Defrauding the American Dream: Predatory Lending in Latino Communities and Reform of California's Lending Law

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INTRODUCTION

Soledad Aviles is a fifty-seven-year-old immigrant from Mexico who came to the United States with the "American dream" of owning his own home.[1] Because the median home price in Orange County, California, was almost $700,000 in 2006,[2] purchasing a first home was difficult. So Aviles was

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1. Christopher Goffard & Jennifer Delson, *When Dream Homes Become Nightmares – Alleged Predatory Lending Often Leads to Higher Payments and Foreclosure. Language Barriers are an Issue in Heavy Latino Areas*, L.A. TIMES, Oct. 8, 2007, at B4 (quoting Soledad Aviles).

2. According to the California Association of Realtors, the median home price in Orange County in 2006, when Aviles purchased his house, was $699,060. *See* Press Release, Cal. Ass'n of Realtors, Median Price of a Home in California at $551,300 in January, up 13.8 Percent from Year Ago, Sales Decrease 24.1 Percent, (Feb. 28, 2006), *available at* http://www.businesswire.com/

elated when a trusted friend referred him to a broker who said he could help. That same year, the broker offered to lend Aviles $615,000, with low monthly payments of $3,600, for a modest three-bedroom home. These payments were going to be difficult for Aviles, who earned $9 an hour as a glass cutter, but his wife and three of his six daughters planned to contribute wages from their own low-paying jobs. “We took out our pencils, figured out our take-home pay and figured out that if we all pitched in, it would work,” said Aviles.[3]

Aviles neither speaks nor reads English. The broker negotiated the deal with him in Spanish and, relying on the broker’s representations, Aviles signed loan documents that were written in English. Unbeknownst to Aviles, the loan application falsified the family’s assets and income, and the loan included hidden charges. Even though Aviles provided pay stubs to the broker indicating that together he and his family earned about $40,000 a year, the application stated that they were the owners of landscaping and housekeeping companies that grossed $157,000 a year.[4] The resulting loan committed him to monthly payments of $4,800, instead of the $3,600 monthly payment he had relied on when he decided to buy the home.[5]

Aviles was shocked to learn how much he had to pay, but the broker told him to keep the property because the broker would refinance his mortgage in one year.[6] The family tried to survive by renting out the bedrooms and the garage to make payments and by feeding their family with food from friends and corn they grew.[7] After one year, however, the broker was not able to refinance the home because, after the collapse of the housing market, it could not be appraised for a sufficiently high price.[8]

Unfortunately, stories like the Aviles’s are not uncommon. The housing market collapse has left numerous individuals and families in precarious circumstances due to increasingly untenable mortgage payments. Kerstin Arusha, former directing attorney at the Law Foundation of Silicon Valley, reported that Spanish speakers were among the most victimized by predatory

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portal/site/google/?ndmViewId=news_view&newsId=20060228005928&newsLang=en (citing January 2006 regional sales and price activity); *see also* CAL. LEGISLATIVE ANALYST’S OFFICE, CAL FACTS 2006: CALIFORNIA'S ECONOMY AND BUDGET IN PERSPECTIVE 6 (2006), *available at* http://192.234.213.2/2006/cal_facts/cal_facts_2006.pdf (showing a graph of California’s median home prices in various regions of the state in 2006).

3. Goffard & Delson, *supra* note 1.

4. *Id.*; Telephone interview with Connie Der Torossian, Director of Marketing and HUD Programs and Sylvia Prata, Fair Housing Council of Orange County (Oct. 8, 2008) [hereinafter 2008 Interview with Fair Housing Council of Orange County]; Telephone interview with Connie Der Torossian, Director of Marketing and HUD Programs and Sylvia Prata, Volunteer Real Estate Agent, Fair Housing Council of Orange County (Feb. 23, 2009) [hereinafter 2009 Interview with Fair Housing Council of Orange County].

5. Goffard & Delson, *supra* note 1; 2008 Interview with Fair Housing Council of Orange County, *supra* note 4.

6. 2008 Interview with Fair Housing Council of Orange County, *supra* note 4.

7. *Id.*

8. *Id.*

lenders because they were often misled about the terms of the loan.[9] She explained that Latinos can be "easy targets for predatory lenders who [could] sell them a bill of goods without giving them disclosures in a language they understand."[10] Echoing these data, stories from major news outlets have reported on brokers who sold additional loans without disclosing them to non-English-speaking clients.[11]

Most of this type of predatory lending occurred in the subprime market.[12] Although subprime lending prior to the housing credit collapse increased access to credit for many Americans,[13] recent studies reveal disparities in lending practices among minority groups.[14] Not surprisingly, a recent study shows that the prevalence of subprime foreclosures has produced a net loss in homeownership, rather than an increase in homeownership.[15] As foreclosure creates more vacant homes, neighborhoods decline, tax revenue is lost, and crime rises resulting in blighted communities.[16]

Such trends, while perhaps not entirely avoidable, might have been ameliorated by governmental regulation to minimize predatory lending. Sadly, California legislation failed to adequately address the predatory lending crisis. In response to predatory lending trends, California in 2001 enacted Division 1.6 of the California Financial Code, Sections 4970 to 4979.8 (hereinafter "Division 1.6"), a law designed to combat these practices in the subprime market.[17] Before the law was passed, consumer advocates supported the bill (AB 489) with the understanding that the legislation would not preempt local regulations.[18] Because predatory lending operated at a local level, posing a

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9. *Id.*

10. Goffard & Delson, *supra* note 1; *see also* Vikas Bajaj & Miguel Helft, *The Loan that Keeps on Taking*, N.Y. TIMES, Sept. 25, 2007, at C1 (discussing a case in which a broker included a down payment loan without telling the client borrowers).

11. *See* Bajaj & Helft, *supra* note 10.

12. CTR. FOR RESPONSIBLE LENDING, LATINO HOMES AT RISK: PREDATORY MORTGAGE LENDING 1 (2004), *available at* http://www.responsiblelending.org/pdfs/ib014-Latino_Homes_at_Risk-1004.pdf.

13. Todd J. Zywicki & Joseph D. Adamson, *The Law & Economics of Subprime Lending*, 80 U. COLO L. REV. 1, 2 (2009) ("[T]he expansion of credit to new borrowers . . . generated unprecedented levels of homeownership, especially among young, low-income, and minority borrowers. . . .").

14. *See, e.g.*, *Study Disputes Lenders' Excuses for Charging Blacks and Latinos Higher Rates*, CONSUMERAFFAIRS.COM, June 2, 2006, http://www.consumeraffairs.com/news04/2006/06/crl_predatory_study.html.

15. *See* CTR. FOR RESPONSIBLE LENDING, SUBPRIME LENDING: A NET DRAIN ON HOMEOWNERSHIP 2 (2007), *available at* http://www.responsiblelending.org/pdfs/Net-Drain-in-Home-Ownership.pdf (finding that there has been a net loss of homeownership from subprime lending between 1998 and 2006, based on a comparison between new homeownership from subprime lending to subprime foreclosures).

16. *See* Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2076 (2007).

17. *See* CAL. FIN. CODE §§ 4970–4979.8 (West Supp. 2008).

18. Am. Fin. Servs. Ass'n v. City of Oakland, 104 P.3d 813, 834–35 (Cal. 2005) (George, C.J., dissenting) (noting that the legislative history shows that financial services companies

particular threat to lower-income neighborhoods with high home values, advocates argued that cities with large numbers of vulnerable residents should be allowed to enact stricter local ordinances to protect their communities.[19] After much legislative debate, the version of AB 489 that became law did not explicitly preempt local ordinances on predatory lending.[20]

After Division 1.6 became law, Oakland quickly became one of many[21] localities to pass a stronger local ordinance to supplement the state law.[22] Oakland's large population of minority homeowners and the ever-increasing property values prior to the credit meltdown made predatory lending a significant problem.[23] The Oakland ordinance provided additional protections including: requiring independent loan counseling; prohibiting lending without regard to repayment ability; prohibiting the financing of points and fees; and prohibiting lenders from recommending default or refinancing without borrower benefit.[24]

Nevertheless, in *American Financial Services Ass'n v. City of Oakland*, the California Supreme Court held that Division 1.6 preempted the passage of stronger local ordinances to address predatory lending.[25] Many commentators agreed with the Court's decision, arguing that local regulations would deter institutional lenders "by creating a confusing labyrinth of laws—each one differing from those applicable to the next community."[26] On the other hand, consumer advocates argued that *American Financial* essentially allowed a weaker state law to preempt a stronger local ordinance even though the legislature specifically intended stronger local ordinances to supplement the

actively lobbied for express preemption and leaving it out was one of its concessions, and thus "the compromise included deliberate silence on the matter of preemption."); *see also* Brief for AARP et al. as Amici Curiae Supporting Defendants-Respondents at 24, Am. Fin. Servs. Ass'n v. City of Oakland, 104 P.3d 813 (Cal. 2005) (No. S119869), 2004 WL 1505461 ("[T]he groups that supported AB 489 always saw the law as establishing a floor, not a ceiling, for the regulation of predatory lending, leaving open the possibility of supplemental local regulation . . . [h]ad AB 489 explicitly preempted local regulation -- which it did not -- Amici, and most other consumer groups, would not have supported the bill."); Telephone Interview with Kevin Stein, Assoc. Dir., Cal. Reinvestment Coalition (Oct. 11, 2007).

19. *See* Brief for AARP et al., *supra* note 18, at 15.

20. *See* sources and notes cited *supra* note 18.

21. *See* Brief for AARP et al., *supra* note 18, at 18–19 (noting that other California cities, including Sacramento and Los Angeles, have adopted stronger predatory lending laws).

22. OAKLAND, CAL., MUN. CODE ch. 5.33 (2001), *available at* http://www.oakland net.com/government/hcd/policy/docs/pred_muni.pdf.

23. OAKLAND, CAL., ORDINANCE 12,361 (Oct. 2, 2001), *available at* http://www.oakland net.com/government/hcd/policy/docs/pred_muni.pdf. ("[B]ecause of the high number of minority and lower-income homeowners in Oakland, and the pressures of gentrification in certain neighborhoods that increase property values and home equity, Oakland residents in low-income areas have been perceived to be 'house rich and cash poor' and thus are prime targets for predatory lending practices . . . .").

