.* ("NAMB firmly believes that part of the solution to consumer abuse and predatory lending is mandatory licensing and education of all residential loan originators."). The initiative is designed to "help reduce the incidence of predatory lending and improve the overall competency of the industry." *Id.*

120. *See id.* at 5.

121. *See id.* at 7 (suggesting that all applicants for a mortgage broker license "submit to a background investigation of, at a minimum, criminal records, and employment history"). Alabama requires that applicants for a mortgage broker license submit six letters of reference concerning the applicant's experience and reputation. ALA. CODE § 5-25-5(c)(3)-(4) (2002). The Alabama law requires that the state conduct a background investigation and that the state "may not license any applicant unless it is satisfied that the applicant may be expected to operate its mortgage brokerage activities in compliance with the laws of this state." *Id.* § 5-25-6(b).

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who have been convicted of a felony or crimes involving fraud, who have been involved in unethical activities, or who have had a financial services license revoked due to past unethical conduct.¹²² Loan officers should be required to pass competency tests that require them to demonstrate the capacity to effectively counsel consumers,¹²³ that test understanding of principles of mortgage ethics and mortgage law, and that otherwise require them to demonstrate familiarity with industry standards and rules.¹²⁴ These fitness and competency requirements should be imposed upon the principals of mortgage companies as well as upon loan officers working for such companies.¹²⁵

In addition to increasing licensing requirements and requiring competency tests, mortgage companies should be required to show that they are financially sound.¹²⁶ Mortgage companies should be

122. In Nevada, the licensing authority can refuse to issue a license to any mortgage company that employs individuals who have been “convicted of, or entered a plea of nolo contendere to” any “felony relating to the practice of mortgage agents,” any “crime involving fraud, misrepresentation or moral turpitude,” or anyone who “[h]ad a financial services license or registration suspended or revoked within the immediately preceding 10 years.” NEV. REV. STAT. § 645B.0243 (2002). Violations of Nevada’s mortgage broker licensing law can result in suspension or revocation of a license as well as fines of up to \$10,000 per violation. *Id.* § 645B.670.

Alabama will not issue a mortgage broker license to any applicant with a principal officer who has been convicted of a felony or any crime involving breach of trust, fraud, or dishonesty. ALA. CODE §5-25-6(c).

123. NAMB INITIATIVE, *supra* note 119, at 9. Nevada law facilitates similar objectives by placing the burden upon lenders to ensure that loan officers and mortgage sellers working for them comply with the law and otherwise understand principles of ethical and sound lending practices. NEV. REV. STAT. § 645B.460.

124. As one commentator notes,

A person who has studied the subject and the law should be able to competently interact with the public and cannot justifiably claim ignorance of permitted and prohibited practices. Testing industry participants also raises the perceived level of professionalism associated with the undertaking, which puts mortgage lenders and brokers more on a par with securities brokers, real estate brokers and others involved in offering complex financial products to the public.

GOODWIN PROCTER, *supra* note 117, at 27.

125. “[E]stablishing minimum educational requirements as well as requiring continuing education will substantially increase each Residential Loan Originator’s awareness of their [sic] responsibility and duty to give consumers fair and honest service.” NAMB INITIATIVE, *supra* note 119, at 10.

126. *See* TREASURY-HUD JOINT REPORT, *supra* note 2, at 81 (noting evidence of “thinly capitalized brokers, contractors and lenders who abused consumers, declared bankruptcy, moved to new states and began operating there under different names”).

required to provide proof of adequate capitalization and should meet minimum bonding and insurance requirements.¹²⁷ Without such requirements,

[a] mortgage broker could easily be judgment-proof in the states that do not require them to be bonded or to maintain a minimum capital. Such mortgage brokers are free to disappear if they are sued. Disreputable brokers have been known to declare bankruptcy, move to another state, and begin business anew under assumed names.¹²⁸

These financial fundamentals would better protect consumers and ensure that consumers have something against which they can recover in the event of a lending abuse in which they are damaged.

b. Set forth prohibited acts and contract provisions and enforce violations. Mortgage lenders should be subject to the supervision of a state regulatory agency that has the power to provide guidelines and enforce them. State enforcement agencies should have power to perform occasional audits to ensure that individual loan sellers and mortgage companies are complying with state and federal laws and regulations.¹²⁹ An enforcement agency should have the power to set forth ethical standards, require licensees to obtain continuing education regarding industry standards, and alert them to developing problems in the industry.¹³⁰ Mortgage broker licensing statutes should allow the agency to revoke individual licenses for violations of standards in addition to licenses issued to mortgage companies, thus removing predatory lenders from the market.¹³¹ Penalties for

127. The Alabama Mortgage Brokers Licensing Act requires that applicants for a mortgage license have a minimum capital net worth of \$25,000. ALA. CODE § 5-25-5(c)(2) (2002).

128. Eggert, *supra* note 24, at 556.

129. The Alabama Act gives enforcement of the Act to the Supervisor of the Bureau of Loans (part of the State Banking Department). ALA. CODE § 5-25-16. Mortgage broker licensees are subject to investigations by examination of their business records. *Id.* § 5-25-9(b).

130. The NAMB Initiative suggests that “[e]very residential mortgage originator, whether a Residential Loan Officer or Principal Mortgage Owner, shall, upon renewal of an existing license, submit proof of satisfactory completion of a course of study.” NAMB INITIATIVE, *supra* note 119, at 9. Alabama’s Act requires mortgage broker licensees to obtain twelve hours of continuing education. ALA. CODE § 5-25-5(b)(6).

131. Violations of the Alabama Act may subject a licensee to suspension or revocation of his mortgage broker license, ALA. CODE § 5-25-14(a), the assessment of civil penalties, *id.* § 5-25-16(b), and could subject him to criminal penalties, *id.* § 5-25-17.

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violations and predatory practices would include fines and increased supervision, as well as prohibitions on collecting fees or requirements that fees obtained through predatory transactions be refunded.

B. Increased Enforcement of State Deceptive Trade Practices Acts

In addition to improving regulation of mortgage brokers and other loan sellers at the state level, states can combat predatory lending practices through increased enforcement of existing deceptive and unfair trade practices acts. Many states have enacted legislation, modeled after the Federal Trade Commission Act (“FTC Act”), aimed at stopping deceptive and unfair trade practices.¹³² These state acts generally protect consumers against a broad range of undesirable, deceptive, and coercive practices.¹³³ In many states, violations can only be prosecuted by state agencies, while others expressly provide private rights of action for violations.¹³⁴

State attorneys general have used state deceptive trade practices acts to combat predatory practices.¹³⁵ In the most notable instance, several states have used their acts against First Alliance Mortgage Company (“FAMCO”), whose

132. *See, e.g.*, NEV. REV. STAT. §§ 598.0903–598.0999; ch. 598A (2002); *see also* 15 U.S.C. § 45 (2000).

133. For example, Nevada Revised Statutes sections 598.0915–598.0925 list practices that are defined as deceptive. Specifically, section 598.0915(15) states that a person who “[k]nowingly makes any . . . false representation in a transaction” engages in a deceptive trade practice, subjecting him to liability under the act. Nev. Rev. Stat. § 598.0915(15). This language could reasonably be interpreted to include representations made in lending transactions.

134. For example, Hawaii, Maine, Oregon, Pennsylvania, Texas, and Washington all provide some sort of private right of action under consumer protection statutes addressing unfair and deceptive trade practices. *See* HAW. REV. STAT. §§ 480-2, 480-13 (2002); ME. REV. STAT. ANN. tit. 5, § 205-A (West 2003); OR. REV. STAT. § 646.638 (2001); 73 PA. CONS. STAT. ANN. § 201-9.2 (West 2003); TEX. BUS. & COM. CODE ANN. § 17.50 (Vernon 2003); WASH. REV. CODE ANN. § 19.86.090 (West 2003); *Bodin v. B. & L. Furniture Co.*, 601 P.2d 848 (Or. Ct. App. 1979). Florida allows anyone to seek injunctive relief under its Uniform Deceptive Trade Practices Act, but only allows consumers, and not competitors, to seek money damages. *See* FLA. STAT. ANN. § 501.211 (West 2003); *Big Tomato v. Tasty Concepts, Inc.*, 972 F. Supp. 662 (S.D. Fla. 1997). Minnesota allows for injunctive relief under its Deceptive Trade Practices Act, but no private damages actions are allowed. *See* MINN. STAT. ANN. § 325D.45 (West 2003); *Mayo Clinic v. Mayo’s Drug and Cosmetic, Inc.*, 113 N.W.2d 852 (Minn. 1962); *Simmons v. Modern Aero, Inc.*, 603 N.W.2d 336 (Minn. Ct. App. 1999).