24. *Id.*

25. Am. Fin. Servs. Ass'n v. City of Oakland, 104 P.3d 813, 828–29 (Cal. 2005).

26. *See, e.g.*, Michael C. Polentz, *Predatory Lending: Borrowers and Lenders Beware*, REAL EST. NEWSALERT (Miller & Starr, Palo Alto, Cal.), May 2005, at 1.

state law.[27] Still others suggested that the decision implicitly acknowledged the need for a stronger state law, and "place[d] the onus on the Legislature to determine the scope of any appropriate legislation."[28]

This Comment subscribes to the last point of view. In the wake of the destruction wrought by predatory lending, California must look to the future and develop stronger state-level regulation. The prevalence of predatory lending after *American Financial* demonstrates the need for the California legislature to adopt a stronger law that sufficiently addresses the needs of California's most vulnerable populations. And although current market conditions have curtailed much of California's subprime and predatory lending, this issue will most likely reemerge when credit markets stabilize. Accordingly, this Comment focuses on predatory lending practices in California that constituted part of the subprime debacle and indirectly contributed to the 2008 credit market meltdown. Despite the current and perhaps unprecedented instability in the American credit markets, when these markets return to a semblance of normalcy, predatory lending might again endanger both individuals like Mr. Aviles as well as the general weal.

In an effort to raise impetus for legislative change, this Comment examines previous predatory lending trends in the Latino[29] population both to provide information on how predatory lenders have operated within this subgroup as well as to demonstrate the need to change the regulatory landscape to prevent such practices in the future. California's Latino population, because of its size, marked growth in homeownership rates between 2001 and 2007 correlating to the increased brokering of subprime mortgages, and its particular vulnerability to predatory lenders provides an informative window into the predatory lending phenomenon.[30] This Comment proposes reforms to the current predatory lending law in light of specific vulnerabilities observed in Latino communities in California.

Part I of this Comment provides a brief history of the subprime market to explain why predatory lending had a particularly harsh effect on minority

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27. *See* Brief for AARP et al., *supra* note 18, at 20 ("[C]ompromises forced by the lending industry meant that AB 489 could not effectively address all of the predatory lending problems in California. Amici, as consumer groups who fought hard for the bill, consider AB 489 as establishing a floor, not a ceiling, for the level of protections that Californians need against predatory lending. That is why the Legislation did not preempt supplemental local regulation in the field.").

28. Polentz, *supra* note 26, at 8.

29. This Comment uses "Hispanic" and "Latino" interchangeably.

30. Mikel Chavers, *Growing Ownership Makes Hispanics Target for Predatory Lending*, BUS. J. GREATER TRIAD AREA, Oct. 20, 2006, http://triad.bizjournals.com/triad/stories/2006/10/23/ focus2.html ("Among the reasons Hispanics are targeted are language barriers and issues with credit, ranging from never having established credit to having impaired ratings. Hispanics often pay with cash and do not have banking or credit accounts."); Sandip Roy, *An Inside Look on Who the Sub-Prime Mortgage Crisis Really Affects*, NEW AM. MEDIA, Oct 13, 2007, http://news.ncmonline.com/news/view_article.html?article_id=d73fa95362c47fc515c466183f9d2b1a.

groups. Part II describes the current California predatory lending law, and discusses why it was not effective in light of two recent cases that have interpreted the law, *Wolski v. Fremont Investment & Loan*[31] and *American Financial*.[32] Part III looks at predatory lending in the context of the Latino population by summarizing trends from recent cases involving Latino victims of predatory lenders in California. Part IV draws on the contextual understanding of predatory lending as it occurred in the Latino community to make recommendations for reforming California's predatory lending law.[33]

I
BRIEF OVERVIEW OF PREDATORY LENDING IN THE SUBPRIME MARKET

It is important to distinguish subprime lending from predatory lending, as not all subprime loans are predatory.[34] Predatory lending must be defined in context: while subprime loan products may be appropriate in certain situations, lack of disclosure, uneven bargaining power, or fraudulent misrepresentation may make them predatory in other situations.[35] During the housing boom, for example, many fully informed and sophisticated borrowers with high income levels used risky subprime loans to take on more debt than they could afford, gambling on the appreciation of their homes.[36] When these risks were fully

31. Wolski v. Fremont Inv. & Loan, 25 Cal. Rptr. 3d 500 (Ct. App. 2005).

32. Am. Fin. Servs. Ass'n v. City of Oakland, 104 P.3d 813 (Cal. 2005).

33. In writing this Comment, I was greatly influenced by the analysis and perspective on the subprime lending crisis that Professor Jo Carrillo presented in two pioneering articles that brought this issue to the forefront of legal academic discourse, *Dangerous Loans: Consumer Challenges to Adjustable Rate Mortgages*, 5 BERKELEY BUS. L.J. 1, 6–7 (2008), and *In Translation for the Latino Market Today: Acknowledging the Rights of Consumers in a Multilingual Housing Market*, 11 HARV. LATINO L. REV. 1, 14 (2008). Also, I drew a great deal from the theories of predatory lending presented by Patricia A. McCoy in the following articles: Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2076 (2007); Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 HARV. J. LEGIS. 123, 125 (2007); Patricia A. McCoy, *A Behavioral Analysis of Predatory Lending*, 38 AKRON L. REV. 725, 734 (2005); PATRICIA MCCOY, WHY THE POOR PAY MORE: HOW TO STOP PREDATORY LENDING 95 (Gregory D. Squires ed., 2004).

34. Tania Davenport, Note, *An American Nightmare: Predatory Lending in the Subprime Home Mortgage Industry*, 36 SUFFOLK U. L. Rev. 531, 532 (2003).

35. *See* U.S. DEP'TS OF THE TREASURY & HOUS. & URBAN DEV., CURBING PREDATORY HOME MORTGAGE LENDING 17 (2000) [hereinafter TREASURY-HUD REPORT], *available at* http://www.huduser.org/Publications/pdf/treasrpt.pdf; JAMES H. CARR & LOPA KOLLURI, FANNIE MAE FOUNDATION, PREDATORY LENDING: AN OVERVIEW 2–3 (2001), *available at* http://www.mplp.org/Resources/mplpresource.2006-06-13.4751698248/getFile (discussing fraudulent techniques that employ unequal bargaining power); Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Address at the Federal Reserve Bank of Chicago's 43rd Annual Conference on Bank Structure and Competition (May 17, 2007), http://www.federalreserve.gov/newsevents/speech/bernanke20070517a.htm ("[S]pecific lend-ing practices that may be viewed as inappropriate in some circumstances are appropriate in others, and the conditions under which those practices are appropriate cannot be sharply delineated in advance.").

36. *See Mortgage Market Turmoil: Causes and Consequences Hearing Before the S.*

disclosed, these subprime loans were likely not predatory.[37] In contrast, if identical subprime loans were made by falsifying a borrower's ability to repay, or by misrepresenting the loan terms to the borrower, then those loans were predatory.[38]

Subprime lending is the practice of making loans to borrowers who are at a high risk of defaulting based on traditional credit formulas.[39] For example, borrowers with high debt-to-income ratios or less than perfect credit histories are considered "high risk" borrowers.[40] To compensate for the risk, a lender will charge extra fees and an interest rate that is higher than "prime." A prime rate is usually the lowest interest rate that a financial institution offers its best customers. Thus, the higher interest rates offered to higher risk customers are called "subprime" rates. Unlike prime-rate loans, which have a standard pricing system based on income, credit scores, and savings, subprime loans have a complicated risk-based pricing system that is often incomprehensible to the average buyer.[41]

Predatory lending is "a syndrome of loan abuses that benefit mortgage brokers, lenders, and securitizers to the serious detriment of borrowers."[42] Although not all subprime loans are predatory, the high-risk nature of subprime loans makes them ripe for abuse.[43] Abusive patterns often occur when unscrupulous lenders use the subprime lending environment to push

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Comm. on Banking, Housing, and Urban Affairs, 110th Cong. (2007) (statement of Sen. Christopher Dodd, Chairman, S. Comm. on Banking, Housing, and Urban Affairs), *available at* http://banking.senate.gov/public/index.cfm?Fuseaction=Hearings.Testimony&TestimonyID=8316a5fd-dbfd-4e1b-a85b-63c5ef5b4992&HearingID=4ccca4e6-b9dc-40b1-bab5-137b3a77364d; Mara Der Hovanesian, *Nightmare Mortgages*, BUS. WK., Sept. 11, 2006, at 70.

37. *See* Les Christie, *Subprime Blame Game*, CNNMONEY.COM, Apr. 19, 2007, http://money.cnn.com/galleries/2007/real_estate/0704/gallery.paly_the_subprime_blame_game/index.html.

38. Engel & McCoy, *supra* note 16, at 2043.

39. *See* Davenport, *supra* note 34, at 532.

40. *See id.*

41. *See* JANIS BOWDLER, NAT'L COUNCIL OF LA RAZA, ISSUE BRIEF NO. 15, JEOPARDIZING HISPANIC HOMEOWNERSHIP: PREDATORY PRACTICES IN THE HOMEBUYING MARKET 4 (2005), *available at* http://www.nclr.org/content/publications/detail/31596/; Patricia A. McCoy, *A Behavioral Analysis of Predatory Lending*, 38 AKRON L. REV. 725, 734 (2005) ("Unlike the prime mortgage market, subprime quotes by different lenders are almost never posted side-by-side and when they are, the quotes do not permit meaningful comparison."); Der Hovanesian, *supra* note 36, at 70 (describing the complexity of subprime pricing loans).

42. Engel & McCoy, *supra* note 16, at 2043.

43. *See* CTR. FOR RESPONSIBLE LENDING, *supra* note 12, at 1; *see also* Ardalan Davis, *Community Reinvestment Act and Efficient Markets Debate: Overview*, J. ECON. & ECON. EDUC. RES., 2006, at 68, *available at* http://www.alliedacademies.org/Publications/Papers/JEEER%20Vol%207%20No%203%202006%20p%2053-70.pdf ("[P]redatory lending in the prime market is avoided by competition among lenders, greater homogeneity in loan terms, greater financial information among borrowers, and the fact that most prime lenders are banks, thrifts, or credit unions, which are subject to extensive federal and state oversight and supervision. This is in sharp contrast to the sub-prime market."). *But see* Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 MD. L. REV. 707, 737 (2006) (predicting more complexity and risk in the traditionally low-risk prime market).

unnecessary or overpriced home mortgage products on vulnerable populations, such as minority groups, the elderly, and recent immigrants.[44]

Professors Kathleen Engel and Patricia McCoy outline seven abusive patterns of predatory lending: (1) encouraging borrowers to take on loans that are structured to result in net harm to borrowers; (2) rent seeking through fees and interest rates that are out of proportion to the risk the borrowers present; (3) procuring loans through illegal fraud or deception; (4) obscuring information through nondisclosure that does not amount to fraud; (5) requiring borrowers to waive legal remedies; (6) discriminating against protected groups even after controlling for risk; and (7) employing abusive servicing practices.[45]

Definitions such as Engel and McCoy's are useful, but "any list of predatory practices is destined to be incomplete because bad actors are constantly developing new abusive practices, sometimes to evade new government regulation."[46] This has led to much debate about the definition of predatory practices.[47] For example, Professor Lauren Willis argues against defining predatory lending using lists of specific predatory practices because, not only do lenders "mutate" their practices in response to loopholes in legislation, but fashioning laws to ban all the predatory features on the list leads to a "bloated regulatory scheme."[48] Instead, Willis defines predatory lending as "noncompetitively overpriced and overly risky home loans" that are facilitated by (1) the structure of the home loan market and (2) borrower vulnerabilities.[49] Exposing the patterns in which predatory lending occurs at the community level makes these "borrower vulnerabilities" concrete and will inform policy makers who are working under this definition.[50]

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44. CTR. FOR RESPONSIBLE LENDING, *supra* note 12; *see also* Benjamin Howell, Comment, *Exploiting Race and Space: Concentrated Subprime Lending as Housing Discrimination*, 94 CALIF. L. REV. 101, 102 (2006) ("Unscrupulous lenders now prey on a history of racial redlining by aggressively marketing overpriced loan products with onerous terms in the same neighborhoods where mainstream lenders once refused to lend.").

45. Engel & McCoy, *supra* note 16, at 2043–45.

46. TREASURY-HUD REPORT, *supra* note 35, at 17.

47. *See id.* For example, Professor Jo Carrillo, a leading scholar in this field, explains that products such as adjustable rate mortgages (ARMs), interest-only loans, and negative amortization loans are considered "aggressive lending" that is "different in degree from predatory lending, yet there can be overlap." Jo Carrillo, *Dangerous Loans: Consumer Challenges to Adjustable Rate Mortgages*, 5 BERKELEY BUS. L.J. 1, 6–7 (2008). These loan products provide for lower payments at the beginning of the life of the loan, but as time goes on, the monthly payment increases. *Id*. Such a graduated payment structure can be useful for a borrower who is anticipating an increase in income in the future, and fully understands the terms of the loan. On the other hand, if terms are not fully disclosed, then this aggressive lending product may cross the line and become predatory. This blurring between predatory practices and legitimate subprime lending leads to debate about what practices should be regulated and how. *See* Rick Brooks & Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy*, WALL ST. J., Dec. 3, 2007, at A1, *available at* http://online.wsj.com/article/SB119662974358911035 .html?mod=hps_us_whats_news.

48. Willis, *supra* note 43, at 740.

49. *Id.* at 733.

50. *See* TREASURY-HUD REPORT, *supra* note 35, at 17 (noting that it important to consider

Distinguishing predatory practices from legitimate subprime lending is particularly important now that the subprime crisis has affected world financial markets. Failure to acknowledge the distinction will allow the debate about the larger market implications of subprime lending to overshadow the debate about the impact of predatory lending at a community level.[51] This Comment does not engage in the larger debate about whether or how much the government should subsidize borrowers who took unnecessary risks, or how regulation would affect the global secondary mortgage markets.[52] Instead, it concentrates on the subset of the most vulnerable borrowers who were defrauded by predatory lenders.

A. Redlining and Reverse-Redlining

To understand why predatory lending has so harshly affected minorities generally and the Latino population specifically, it is necessary to look at the history of subprime lending.[53] During the early twentieth century, most minorities were precluded or "redlined" from traditional credit sources.[54] The term "redlining" refers to the practice of "denying the extension of credit to specific geographic areas due to the income, race, or ethnicity of its residents."[55] The term "redlining" derives from the practice of the Home Owners Loan Corporation, a Depression-era federal lending institution that extended low-interest loans, of color-coding maps of geographic areas in which it would lend. Red designated the "lowest-quality, highest-risk neighborhoods" on the maps.[56] At the time, banks stereotyped African Americans, Latinos, and members of other minority groups as inherently risky and often unconditionally denied them loans by "redlining" neighborhoods in which high concentrations

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the context in which predatory practices occur).

51. S*ee, e.g.*, Steven L. Schwarcz, *Systematic Risk*, 97 GEO L.J. 193, 204 n.55 (2008) (advocating a "top-down" approach that would "increase the availability of home mortgages, causing home prices to rise and thereby greatly reducing mortgager defaults" over a "bottom-up" approach that attempts to "micromanage loan terms"); Aaron Unterman, *Exporting Risk: Global Implications of the Securitization of U.S. Housing Debt*, 4 HASTINGS BUS. L.J. 77 (2008) ("As the U.S. mortgage-backed securities market drags the global economy towards a financial crisis the need for international regulation of debt has never been so clear.").

52. For a sample of this debate, see *Mortgage Market Turmoil: Causes and Consequences*, *supra* note 36; Ardalan & Davis, *supra* note 43 (discussing the debate between the Community Reinvestment Act and related legislation with the efficient markets hypothesis); Ted Frank, *Prime Target*, WALL ST. J., Apr. 25, 2007 (arguing against regulation so that the markets adjust); *see also* David Wessel, *Why Some Mortgage Bailouts Make Sense*, WALL ST. J., Nov. 15, 2007, at A2. For coverage on how the subprime crisis is affecting world financial markets, see Jonathan Stempel, *Countrywide Plunges on Downgrade, Bankruptcy Fear*, REUTERS, Aug. 15, 2007 (discussing how Countrywide bankruptcy is helping drag down U.S. stock market); Nelson D. Schwartz, *One World, Taking Risks Together*, N.Y. TIMES, Oct. 21, 2007, § 4, at 3 (discussing the worldwide economic impact of the subprime credit crisis).

53. *See* CRL 2004 STUDY, *supra* note 12.

54. Howell, *supra* note 44, at 107.

55. *Id.*

56. *Id.*

of minority groups resided.[57]

Continued into the late 1970s, these redlining policies contributed to the persistence of lower average family assets among minority families as compared to white families,[58] even as minority family incomes rose during the 1960s and 1970s with new federal antidiscrimination laws and increasing opportunities in the workplace.[59] Lower-valued assets were correlated with higher debt and financial insecurity, which, in turn, made families more vulnerable to predatory lenders. Redlining artificially depressed the home values in minority neighborhoods and prevented minority families from increasing family wealth through homeownership.[60]

In the 1980s, however, the residential mortgage market underwent a transformation that caused lenders to reenter minority neighborhoods.[61] The impetus for this change was the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA), a piece of legislation designed to ensure that, even in the face of record high interest rates, borrowers in states with low usury ceilings could still obtain loans to purchase their first homes.[62] The DIDMCA preempted state usury ceilings for loans secured for a borrower's first home and thereby permitted higher conventional mortgage rates.[63] The financial industry responded with the innovation of "risk-based pricing," and the subprime market was born.[64]

The emergence of the subprime market led banks to begin lending to previously redlined borrowers by charging higher interest rates and fees to account for the higher risk posed by lending to individuals with lower incomes and net worth.[65] Scholars are quick to point out, however, that such "risk-based pricing" is often based on other factors besides risk, such as mortgage broker compensation and discrimination.[66] The return of lenders to minority

57. Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 HARV. J. LEGIS. 123, 125 (2007).

58. *See generally* THOMAS M. SHAPIRO, THE HIDDEN COST OF BEING AFRICAN AMERICAN: HOW WEALTH PERPETUATES INEQUALITY (2004).

59. *See* Civil Rights Act of 1964, 42 U.S.C. §2000(a)–(e) (1994).

60. *See generally* SHAPIRO, *supra* note 58.

61. McCoy, *supra* note 57, at 125.

62. Davenport, *supra* note 34, at 535–36.

63. *Id*.

64. McCoy, *supra* note 57, at 126.

65. *See id.*

66. *See id.* ("[I]t is important to add a caveat: in reality, 'risk-based pricing' is a misnomer. 'Risk-based pricing' implies that pricing is accurately calibrated to credit risk. In reality, prices in the subprime market are only partly based on differences in borrowers' risk. Other factors, including mortgage broker compensation, discrimination, and rent-seeking can and do push up subprime prices." (citing Howard Lax et al., *Subprime Lending: An Investigation of Economic Efficiency*, 15 HOUSING POL'Y DEBATE 533, 565 (2004), *available at* http://www.mi.vt.edu/data/files/hpd%2015(3)/hpd%2015(3)_article_lax.pdf)). The implication is that these non-risk factors could help explain why, according to a recent Gallup survey, "subprime borrowers are generally more likely to come from a protected class or an underserved group." Lax et al., *supra*, at 544–45. For a breakdown of subprime and prime loans to different ethnic groups, see *id.* at 545.

neighborhoods under this rubric has been described as "reverse redlining."[67]

B. Growth and Function of the Subprime Market after Reverse-Redlining

The subprime market grew dramatically in the 1990s and early 2000s due to a variety of factors. First, because subprime lenders would agree to extend credit to borrowers unable to obtain loans in the conventional market, there was a great demand for subprime mortgages.[68] Second, the Tax Reform Act of 1986 provided additional incentives for individuals to take on home equity debt by preserving the mortgage-interest income tax deduction.[69] Third, during the late 1980s investors began to securitize pools of subprime mortgages, which provided capital and encouraged the growth of finance companies in the subprime market.[70] Fourth, in the late 1990s and early 2000s, very low federal interest rates coincided with an historic increase in global investment capital, leading to massive investment in securitized subprime mortgages.[71] Finally, the subprime industry lacked much of the federal and state regulation that confined traditional lenders, allowing the subprime industry to grow unchecked.[72]

One positive result of the proliferation of subprime lending was that borrowers who were previously excluded from conventional mortgages gained access to homeownership.[73] The homeownership rate in the U.S. climbed from 64 percent in 1994 to 69 percent in 2004, an increase that represents over twelve million new homeowners.[74]

The authors of this study admit, however, that their findings are not conclusive because "there is not always a clear distinction between risk-related and non-risk-related variables." *Id.* at 565.

67. *See* Donita Judge, Note, *Predatory Lending: Legalized Theft of Home Equity*, 5 RUTGERS RACE & L. REV. 293, 296 (2003); *see also* Willis, *supra* note 43, at 733 ("The targeting of minority and elderly communities for predatory loans has been dubbed 'reverse redlining.'").

68. Davenport, *supra* note 34, at 539.

69. *Id.* at 538–39.