135. *Hearings, supra* note 1, at 53 (statement of Thomas J. Miller, Attorney General, State of Iowa).

employees were rigorously trained as to how to disguise their 20-point charges through a sales script full of tricky and misleading information designed to mislead consumers into thinking that the charges were much lower than they were. This sales script was dubbed “The Monster Track.” Attorneys General in Minnesota, Massachusetts, Illinois, Florida, California, New York, and Arizona have taken action against the company, along with the Department of Financial Institutions in Washington State. (In the wake of all the litigation and enforcement actions, the company filed bankruptcy.)¹³⁶

Other jurisdictions have also allowed deceptive trade practices acts to be used against lenders for various actions that were considered deceptive or unfair under their states’ respective acts.¹³⁷

Following the lead of the attorneys general in the FAMCO case and others, state regulators and prosecutors can bring actions under state trade practice laws in order to combat predatory practices employed by all types of lending interests, including mortgage brokers and federally and state-chartered banks. State deceptive and unfair trade practices acts can be enforced against national and state banks alike, regardless of the scope of the OCC’s proposed

136. *Id.* at 61.

137. *See In re Russell*, 72 B.R. 855, 870–72 (Bankr. E.D. Pa. 1987) (applying Pennsylvania Unfair Trade Practices and Consumer Protection law to the conduct of a commercial lender); *Haw. Cmty. Fed. Credit Union v. Keka*, 11 P.3d 1, 15 (Haw. 2000) (holding that claims regarding the interest rate of a loan made by a credit union fell within the ambit of the Hawaii unfair practices act and could be brought under that act); *People v. N. Ill. Mortgage Co.*, 559 N.E.2d 14 (Ill. App. Ct. 1990) (reversing order for summary judgment in favor of a mortgage company that was sued by the state for conduct amounting to a pattern of unfair or deceptive acts under the Illinois Consumer Fraud and Uniform Deceptive Practices Acts); *Baird v. Norwest Bank*, 843 P.2d 327, 334 (Mont. 1992) (holding that the Montana Unfair Trade Practices and Consumer Protection Law applies to the conduct of a commercial lender); *Chavers v. Fleet Bank*, No. PC 00-5237, 2001 WL 506776, at *8 (R.I. Super. Apr. 20, 2001) (upholding an action under the Rhode Island Unfair and Deceptive Trade Practices Act by a consumer against Fleet Bank, a federally chartered bank, for employing “bait and switch” tactics in soliciting credit card accounts); *Norwest Mortgage, Inc. v. Salinas*, 999 S.W.2d 846, 851–52 (Tex. App. 1999) (upholding a judgment under the Texas Deceptive Trade Practices Act against lender for deceptive acts in connection with home loan financing); *Wieler v. United Sav. Ass’n of Tex.*, 887 S.W.2d 155, 160 (Tex. App. 1994) (holding that “unconscionable acts in connection with a foreclosure can support recovery” under the Texas Deceptive Trade Practices Act); *Forth Worth Mortgage Corp. v. Abercrombie*, 835 S.W.2d 262, 266 (Tex. App. 1992) (holding that a lender’s act of canceling a borrower’s mortgage protection policy and substituting it for one with less benefits was deceptive and subjected it to liability under the Texas Deceptive Trade Practices Act); *Investors, Inc. v. Hadley*, 738 S.W.2d 737 (Tex. App. 1987) (allowing an action against a lender under the Texas Deceptive Trade Practices Act).