70. *Id.*; *see* Engel & McCoy, *supra* note 16, at 2045 ("By the early 1990s, technological advances made it possible to estimate and price the risk of subprime home loan pools, paving the way for subprime securitizations. In 2005, total securitizations of subprime and home equity loans ballooned to an estimated $525.7 billion. Today, lenders securitize almost eighty percent of subprime mortgages.").

71. *This American Life: The Giant Pool of Money* (Public Radio International radio broadcast May 9, 2008).

72. Davenport, *supra* note 34.

73. *See* Cassandra Jones Havard, *Democratizing Credit: Examining the Structural Inequities of Subprime Lending*, 56 SYRACUSE L. REV. 233, 234 (2006); Edward M. Gramlich, Governor, Bd. of Governors of the Fed. Reserve Sys., Remarks at the National Community Reinvestment Coalition 11th Annual Conference (Mar. 1, 2002), *available at* http://www.federalreserve.gov/Boarddocs/Speeches/2002/20020301/default.htm; Edward M. Gramlich, Governor, Bd. of Governors of the Fed. Reserve Sys., Remarks at the Financial Services Roundtable Annual Housing Policy Meeting (May 21, 2004), *available at* http://www.federalreserve.gov/boarddocs/Speeches/2004/20040521/default.htm.; *see also* Carrillo, *supra* note 47, at 23–24 (discussing the "democratization" of credit that occurred with the advent of subprime lending); Zywicki & Adamson, *supra* note 13, at 2.

74. MARK DOMS & MERYL MOTIKA, FED. RESERVE BANK OF S.F., FRBSF ECONOMIC LETTER NO. 2006-30, THE RISE IN HOMEOWNERSHIP (2006), *available at* http://www.frbsf.org/

The growth in homeownership did not come without a cost. Between 1980 and 2002, the number of foreclosures grew by 335.6 percent, as compared to a 3.6 percent growth in homeownership during that same time period.[75] Initially, this increase in foreclosures was primarily concentrated in minority and low-income communities.[76] More recently, however, foreclosures have increased at much quicker rates, especially in California. The problem has now grown well beyond the confines of the minority and low-income communities that were affected by the earlier increase in foreclosures.[77]

Yet beyond the recent decades' increase in foreclosures, a less visible cost of the subprime explosion was the rising incidence of predatory lending. Because predatory lending "breeds in an environment characterized by little competition for traditional financial services,"[78] a subprime customer's lack of capital, bad credit score, and high credit dependency make him or her more vulnerable to predatory practices.[79]

Disparities in the subprime market suggested that minorities were particularly vulnerable to the growing problem of predatory lending.[80] The Center for Responsible Lending (CRL) in a 2006 study of 50,000 subprime loans in California reported that "African-American and Latino borrowers [were] at greater risk of receiving higher-rate [subprime] loans than white borrowers, even after controlling for legitimate risk factors."[81] Specifically, African American borrowers were 6 to 34 percent more likely, and Latino borrowers were 29 to 142 percent more likely to receive a higher rate subprime

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publications/economics/letter/2006/el2006-30.pdf.

75. Bowdler, *supra* note 41, at 5–6.

76. Dan Immergluck & Geoff Smith, *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values*, 17 HOUSING POL'Y DEBATE 57, 63 (2006), *available at* http://www.mi.vt.edu/data/files/hpd%2017(1)/hpd_1701_immergluck.pdf ("Subprime lending is resulting in substantially higher levels of foreclosures, with much of the increase concentrated in minority and lower-income communities."); *see also* A. Brooke Overby, *Mortgage Closure in Post-Katrina New Orlean*s, 48 B.C. L. REV 850, 904; Juliana Barbassa, *Report: Minorities Hit by Foreclosures*, USA TODAY, Mar. 6, 2008, *available at* http://www.usatoday.com/money/economy/housing/2008-03-06-minority-foreclose_N.htm.

77. *See*, *e.g.*, Keisha Lamothe, *Foreclosures: Moving on up: Filings Rise with More on the Horizon as Interest Rates Jump on a Record Number of Adjustable Mortgages*, CNNMONEY.COM, Nov. 1, 2007, http://money.cnn.com/2007/10/30/real_estate/foreclosure_ activity/index.htm ("California recorded the second-highest foreclosure rate [in the 3rd quarter of 2007] with one filing for every 88 households. Numerically, the state had the most filings with 94,772 properties, which was up 36 percent from the second quarter.").

78. CARR & KOLLURI, *supra* note 35, at 2.

79. *See* David A. Skeel, *Racial Dimensions of Credit and Bankruptcy*, 61 WASH. & LEE L. REV. 1695, 1697 (2004).

80. *See id.*

81. DEBBIE GRUENSTEIN BOCIAN ET AL., CTR. FOR RESPONSIBLE LENDING, UNFAIR LENDING: THE EFFECT OF RACE AND ETHNICITY ON THE PRICE OF SUBPRIME MORTGAGES 3 (2006), *available at* http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf [hereinafter 2006 CRL STUDY] (using data from the 2004 HDMA and supplementing it with a large, proprietary subprime loan dataset).

loan than similarly-situated white borrowers.[82] The study's results were widely reported and sent a ripple through the home-finance industry.[83]

Lenders justified the disparities by arguing that subprime loan borrowers represented a substantially greater risk.[84] The CRL study showed, however, that higher risk alone cannot account for the disparities.[85] For example, African American borrowers were more likely than similarly situated white borrowers to have high prepayment penalties, whereas Latino borrowers were more likely to have adjustable-rate mortgages.[86] This variance in subprime trends among different minority groups suggests that each group might have been targeted with certain types of loans. If legitimate risk factors do not explain this disparity, as the CRL study suggests, then predatory lenders may have tailored their tactics to their perceptions of each groups' particular vulnerabilities. This is another reason why an examination of predatory trends in different subgroups of borrowers could be useful to drafters of predatory lending legislation.[87]

C. Weak Federal Regulation and Gap-Filling State Regulation

In response to predatory practices in the subprime market, Congress enacted the Home Ownership and Equity Protection Act of 1994 (HOEPA).[88] HOEPA's stated purpose was to combat reverse-redlining.[89] Specifically, it was intended to protect "communities lacking access to traditional lending institutions" by ensuring that "consumers understand the terms of [subprime] loans and are protected from high pressure sales tactics."[90]

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82. *Id.* at 3. A study of subprime lending in New York City uncovered similar results. *See* Manny Fernandez, *Study Finds Disparities in Mortgages by Race*, N.Y. TIMES, Oct. 15, 2007, at B1.

83. *See, e.g., Ending Mortgage Abuse: Safeguarding Homebuyers: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. (2007) (statement by Wade Henderson, President, Leadership Conference on Civil Rights), *available at* http://www.civilrights.org/resources/testimony/pdfs/wade-henderson-senate-subprime-testimony - 06-26-07.pdf) (addressing the 2006 CRL study); Bill Baue, *Why Do Minorities Receive More Subprime Mortgages? Can You Say, Kickback?*, SOCIALFUNDS.COM, June 14, 2006, http://www.socialfunds.com/news/article.cgi/article2032.html; *see also* Denise Rolark Barnes, *Buyers Beware: Predatory Lenders Are out to Get You*, WASH. INFORMER, June 15, 2006, http://www.washingtoninformer.com/OPEDLetsTalk2006Jun15.html.

84. *See* 2006 CRL STUDY, *supra* note 81, at 6.

85. *See* 2006 CRL STUDY, *supra* note 81; *see also supra* note 66 and accompanying text.

86. 2006 CRL Study, supra note 81, at 4.

87. Although this Comment only addresses the challenges facing the Latino community, a similar study addressing the challenges facing the African American community would be useful in informing legislative reform efforts.

88. Pub. L. 103-325; 108 Stat. 2190 (1994) (codified as amended in scattered sections of the Truth in Lending Act, 15 U.S.C. §§ 1601–1667).

89. S. REP. NO. 103-169, at 21 (1994), *reprinted in* 1994 U.S.C.C.A.N. 1881, 1905.

90. *Id.* Several other federal laws offer relief to predatory lending victims, but this Comment focuses on HOEPA because state predatory lending laws are structured like HOEPA, but with expanded restrictions. Other federal laws that provide relief include the Equal Credit

HOEPA amended the Truth in Lending Act (TILA), which was originally enacted to ensure that creditors provided meaningful disclosure of credit terms and thereby allowed consumers to compare the real cost of various loans.[91] When TILA passed in 1968, however, the prime market was the only mortgage market.[92] So while TILA disclosure provisions were relatively effective for consumers who were comparing fixed-rate prime loans, the disclosure provisions were insufficient for the variable-rate subprime market.[93] Because subprime loan rates are based on risk, which is determined by a number of variables, a lender cannot give a firm quote until the borrower has actually applied for the loan.[94] Consequently, the pre-application disclosures required by TILA were not as effective for risk-based subprime loans.

The HOEPA amendments to TILA created a three-part framework to protect borrowers taking out high-cost mortgage loans in the subprime market.[95] First, it imposes pre-closing disclosure requirements. If the lender fails to meet these requirements, the borrower has the right to cancel the loan.[96] Second, it provides a three-day waiting period before the loan is consummated so potential borrowers can decide whether the loan is acceptable.[97] Finally, it proscribes certain deceptive terms that disguise the actual cost of a loan.[98] Both lenders and assignees of HOEPA loans can be liable for violations of these terms.[99]

Despite the additional protections HOEPA created for subprime borrowers, its impact has been limited, primarily because so few loans qualify for the law's regulatory scheme.[100] Some scholars estimate that only 1 percent

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Opportunity Act, 15 U.S.C. § 1691 (2006); Federal Trade Commission Act, 15 U.S.C. § 45(a)(1) (2006) (declaring unlawful "unfair or deceptive acts or practices in or affecting commerce"); the Fair Housing Act, 42 U.S.C. § 3605 (2006) (prohibiting discrimination regarding "the making or purchasing of loans or providing other financial assistance."); and the Real Estate Settlement Procedures Act, 12 U.S.C §§2603–2605 (2006) (requiring lenders who make federally related mortgage loans to disclose their closing costs at two different points in the mortgage process).

91. 15 U.S.C. § 1601(a) (2006); *see also* Davenport, *supra* note 34, at 546.

92. McCoy, *supra* note 57, at 138.

93. *See id.* at 143.

94. *See id.* at 140.

95. *See* Home Ownership and Equity Protection Act of 1994, Pub. L. 103-325, 108 Stat. 2190 (1994) (codified as amended in scattered sections of Truth in Lending Act, 15 U.S.C. §§ 1601–1667); *see also* Eric C. Bartley, Comment, *And Federal Regulation for All: Federally Regulating the Mortgage Banking Industry*, 2006 MICH. ST. L. REV. 477, 493 (2006).

96. 15 U.S.C. § 1639(a). *See also* Laura Dietrich, Note, *Massachusetts' New Predatory Lending Law and the Expanding Rift Between Federal and State Lending Protection*, 26 B.C. THIRD WORLD L.J. 169, 187 (2006).

97. 15 U.S.C. § 1635(a); Dietrich, *supra* note 96, at 187.

98. § 1639(e)–(g); Dietrich, *supra* note 96, at 188.

99. Raphael Bostic et al., *The Impact of State Anti-Predatory Lending Laws: Policy Implications and Insights* 3 n.11 (Joint Ctr. for Hous. Studies, Harvard Univ., Working Paper No. UCC08-9, 2008), *available at* http://www.jchs.harvard.edu/publications/finance/understanding_consumer_credit/papers/ucc08-9_bostic_et_al.pdf.

100. *See* Polentz, *supra* note 26, at 3.

of mortgage loans actually cross the threshold that requires lender compliance with HOEPA because HOEPA only covers refinance and second mortgages, not purchase-money mortgages.[101] Further, for HOEPA to cover a mortgage loan, the loan must meet the "high cost trigger" and "fee trigger."[102] The problem is that most lenders avoid HOEPA by setting high-cost loans just under the triggers in the law.[103]

In July 2008, in the wake of the subprime mortgage crisis, the Federal Reserve amended TILA regulations again to "protect consumers from unfair or deceptive acts and practices in mortgage lending, while keeping credit available to qualified borrowers and supporting sustainable homeownership."[104] The new rules added three key protections, which (1) require the lender to verify the borrower's income and assets to evaluate ability to repay, (2) ban prepayment penalties on short-term adjustable rate mortgages if the payment can change in the first four years, and (3) require lenders to include taxes and insurance in escrow.[105]

The new amendments to TILA will become effective October 1, 2009, and the escrow requirement will be phased in during 2010, so it is too early to discern their impact. The Center for Responsible Lending ("CRL") commended the Federal Reserve for adding additional consumer protections, but also highlighted the weaknesses of the forthcoming protections. Specifically, the CRL pointed out that the rules do not cover nontraditional subprime loans, such as payment-option ARMs, interest-only loans, or Alt-A loans.[106] Further, the rules do not ban yield spread premiums (YSPs), which are bonuses the lender pays to the broker for originating a loan at an interest rate higher than the minimum rate approved by the lender. In essence, YSPs are the kickbacks that create incentives for mortgage brokers to sell borrowers costlier loans.[107]

Prior to the new TILA regulations, states began enacting supplementary laws to fill in the regulatory gap.[108] In 1999, North Carolina was the first state

101. Zywicki & Adamson, *supra* note 13, at 53; *see* Bostic et al., *supra* note 99; Bartley, *supra* note 95, at 494.

102. Bartley, *supra* note 95, at 493.

103. *See* Margot Saunders, *The Increase in Predatory Lending and Appropriate Remedial Actions*, 6 N.C. BANKING INST. 111, 129 (2002); *see also* Zywicki & Adamson, *supra* note 13, at 53 ("Most lenders, even predatory lenders, can tailor their loans so that they do not fall under HOEPA rules."); Bartley, *supra* note 95, at 494.

104. Press Release, Bd. of Governors of the Fed. Reserve Sys., Board Issues Final Rule Amending Home Mortgage Provisions of Regulation Z (Truth in Lending) (July 14, 2008) (quoting Ben Bernanke), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20080714a.htm.

105. Truth in Lending, 73 Fed. Reg. 44,522 (July 30, 2008) (to be codified at 12 C.F.R. pt. 226); Press Release, Bd. of Governors of the Fed. Reserve Sys., *supra* note 104.

106. Press Release, Ctr. for Responsible Lending, Calhoun Statement on Release of FRB Rules (July 14, 2008), *available at* http://www.responsiblelending.org/press/releases/calhoun-statement-on-release-of-frb-rules.html.

107. *See id.*

108. HOEPA's legislative history suggests that Congress in fact intended for states to build

to enact its own predatory lending law.[109] Initially, these regulations were effective; later, however, lenders began to sidestep regulations by designing adjustable-rate mortgage schemes that predominated the subprime market by 2003.[110] In response, North Carolina strengthened its predatory lending law in August 2007.[111] The new law, the North Carolina Home Loan Protection Act, includes all broker compensation in the determination of points and fees, increases mortgage broker's duties, and bans prepayment penalties.[112] Studies have shown that North Carolina's aggressive predatory lending laws have helped to buffer the national foreclosure crisis in that state.[113]

As predatory lending increased, many states followed North Carolina's lead. As of 2007, forty-four states had predatory lending laws.[114] At least thirty-six of those laws have been patterned on the federal HOEPA law, while other state laws have focused on expanding disclosures to borrowers or subjecting brokers to greater regulation.[115] Among the state laws patterned after HOEPA, the strength of the "coverage, restriction and enforcement" provisions vary.[116] Recently, some states, including Ohio, Maine, and Minnesota, have strengthened their laws in response to the increase in foreclosures.[117] California has not done so, even though the state currently leads the country in foreclosures.[118]

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on the minimum standards set by HOEPA. *See* H.R. REP. NO. 103-652, at 162 (1994) (Conf. Rep.), *reprinted in* 1994 U.S.C.C.A.N. 1977 ("Conferees intend to allow states to enact more protective provisions than those in this legislation."); *see also* Dietrich, *supra* note 96, at 189.

109. *See* Predatory Lending Act, ch. 332, 1999 N.C. Sess. Laws 1202 (codified principally in N.C. GEN STAT. ch. 24 (1999)); *see also* Robert G. Quercia et al., *Assessing the Impact of North Carolina's Predatory Lending Law*, 15 HOUSING POL'Y DEBATE 573, 577 (2004), *available at* http://www.mi.vt.edu/data/files/hpd%2015(3)/hpd%2015(3)_article_quercia.pdf.

110. *See* Clifford Krauss, *States Begin Action on Subprime Lending*, N.Y. TIMES, Aug. 24, 2007, at C1 (noting that lenders were able to sidestep several states' late 1990s regulations initially and that states were unable to act until a spike of three or more percentage points in the interest on adjustable-rate mortgages caused massive foreclosure in 2007).

111. *Id.*

112. North Carolina Home Loan Protection Act, ch. 352, 2007 N.C. Sess. Laws 1072 (2007) (codified primarily in N.C. GEN. STAT. § 24-1.1(E)–(F) (2009).

113. Susan E. Hauser, Article, *Predatory Lending, Passive Judicial Activism, and the Duty to Decide*, 86 N.C. L. REV. 1501, 1523–24 (2008) ("In early 2008 . . . North Carolina was well below the national averages for nontraditional mortgages, adjustable rate loans, subprime loans, and mortgage fraud. These facts support the inference that North Carolina's strong predatory-lending laws have protected the state's borrowers from the worst effects of the subprime lending crisis.").

114. Bostic et al., *supra* note 99, at 3 n.12.

115. *Id.* at 5.

116. *Id.*

117. N.C. GEN. STAT. §24-8 (2009); OHIO REV. CODE ANN. §1349; ME. REV. STAT. ANN. 9-A §8 (2008); MINN. STAT. §§ 58.02, 58.13, 58.137.

118. Krauss, *supra* note 110.

II
CALIFORNIA PREDATORY LENDING LAW AFTER *WOLSKI* AND *AMERICAN FINANCIAL*

The case for stronger state legislation of anti-predatory lending laws in California is particularly compelling. Until the credit market meltdown, most predatory lending was occurring in the subprime market, and one quarter of all subprime lending in the nation took place in California.[119] It is estimated that more than one in five of those subprime loans will result in foreclosure.[120]

California's predatory lending law, a compromise between consumer advocates and industry groups, contains three main deficiencies. First, the law covers too few loans and does not have strong enough restrictions on those loans that are covered. Second, yield spread premiums (YSPs), or the bonuses the lender pays the broker for originating a loan at a higher interest rate, are not included in the definition of points and fees used for calculating which loans are covered under the law, which further reduces the number of loans that are covered.[121] Finally, because the California Supreme Court has held that the state law preempted stronger local laws designed to protect vulnerable communities, the law is constrained in its ability to correct its own deficiencies as any reformation or revision must consider and speak to the needs of California's diverse local communities.[122]

A. The Current California Predatory Lending Law

California's Predatory Lending Act is ineffective because it covers too few loans and insufficiently regulates the loans it does cover. In 2002, the Act was codified in Division 1.6 of the California Financial Code, Sections 4970 to 4979.8 ("Division 1.6").[123] Because it is patterned after the HOEPA law,

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119. *Preserving the American Dream: Legislative Recommendations to Protect Future Borrowers in California: Informational Hearing Before the Cal. S. Comm. on Banking, Finance, and Insurance*, 2007–2008 Leg. Sess. 1 (Cal. 2007) (statement of Paul Leonard, Cal. Office Director, Center for Responsible Lending) [hereinafter Leonard Statement], *available at* http://www.responsiblelending.org/pdfs/pal-9-21-testimony.pdf.

120. *Id.* at 2. Foreclosure rates for subprime loans have been much higher than for prime loans. For example, "in mid-2004, 4.6 percent of subprime loans were in foreclosure compared to 0.5 percent for prime loans." *Covered Loans in California: Are Consumers Getting the Protection They Need?: Cal. Assem. Banking and Finance Comm. Informational Hearing*, 2005-2006 Leg. Sess. 6 (Cal. 2005) (background briefing paper), *available at* http://www.assembly.ca.gov/acs/newcomframeset.asp?committee=3.

121. The law was silent on the inclusion of YSPs as points and fees. A subsequent case, Wolski v. Fremont Inv. & Loan, 25 Cal. Rptr. 3d 500, 503 (Ct. App. 2005), held that YSPs do not count toward the law's fee trigger.

122. *See* Am. Fin. Servs. Ass'n v. City of Oakland, 104 P.3d 813, 828–30 (Cal. 2005); Concerned Consumer and Fair Housing Advocates, *infra* note 131, at 6 (discussing how Division 1.6 was a result of compromises, but was meant to preserve local governments' right to protect their inhabitants with stronger regulations).

123. 2 HARRY MILLER, MILLER & STARR CAL. REAL EST. § 4:35.1 (3d ed., West 2007).