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rulemaking or any other preemptive action federal regulatory agencies take.¹³⁸ As explained in Part III.A, the OCC reasoned in its

138. The Supreme Court of Connecticut ruled that the Connecticut Uniform Trade Practices Act (CUTPA) is applicable to banks in *Normand Josef Enterprises v. Connecticut National Bank*, 646 A.2d 1289, 1306 (Conn. 1994). In that case, Connecticut National Bank argued that CUTPA did not apply to it because the statute was similar to the Federal Trade Commission Act, which exempts banks from enforcement by the Federal Trade Commission of the FTC Act. *Id.* at 1300–01. The Supreme Court of Connecticut, however, reasoned that the fact of bank exemption “from the Federal Trade Commission Act does not establish their exemption from CUTPA.” *Id.* at 1301. The court further reasoned that

[w]hile banks are arguably comprehensively regulated under federal law, even national banks, which are instrumentalities of the federal government, have always been subject to the laws of the state in which they do business. State laws are preempted only when their operation expressly conflicts with the laws of the United States.

Id. at 1304–05. Finally, the court explained that “[t]he mere existence of generic state and federal banking regulations does not exclude CUTPA coverage. CUTPA is applicable even when its regulatory scheme overlaps that authorized by another statute or regulation.” *Id.* at 1305. Thus, the CUTPA was applicable against banks and can be enforced against banks in spite of the general scheme of federal regulation of banks.

The court in *Normand Josef Enterprises* cited a long list of cases from other jurisdictions that have likewise held that their state’s deceptive and unfair trade practices or consumer protection statutes are applicable to banks, including cases from California, Illinois, Kansas, Massachusetts, Michigan, Montana, New Mexico, and Washington. *See, e.g.*, *Heastie v. Cmty. Bank of Greater Peoria*, 727 F. Supp. 1133, 1138 (N.D. Ill. 1989) (applying an Illinois consumer fraud statute); *Perdue v. Crocker Nat’l Bank*, 702 P.2d 503, 514 (Cal. 1985); *Fletcher v. Sec. Pac. Nat’l Bank*, 591 P.2d 51, 56–57 (Cal. 1979); *First Nat’l Bank of Anthony v. Dunning*, 855 P.2d 493, 498 (Kan. Ct. App. 1993); *Raymer v. Bay State Nat’l Bank*, 424 N.E.2d 515, 521 (Mass. 1981); *Attorney Gen. v. Mich. Nat’l Bank*, 312 N.W.2d 405, 414 (Mich. Ct. App. 1981), *rev’d in part*, 325 N.W.2d 777 (Mich. 1982); *Baird v. Norwest Bank*, 843 P.2d 327, 333–34 (Mont. 1992); *Ashlock v. Sunwest Bank of Roswell*, 753 P.2d 346, 348 (N.M. 1988); *Pa. Bankers Ass’n v. Commonwealth*, 427 A.2d 730, 732–33 (Pa. Commw. Ct. 1981). *Normand Josef Enterprises* also cited the Washington Supreme Court’s opinion in *Vogt v. Seattle-First National Bank*, which noted that

Although the Comptroller of the Currency has regulatory and supervisory authority over national banks, that authority alone does not result in exemption under the Consumer Protection Act for Seafirst in this case. Its conduct as trustee is not preempted by federal regulation and thus is subject to the Consumer Protection Act.

817 P.2d 1364, 1371 (Wash. 1991).

Since the decision in *Norman Josef Enterprises*, the Office of the Comptroller of the Currency (“OCC”) has determined that although the Federal Trade Commission has no power to enforce the FTC Act against national banks, it does have the authority to do so. *See* Guidance on Unfair or Deceptive Acts or Practices, OCC Advisory Letter AL 2002-3 (Mar. 22, 2002), available at <http://www.occ.treas.gov/ftp/advisory/2002-3.doc>. However, the mere fact that the OCC has decided to enforce violations of the act in this area does not mean that state acts are preempted and that states no longer have the ability to enforce their deceptive trade practices acts against the state banks. As noted by the Connecticut Supreme Court, banks are still subject to the laws of the jurisdiction in which they do business. The

order preempting the GFLA that the OCC had been given broad powers to regulate federally chartered banks' real estate lending powers under 12 U.S.C. § 371(a).¹³⁹ National bank powers are limited to those given them explicitly by Congress, and Congress has not given them the power to engage in acts and practices that violate the FTC Act or are otherwise fraudulent.¹⁴⁰ Enforcement by states of substantively similar state statutes does not interfere with any properly-given national bank real estate lending power and therefore cannot be stopped through federal preemption.¹⁴¹