Division 1.6 first defines which loans are covered,[124] and then enumerates predatory practices that are prohibited.[125]

Every loan covered by the law must have two elements: (1) a maximum original principal balance, and (2) a minimum annual percentage rate (APR) or a minimum total points and fees. The first element, the limit on the original principal balance, precludes many loans from qualifying because the maximum amount is so low. It was originally set at $250,000 in 2002. In 2006, the legislature increased the loan limit to Fannie Mae's conforming limit for a single-family first mortgage, which was $417,000.[126] Despite this increase, the limit was still too low considering the median home price in California is $576,000.[127] Kerstin Arusha, former directing attorney at the Fair Housing Law Project at the Law Foundation of Silicon Valley, who represented victims of predatory lending in suits against lenders and brokers, stated that she could not use the state law in most of her cases because the loan amounts are too large.[128]

Even when the loan amount is small enough to qualify, most loans do not meet the second element because the APR and points and fees are just below the maximum. For Division 1.6 to apply, the loan must either have an APR that exceeds the yield on treasury securities by more than eight percentage points, or the total points and fees must exceed 6 percent of the total loan amount.[129] Most national subprime lenders are aware of the law and accordingly tailor loan terms so that the loans are covered by neither the California law nor the HOEPA restrictions.[130] Consequently, many consumer advocates claim that the current parameters of these elements result in too few covered loans.[131] For example, if a borrower purchased a home for $576,000 (the median home price in California), and borrowed $417,000 of the purchase price, the points and fees would need to total $25,020 before the loan would qualify. Thus, even though 6 percent is less than the federal HOEPA minimum of 8 percent, it is

124. CAL. FIN. CODE § 4970 (West Supp. 2008).

125. *See id.* § 4973.

126. *See id.* § 4970(b); Press Release No. 55-FS, Dept. of Corps, Changes to the Covered Loan Law 1–2 (Feb. 17, 2006), *available at* http://www.corp.ca.gov/press/commissioner/releases/pdf/55fs.pdf (noting that changes to the maximum principle balance were effective January 1, 2006). The Housing and Economic Recovery Act of 2008 will allow the maximum to be raised for high-cost areas and to be adjusted annually, beginning January 1, 2009. Pub. L. 110-289, 122 Stat. 2654 (2008).

127. CAL. LEGISLATIVE ANALYST'S OFFICE, *supra* note 2, at 6 ("The median California home price was $576,000 in mid-2006—more than double the level in mid-2001.").

128. Telephone Interview with Kerstin Arusha, Former Directing Attorney, Law Foundation of Silicon Valley (Oct. 12, 2007) (describing how most of her clients' houses cost more than the conforming loan limit because San Jose's housing market is so expensive).

129. CAL. FIN. CODE § 4970 (West Supp. 2008).

130. Zywicki & Adamson, *supra* note 13, at 53 ("Most lenders, even predatory lenders, can tailor their loans so that they do not fall under HOEPA rules.").

131. Concerned Consumer and Fair Housing Advocates, Predatory Lending in San Jose: A Crisis Demanding Legislative Action 6 (May 13, 2004), http://www.sanjoseca.gov/clerk/Agenda/05_25_04docs/05_25_04_4.4.attB.pdf#xml=http://web-search.sjcity.net/isysquery/c11a16bf-4939-415a-b553-16421e28780f/1/hilite/.

still an exorbitant amount considering the price of homes in California. Therefore, lenders need to do very little to keep loans outside the reach of current laws and can manipulate them to be predatory quite easily.

For the few loans that are covered by the law, Division 1.6 restrictions on predatory practices are too weak. For example, the law technically prohibits prepayment penalties, which trap borrowers in unaffordable loans even when they could qualify for refinancing, but easily exploited loopholes exist.[132] Also, although the law requires certain disclosures of the loan terms in writing, such disclosures nonetheless do not have to be in a language the borrower can understand.[133] The disclosure document must include a notice of the availability of loan counseling, but unlike other states' predatory lending laws, Division 1.6 does not require actual loan counseling.[134]

While the California law does purport to prohibit brokers from steering a borrower to accept a covered loan at a higher cost than the best loan for which the borrower could qualify,[135] in reality, it does very little to actually prevent this behavior. A broker need only "reasonably believe" that the consumer has the capacity to repay the loan obligation.[136] At least one court has interpreted this section as *not* creating a general duty by the lender to evaluate the borrower's ability to repay a loan.[137] Thus, California's law is weaker than the

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132. The law prohibits a prepayment fee or penalty in a covered loan, but there are ways for lenders effectively to include a prepayment fee. For example, if a person who originates the covered loan has also offered the consumer a choice of another product without a prepayment fee or penalty, or has disclosed in writing to the consumer the terms of the prepayment fee and rates, points, and fees available for covered loans without prepayment penalties, or the prepayment does not to exceed the payment of six months' advance interest, the lender can include a prepayment fee. *See* CAL. FIN. CODE § 4973(a) (West Supp. 2008).

133. There is no translation requirement in Division 1.6. *See id.* § 4973(k)(1). Another California law, Civil Code section 1632, requires anyone who negotiates contracts or agreements primarily in the languages of Spanish, Chinese, Tagalog, Vietnamese, and Korean to deliver to a translation of the contract or agreement in the applicable foreign language. CAL. CIV. CODE § 1632 (West Supp. 2008). Section 1632 does not, on its face, cover secured home loans from banks, credit union, and mortgage banks. *See* Barbara E. Hernandez, *Mortgage Translation Bill Clears Hurdle*, OAKLAND TRIB., June 9, 2007 ("So far, secured home loans from banks, credit unions, thrifts and mortgage banks have been excluded from the law."). Yet, Professor Jo Carrillo analyzed section 1632 in a pioneering article and revealed that some courts in the Ninth Circuit have applied it in the mortgage arena despite earlier interpretations of the law. *See* Jo Carrillo, *In Translation for the Latino Market Today: Acknowledging the Rights of Consumers in a Multilingual Housing Market*, 11 HARV. LATINO L. REV. 1, 14 (2008) (analyzing two cases in which courts upheld complaints invoking section 1632 in the mortgage context and suggesting that proposed amendments to section 1632 in A.B. 512, if signed into law would codify, this view). Section 1632 is more fully discussed *infra*.

134. *See* CAL. FIN. CODE § 4973(k)(1) (West Supp. 2008). In contrast, Arkansas, Georgia, Indiana, New Jersey, New Mexico, New York, North Carolina, and South Carolina require loan counseling along with the disclosure. *See* Giang Ho & Anthony Pennington-Cross, *The Impact of Local Predatory-Lending Laws on the Flow of Subprime Credit*, 60 J. URB. ECON. 210, app. A (2006).

135. *See* CAL. FIN. CODE § 4973 (West Supp. 2008).

136. *See id.* § 4973(f)(1).

137. Plata v. Long Beach Mortgage Co., No. C 05-02746 JF, 2005 WL 3417375, at *7

predatory lending laws of other states.[138] Moreover, the law covers only licensed mortgage brokers.[139] This is a problem because many lenders engaged in predatory lending often are not licensed brokers.[140]

B. After Wolski, *Yield Spread Premiums Do Not Count Toward the Point Trigger*

In 2005, a state court rendered Division 1.6 even less effective by holding in *Wolski v. Fremont Investment & Loan* that yield spread premiums (YSPs) should not be included in the definition of points and fees.[141] YSPs are a commission "paid from lending institutions to mortgage brokers . . . . The more an interest rate charged on an above par loan exceeds the rate for a comparable par loan, the greater the yield spread premium payment to the mortgage broker."[142] YSPs, then, reward brokers for selling the highest-interest loans possible.

Under Division 1.6, fees and costs in excess of 6 percent of the loan qualify the loan as potentially predatory if the original balance is large enough.

(N.D. Cal. Dec. 13, 2005) (unpublished order) (holding that Cal. Fin. Code § 4973(f)(1) does not create a duty by the lender to the borrower). Because this case is unpublished, it technically has no general precedential value according to CAL. R. CT. 8.1115(a).

138. For example, in North Carolina, the broker must

> (1) [s]afeguard and account for any money handled for the borrower; (2) [f]ollow reasonable and lawful instructions from the borrower; (3) [a]ct with reasonable skill, care, and diligence; and (4) [m]ake reasonable efforts to secure a loan that is reasonably advantageous to the borrower considering all the circumstances, including the rates, charges, and repayment terms of the loan and the loan options for which the borrower qualifies with such lenders.

N.C. GEN. STAT. § 53-243.10(a)(1)–(4) (2007). "These affirmative duties establish a clear legal precedent that the broker has a statutory responsibility to their client, a point that some mortgage brokers have tried to refute in recent years." Ctr. for Responsible Lending, NC Mortgage Broker Licensing Law Frequently Asked Questions, http://www.responsiblelending.org/policy/state/north-carolina/NCbrokerfaq.html [hereinafter NC Mortgage FAQs].

Other states with similar duties include Minnesota, Illinois, and Washington. Telephone interview with Chris Kukla, Director of Governmental Affairs, Ctr. for Responsible Lending (Oct. 8, 2008) [hereinafter Oct. 2008 Interview with Chris Kukla]; MINN. STAT. § 58.161 (2008); 815 ILL. COMP. STAT. 137/15–105 (2009); WASH. REV. CODE §§ 19.146.005–905 (2009).

139. The law only applies to mortgage brokers, and the broker-licensing agency has authority to enforce it. Specifically, the licensing agency may revoke a broker's license or charge an administrative penalty of up to $2,500. *See* CAL. FIN. CODE § 4977(a) (West Supp. 2008).

140. Many lenders, such as the lenders in the *Garvin* case, discussed *infra*, are merely lenders but do not have a mortgage broker's license. Telephone interview with Jessica Fry, Staff Attorney, Fair Housing Law Project (Oct. 1, 2008) [hereinafter Interview with Jessica Fry]; *see* CONFERENCE OF DELEGATES OF THE CAL. BAR ASS'N, RESOLUTION 06-03-2007, PREDATORY LENDING: YIELD SPREAD PREMIUM IN CALCULATION OF COVERED LOANS: RESOLUTION COMMITTEE RECOMMENDATION (June 3, 2007), *available at* http://www.cdcba.org/pdfs/R2007/06-03-2007.pdf (recommending the definition of "licensed broker" to extend to a licensed salesperson working under a broker); NC Mortgage Broker FAQs, *supra* note 137.

141. 25 Cal. Rptr. 3d 500 (Ct. App. 2005).

142. Howell E. Jackson & Laurie Burlingame, *Kickbacks or Compensation: The Case of Yield Spread Premiums*, 12 STAN. J.L. BUS. & FIN. 289, 291–92 (2007).

The plaintiff borrower in *Wolski* included the additional cost of the YSP toward the calculation of points for qualification under Division 1.6. But the court read the statute, which defines points and fees as those "payable by the consumer at or before closing," as excluding YSPs.[143] The court reasoned that YSPs do not count as points and fees under the statue because they are paid by the *lender* rather than the *consumer*.[144] What the court did not consider, however, is that the borrower does ultimately pay for the YSP, in the form of a higher interest rate after closing.[145]

After *Wolski*, Division 1.6 covers even fewer loans. YSPs are exactly the type of fees that should count toward a predatory lending law's fee trigger because they increase the overall cost of a loan dramatically without any incremental benefit to the borrower.[146] Professor Howell E. Jackson of Harvard Law School stated in testimony that YSPs "are inherently confusing and serve primarily to raise the cost of homeownership for many Americans, particularly the less-educated and the financially unsophisticated."[147] The California Department of Real Estate has also issued an opinion that the California legislature originally intended that YSPs be included in the points and fees calculation.[148] Many brokers and lenders take advantage of the complexity of the transaction, using YSPs as a way to gain profit behind the scenes without informing borrowers of up-front fees.[149]

C. After American Financial, *California's Narrow Predatory Lending Law Is Now the Ceiling for Predatory Lending Legislation in California*

As discussed in the introduction, Oakland passed a local predatory lending ordinance[150] to enhance Division 1.6's protection, tailoring its provisions to the

143. CAL. FIN. CODE § 4970(b)(2) (West Supp. 2008).

144. *See Wolski*, 25 Cal. Rptr. 3d at 505.

145. *See Predatory Mortgage Lending Practices: Abusive Uses of Yield Spread Premiums: Hearing Before S. Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. (2002) [hereinafter *Hearing*] (statement of Professor Howell Jackson), *available at* http://banking.senate.gov/02_01hrg/010802/jackson.htm ("[T]he higher interest rate is used to finance a payment to the mortgage broker."); *see also* Jackson & Burlingame, *supra* note 142, at 291 ("The traditional method of compensation was direct cash payments from the borrower. . . . [However] yield spread premiums are paid from lending institutions to mortgage brokers.").

146. *Hearing*, *supra* note 145 (statement of Professor Howell Jackson) ("[Subprime borrowers . . . never understand that the interest rate is higher than it needs to be or that the higher interest rate is used to finance a payment to the mortgage broker.").

147. *Id.*

148. Leonard Statement, *supra* note 119, at 10.

149. *Hearing*, *supra* note 145 (statement of Professor Howell Jackson) ("[H]omeowners who are short on cash could, theoretically, use yield spread premiums to finance settlement costs. [Instead], the manner in which yield spread premiums are levied . . . serves principally to allow mortgage brokers to impose higher prices on borrowers who bear the cost of these charges--particularly on individuals who are less educated and less sophisticated about financial matters."); *see also* Plata v. Long Beach Mortgage Co., No. C 05-02746 JF, 2005 WL 3417375, at *5 (N.D. Cal. Dec. 13, 2005) (unpublished order) (providing an example of this type of abuse).

150. OAKLAND, CAL., MUN. CODE ch. 5.33.020 (2001) [hereinafter the Ordinance],

hallmarks of predatory lending in that city.[151] To address these particular vulnerabilities, Oakland implemented stricter standards on lenders and provided stronger enforcement provisions.[152]

Shortly after Oakland passed the local ordinance, however, the California Supreme Court held in *American Financial* that Division 1.6 fully occupied the field of regulation of predatory tactics in home mortgages and, as such, preempted any local regulation.[153] In light of *American Financial*'s holding, communities can no longer address the problems created by predatory lending on a local level.[154] It is unlikely that the legislature would respond by explicitly negating any preemptive effect of Division 1.6 because of substantial opposition to the idea of patchwork municipal regulatory schemes.[155] Instead, the legislature must craft a state law strong enough to protect the state's most vulnerable populations.

The Oakland ordinance provides helpful guidance for crafting legislation at the state level.[156] The ordinance responded to the findings of a study that documented the predatory lending trends within low-income and minority neighborhoods in Oakland.[157] It was also based on testimony from predatory lending victims, and community organizations, which produced "strong anecdotal evidence" of specific predatory practices that were being deployed in Oakland.[158] With this information, the Oakland City Council was able to craft legislation that prohibited those specific practices. Just as knowledge of the specific predatory practices in Oakland helped the City Council tailor their

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available at http://www.oaklandnet.com/government/hcd/policy/docs/pred_muni.pdf.

151. *See* Brief for AARP et. al, *supra* note 18, at 13, 17–20.

152. The Ordinance, *supra* note 150, prohibited prepayment penalties, whereas Division 1.6 allowed prepayment penalties during the first thirty-six months of the loan. *See* Am. Fin. Servs. Ass'n v. City of Oakland, 104 P.3d 813, 819 (Cal. 2005). The main differences in enforcement mechanisms were: (1) the Ordinance imposed up to $50,000 in penalties, instead of $25,000 as under Division 1.6 (2) the Ordinance had a lower standard of proof for punitive damages, and (3) the Ordinance's remedies were cumulative, as opposed to the provision in Division 1.6 that prohibits double recovery. *See id.* at 819-20. The Ordinance, *supra* note 150, also required a borrower to discuss the loan with a credit counselor, and provide a certification of that counseling session. Stephen E. Paffrath, NIXON PEABODY LLP, *California Supreme Court Rules that Local Ordinance Imposing Expansive Prohibitions on Predatory Lending Is Preempted by State Statute Addressing Same Practices*, CLASS ACTION ALERT (Nixon Peabody LLP), Feb. 1, 2005, at 2, *available at* http://www.nixonpeabody.com/linked_media/publications/CAA_02012005.pdf.

153. *Am. Fin. Servs. Ass'n*, 104 P.3d at 829.

154. *See id.*

155. *Id.* at 831–34 (George, C.J., dissenting) (noting that financial services companies actively lobbied for express preemption when Division 1.6 was passed their concessions).

156. *See* Jonathan L. Entin & Shadya Y. Yazback, *City Governments and Predatory Lending*, 34 FORDHAM URB. L.J. 757, 758 (2007) ("[L]ocal efforts have served as a catalyst for predatory lending policies at the state level and might stimulate more effective national policies as well.").

157. OAKLAND, CAL., ORD. 12,361 (Oct. 1, 2001), *available at* http://www.oaklandnet.com/government/hcd/policy/docs/pred_muni.pdf.

158. *Id.*

predatory lending ordinance, similar information about how predatory lenders targeted subgroups in California could assist the California Legislature in crafting a stronger anti-predatory lending law.

To consider properly the needs of the most vulnerable populations when designing a stronger state law, one must look at how predatory lending occurs on a local level. As the dissent pointed out in *American Financial*, some local conditions, especially conditions in low-income and minority neighborhoods, allow predatory lenders to thrive.[159] The CRL study, discussed above, reinforced this idea by revealing that predatory lenders target different minority groups with different predatory tactics.[160] The CRL study suggests that the cultural context heavily influences the tactics used by lenders who target minority borrowers. This is why California legislators should consider the variety of predatory practices deployed against different minority groups when reforming state predatory lending laws.

III
A CASE STUDY OF PREDATORY LENDING IN CALIFORNIA'S LATINO COMMUNITIES

Because predators target different minority groups in different ways, it would be useful to examine the conditions under which certain vulnerable groups fall prey to predatory tactics. Empirical studies reveal racial disparities in the distribution of higher-rate subprime mortgages, and this strongly suggests that predatory lending occurs disproportionately in minority populations.[161] While these studies demonstrate racial and ethnic variance in financial problems, they are limited by an inability to account for the experiences of individuals in different communities.[162] For example, a U.S. Department of Housing and Urban Development study of Hispanic homeownership revealed different patterns among Hispanics in three different cities across the United States.[163] Even though no empirical studies have yet

159. *See* Am. Fin. Servs. Ass'n v. City of Oakland, 104 P.3d 813, 832–33 (Cal. 2005).

160. *See* 2006 CRL STUDY, *supra* note 81, at 4.

161. *See* TREASURY-HUD REPORT, *supra* note 35, at 23, 48 (noting subprime loans are five times more common in black neighborhoods than in white neighborhoods and that homeowners in high-income black neighborhoods are six times likelier to have a subprime loan as homeowners in high-income white neighborhoods). The authors of the 2006 CRL Study acknowledge that their analysis does not allow them to "estimate precisely how much race and ethnicity increase the prices charged to borrowers" and consider it beyond the scope of their research "to determine definitively why these disparities exist." 2006 CRL STUDY, *supra* note 81, at 5. However, the CRL study does speculate that mortgage broker discretion, such as leeway given by the yield spread premium, might be to blame. *Id.*

162. *See* TERESA A. SULLIVAN ET AL., THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT 44 (2000) (discussing how it is difficult to isolate the influence of race and ethnicity when other community and jurisdictional factors play a role).

163. OFFICE OF POLICY RESEARCH, U.S. DEP'T OF HOUS. & URBAN DEV., SUMMARY OF THE HUD RESEARCH SERIES EXAMINING BARRIERS TO HISPANIC HOMEOWNERSHIP AND EFFORTS TO ADDRESS THESE BARRIERS 11 (2006), *available at* http://www.huduser.org/Publications/PDF/

conclusively explained the disparities in predatory lending, it is useful to consider a qualitative analysis of predatory lending cases in a subgroup of vulnerable borrowers.[164]

A. Revealing Patterns of Predatory Lending Through a Qualitative Analysis of Recent California Court Cases

This qualitative analysis is meant to highlight patterns across cases involving the Latino community. This is merely a descriptive survey of cases, and has its limitations because it only reveals patterns in one subgroup of vulnerable borrowers.[165] However, highlighting common predatory lending practices could help researchers identify variables that should be considered in future empirical studies and consider ways in which these variables may best be measured.

One scholar has argued that a behavioral analysis of predatory lending would facilitate legal reforms.[166] Legal behavioral analysis aims to examine "contradictions between law on the books and the reality of these laws as enforced."[167] Such analysis includes an examination of a group's culture, practices, preferences, and perceptions.[168] This type of study is particularly useful for predatory lending because, while "[s]ubprime lending is more easily identified and measured[,] predatory lending is contextual and often difficult to pinpoint."[169]

Although some loan *products* are inherently predatory, this Comment focuses on predatory *tactics* that lenders have used to sell unsuitable loans to Latino borrowers. Predatory tactics are harder to regulate because even loan products that are deemed safe for a specific clientele can be abused by predatory actors if they sell such products to borrowers who do not qualify for those products.[170] Additionally, when locally-driven entities target vulnerable borrowers who are unlikely to report suspect activity to the authorities, abuses in the *manner* in which loans are sold often 'slip beneath the regulatory

hisp_homeown8.pdf.