The fact that state deceptive trade practice laws may not be identical to the FTC Act also should not hinder states' ability to prosecute violations without interference from federal regulators. Although state deceptive trade practice acts are often not identical to the FTC Act, they are, in most cases, substantively the same; where

enforcement by states of substantively similar provisions where states follow the guidance provided by the FTC and OCC in their advisory letters cannot be said to conflict with any law or purpose of the United States and therefore should not be preempted. Rather than conflicting with federal law, such continued enforcement by states complements the federal scheme.

139. 12 U.S.C. § 371(a) (2000). Section 371(a) gives national banks the ability to "make, arrange, purchase or sell loans or extensions of credit secured by liens on interests in real estate, subject to section 1828(o) of [the Federal Deposit Insurance Act] and such restrictions and requirements as the Comptroller of the Currency may prescribe by regulation or order." *Id.*

140. It is true that enforcing state deceptive trade practices laws may affect the "manner or content" of national bank real estate lending, at least indirectly—the OCC indicated in its GFLA preemption order that such laws are preempted. However, the fact remains that Congress has not given national banks the power to engage in illegal or deceptive lending practices. *See* 12 U.S.C. § 24 (2000) (listing national bank powers); *Tex. & Pac. Ry. Co. v. Pottorff*, 291 U.S. 245, 253 (1934) ("The measure of [national bank] powers is the statutory grant; and powers not conferred by Congress are denied. For the act under which national banks are organized constitutes a complete system for their government.") (citations omitted). Instituting enforcement actions to stop such practices does not interfere with any lawful or proper power given to national banks under federal law.

141. The Treasury-HUD Joint Report recognized the value of enforcement through state deceptive trade practices acts:

Through the regional Task Force forums, HUD and Treasury learned that the exact nature of abusive lending practices often varies from community to community. State regulators and enforcement agencies should give increased focus to the growing problem of fraudulent, unfair and deceptive practices in the mortgage lending market, as they may be best equipped to understand the roots of the problems that exist within their own borders.

TREASURY-HUD JOINT REPORT, *supra* note 2, at 83.

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they are not, they can be amended to mirror the FTC Act.¹⁴² States can enforce deceptive trade practice acts for lending violations as is done in other contexts in which states enforce federal lending law. For example, Connecticut has restated and adopted TILA “almost verbatim,” and Arizona has made it a state law violation to infringe upon the terms of “RESPA or the Consumer Credit Protection Act, which includes the Fair Credit Reporting Act, ECOA, and the Fair Debt Collection Practices Act, as well as TILA.”¹⁴³ West Virginia makes any violation of a “federal law regulating mortgage loan transactions” a violation of West Virginia law.¹⁴⁴ Similar action can be taken in those states where mini-FTC Acts have not been adopted or in instances where amendments are necessary to bring state unfair trade practices laws in line with federal laws.

Because state acts are usually substantively similar and typically contain much of the same language as the FTC Act, states can use federal guidance in determining what sorts of deceptive and predatory lending practices can be combated under state unfair trade practices acts. In particular, states should follow OCC guidance in determining what is unfair and deceptive and should therefore subject mortgage sellers to prosecution under state deceptive trade practices acts. In a recent letter, the OCC reasoned that certain deceptive loan practices, including loan flipping and equity stripping, are deceptive and unfair under the FTC Act and will be prosecuted under the Act.¹⁴⁵ This guidance is valuable to states because it assists state enforcement officers in determining what types of action can be prosecuted without concern for preemption by the OCC, in developing standards for which practices should be considered violations of their acts, and in deciding when to bring an action.

Specifically, the OCC stated that lending practices are deceptive if:

[f]irst, there is a representation, omission, act, or practice that is likely to mislead; [s]econd, the act or practice would be likely to mislead a reasonable consumer (a reasonable member of the group targeted by the acts or practices in question); and [t]hird, the

142. Like state statutes, the FTC Act is broad and serves to protect consumers and businesses from unfair and deceptive trade practices. *See* 15 U.S.C. § 45 (2000).

143. GOODWIN PROCTER, *supra* note 117, at 56.

144. *Id.* at 57.

145. OCC Predatory Abuses Guidelines Letter, *supra* note 25, at 2, 4–6.

representation, omission, act, or practice is likely to mislead in a material way.¹⁴⁶

A practice is considered unfair under the FTC Act if: “[f]irst, the practice causes substantial consumer injury, such as monetary harm; [s]econd, the injury is not outweighed by benefits to the consumer or to competition; and [t]hird, the injury caused by the practice is one that consumers could not reasonably have avoided.”¹⁴⁷ Because the terms “deceptive” and “unfair” are defined somewhat broadly under this standard, states can tailor solutions to address the specific types of abusive practices that are occurring within their jurisdictions.

Finally, in order to ensure that actions brought under state deceptive trade practices acts have a deterrent effect on loan sellers and those actors engaging in predatory practices, state lawmakers should enact provisions giving consumers a private right of action where one is not explicitly given.¹⁴⁸ Many state deceptive trade practices acts explicitly allow a private right of action, but others do not.¹⁴⁹ Because states often do not have the necessary resources to investigate every violation and abuse of state laws, state lawmakers should amend state acts to allow private rights of action. Also, some states do not include credit as a good and lending as a service that is covered under state deceptive trade practices acts.¹⁵⁰ In such instances, the necessary amendments should be made in order to ensure adequate enforcement. Enforcement by states of deceptive

146. *Id.* at 4.

147. *Id.*

148. The FTC Act does not allow any private right of action, but instead leaves enforcement up to the Federal Trade Commission. 15 U.S.C. § 45(a)(2) (2000) (giving the Federal Trade Commission power “to prevent persons, partnerships, or corporations . . . from using unfair methods of competition in or affecting commerce and unfair or deceptive acts or practices in or affecting commerce”).

149. *See supra* note 134.

150. Thomas J. Miller, Attorney General of Iowa, stated:

Some State UDAP statutes do not include credit as a “good or service” to which the Act applies, or lenders may be exempted from the list of covered entities. Some State statutes prohibit “deceptive” practices, but not unfair practices. In my State, we have no private right of action for our UDAP statute, magnifying the impact of the problem of inadequate resources for public enforcement. Other claims which might apply to a creditors’ [sic] practices may be beyond the jurisdictional authority given to public agencies.

Hearings, supra note 1, at 53, 62 (statement of Thomas J. Miller, Attorney General, State of Iowa).

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and unfair trade practices acts would therefore be an effective deterrent that would not interfere with national bank lending powers but would allow the states to tailor the remedy to fit the problems that they are facing.

V. CONCLUSION

This Comment illustrates that abusive and predatory lending practices continue to be a significant problem in many parts of the country. State and federal regulators are at odds in determining how to deal with the problem. The OCC's recent order preempting the GFLA, its recent rulemaking which may result in the OCC occupying the field of regulation of national real estate lending, and the OTS's preemption orders on the same topic provide evidence that it is unlikely that states will be able to enact legislation prohibiting specific lending terms and conditions that will be effective against federally chartered banks. Federal regulatory agencies seem willing to preempt any law that interferes with a nationally chartered financial institution's power to make real estate loans.

It is therefore important that states develop remedies that do not run afoul of OCC and OTS preemption principles. Because a significant portion of predatory practices are engaged in by nonbank sellers of loans that are regulated by states, state legislators should develop laws that target sellers of loans, such as heightened licensing requirements for loan originators, and the creation of state agencies that enforce such requirements and punish lending abuses. Additionally, states can effectively stop predatory practices through enforcement of state unfair and deceptive trade practices acts against federal and state-chartered financial institutions. These solutions can be taken without impinging upon federal real estate lending powers. Using these tactics, states may prevent predatory lending abuses without interfering with national banking powers.

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