164. *See* Bowdler, *supra* note 41, at 15. ("No minority homeownership policy agenda can be complete or fully effective without addressing the incidence of predatory lending in minority communities. For Latino homebuyers, the priority is not whether these protections exist at the federal or the state level, *but that the protections are meaningful and the market is serving them adequately*." (emphasis added)).

165. Further, it is subject to observer bias and injection of normative assumptions.

166. *See* Regina Austin, *Of Predatory Lending and the Democratization of Credit: Preserving the Social Safety Net of Informality in Small-Loan Transactions*, 53 AM. U. L. REV. 1217, 1220–21 (2004).

167. *Id.* at 1220.

168. *Id.* at 1221.

169. Bowdler, *supra* note 41, at 9. Predatory lending is difficult to pinpoint because while subprime loan products may be appropriate in certain situations, lack of disclosure, uneven bargaining power, or fraudulent misrepresentation make them predatory in others. *See* sources cited *supra* note 35.

170. *See* Bowdler, *supra* note 41, at 9.

radar.'[171]

By focusing on context-sensitive predatory tactics, scholars have illuminated common patterns of predatory lending. For example, Professor Regina Austin at the University of Pennsylvania Law School examined predatory lending in low-income urban African American populations. She found that many of these consumers prefer cash transactions and depend heavily on small-sum informal credit.[172] She also found that, when subprime lenders entered low-income African American neighborhoods, they incorporated elements of informal lending into their practice, such as staying open later, providing frequent face-to-face transactions, making quick approvals, and granting short-term, small-scale loans.[173] Although one could view these practices as accommodating subprime borrowers' needs, the addition of these elements of informality often increased the cost of credit.[174] Because of their cash-basis orientation, many consumers were unaware that making frequent small payments over an extended period of time resulted in greater overall expense.[175] Hence, Austin concluded that low-income African Americans' preference for informality in credit transactions facilitated exploitation and overreaching by subprime lenders.[176]

Professor Patricia McCoy of the University of Connecticut also examined predatory lending within a subset of borrowers: elderly victims who have a great deal of equity in their homes, but are facing financial problems.[177] McCoy noted that homeowners in this situation often take out subprime loans against the equity in their homes even though such loan agreements contain abusive terms.[178] McCoy then applied the behavioral economics concept of loss aversion, which explains why individuals take substantial risks to avoid losses and make seemingly irrational financial sacrifices to avoid losing their homes.[179] Based on this framework, McCoy concluded that predatory lenders use manipulative marketing to exploit homeowners' loss aversion in four ways: (1) framing loans as gains, while obscuring potential losses;[180] (2) minimizing

171. *Id.*

172. Austin, *supra* note 166, at 1228, 1246.

173. *See id.* at 1240–41, 1247–48.

174. *See id.* at 1248.

175. *See id.*

176. *See id.* at 1243. Although Austin's findings relate primarily to small-amount personal loans, which are obviously of a different magnitude than a large mortgage loan involving hundreds of thousands of dollars, similar biases span across all types of personal finance decision making. *See, e.g.*, Lauren E. Willis, *Against Financial-Literacy Education*, 94 IOWA L. REV 197, 219–31 (2008) (surveying psychology and behavior economics literature that describe various biases affecting all types of personal finance decision making, including choosing between retirement plans, home-finance options, and life-insurance plans).

177. McCoy, *supra* note 41.

178. *Id.* at 726.

179. *Id.* at 728–29.

180. They frame the loan as a gain, rather than a loss, by highlighting fast cash and initial low monthly payments, and hiding looming balloon payments and prepayment penalties. *Id.* at

transparency of the loan terms;[181] (3) seeking out inexperienced borrowers;[182] and (4) promoting erroneous use of heuristics, or mental shortcuts, in weighing the risks of the loan.[183]

Although Austin and McCoy analyzed predatory lending in two subgroups of vulnerable borrowers, literature on predatory lending across the nation echoes the trends they described.[184] Therefore, a contextual case study of predatory lending among one subgroup of borrowers in California may inform future protections for vulnerable populations in general. Of the affected groups in California, Latino borrowers are especially at risk because of their growing population and, before the subprime crisis, increasing rates of home-ownership.[185]

B. Choosing the Latino Population for a Contextual Case Study

California is a diverse state and, as discussed above, the state predatory lending law does not adequately protect many minority groups. This Comment focuses on the Latino community for three reasons. First, Latinos are California's largest minority group. According to 2006 U.S. Census Bureau data, 35.9 percent of California's population self-identifies as Hispanic, whereas 43.1 percent identifies itself as non-Hispanic white.[186] Moreover, the Latino population is significantly larger than the other large minority groups in California, Asians and African Americans, who represent 12.4 percent and 6.7 percent of the population, respectively.[187] Prior to the collapse of the financial markets in late 2008, the explosive growth in the Latino population created a high demand for homes and accompanying services in Latino communities.[188] The number of Hispanic owner-occupied homes increased by 3.1 million between 1995 and 2005, representing a growth of 81 percent.[189]

731.

181. Predatory lenders exclude cost elements from the APR and employ high-pressure closings, thereby preventing comparison shopping. *Id.* at 734.

182. *Id.* at 735.

183. A heuristic is a shortcut to understanding a problem and making a decision. Some heuristics that lead borrowers to take on bad loans include: focusing on lower monthly payments rather than on lower interest rates, underestimating the probability of general risks such as default, and overestimating the likelihood of catastrophic risks (which leads people to pay to over-insure for those risks). *Id.* at 736–37.

184. *See, e.g.*, Overby, *supra* note 76 (offering a post-Katrina study of foreclosure and predatory lending in New Orleans that particularly targeted poor black families); Roger M. Groves, *Time to Step Up: Modeling the African American Ethivestor for Self-Help Entrepreneurship in Urban America*, 13 MICH. J. RACE & L. 99 (2007) (discussing predatory lending in minority communities and its implications for the greater investment market).

185. Chavers, *supra* note 30.

186. U.S. Census Bureau, State and County Quickfacts, http://quickfacts.census.gov/qfd/states/06000.html (last visited Nov. 24, 2007). Hispanics comprise the largest minority in the United States as well, respresenting 14.4 percent of the population. *Id.*

187. *Id.*

188. Bowdler, *supra* note 41, at 1.

189. TIMOTHY READY, HISPANIC HOUSING IN THE UNITED STATES 9 (2006), *available at*

Second, until the market collapse, predatory lending against Latinos was on the rise.[190] From 1996 to 2006, homeownership rates increased in every segment of the population, and the largest increase occurred among Latinos.[191] Between 1993 and the fourth quarter of 2005, homeownership rates rose by 10.6 points for Hispanics, whereas homeownership rates rose by 5.8 percent for non-Hispanic whites and by 6.6 percent for African Americans.[192] Although this increase was positive, the "growth [came] with the price of predatory lending practices."[193] Scholars who have studied psychological biases in financial decision making have noted that "the positive vision of homeownership could lead households to underweight future costs and the risk of foreclosure . . . [which could] land the consumer in a fraudulent financial scheme."[194] Because of the ownership aspirations of Latino workers, predatory lenders aggressively targeted Latino neighborhoods.[195]

Third, the Latino community provides a lens through which to view other struggling populations. Although some characteristics of the Latino community that increase its members' susceptibility to predatory lending are unique, others are common in many communities.[196] For example, a large portion of the Latino population is comprised of working people with low incomes,[197] so trends in this portion of the Latino population may reflect trends among low-income communities in general. Also, because much of the Latino population consists of first- or second-generation immigrants,[198] many of the linguistic and cultural barriers they face may be similar to those faced by other immigrant communities who speak English as a second language.[199]

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http://latinostudies.nd.edu/pubs/pubs/Esperanza_Web.pdf.

190. *See* NAT'L COUNCIL OF LA RAZA AND NAT'L ASS'N OF HISPANIC REAL EST. PROF'LS, SAVING HOMES, SAVING COMMUNITIES: LATINO BROKERS SPEAK OUT ON HISPANIC OWNERSHIP 9 (2007) [hereinafter SAVING HOMES], *available at* http://www.nclr.org/content/publications/download/48388 (concluding that "Latino families were particularly vulnerable to such [predatory lending] practices."); Chavers, *supra* note 30; Eunice Moscoso, *Report: Lenders Prey on Latinos*, AUSTIN AM.-STATESMAN, Sept. 13, 2007, at A7; Roy, *supra* note 30.

191. OFFICE OF POLICY RESEARCH, *supra* note 163, at 1.

192. *Id.*

193. Press Release, Nat'l Council of La Raza, NAHREP & NCLR Issue Report on Mortgage Lending Crisis and its Impact on Hispanic Community (Sept. 12, 2007), http://www.nclr.org/content/news/detail/48381 (quoting NAHREP President and CEO Tim Sanders).

194. Willis, *supra* note 176, at 233.

195. *See* Bowdler, *supra* note 41, at 2 (discussing the influx of nontraditional lenders in Hispanic neighborhoods); *see also* SAVING HOMES, *supra* note 190.

196. *Cf.* OFFICE OF POLICY RESEARCH, *supra* note 163, at 8.

197. *See* U.S. Census Bureau, U.S. Hispanic Population Power Point 2006, at slides 20–22, http://www.census.gov/population/socdemo/hispanic/cps2006/CPS_Powerpoint_2006.ppt.

198. *See* U.S. Census Bureau, The Hispanic Population in the United States: Detailed Tables 2006, *available at* http://www.census.gov/population/www/socdemo/hispanic/cps2006.html (noting in table 8.2 the national origin and year of entry to the United States).

199. 2008 Interview with Fair Housing Council of Orange County, *supra* note 4 (noting that in their work at the Fair Housing Council they see that language barriers create similar problems for immigrants from many countries).

Of course, these commonalities between Latinos and other subgroups are tempered by the vast diversity within the Latino population. In an analysis of the Latino population as an emerging market sector, Professor Jo Carrillo posits that "[a]s a group, Latinos in the United States might be likened to Europeans in the United States" because of their diversity of nationality, socioeconomic group, and cultural identity.[200] With regard to financial behavior, she explains that the Latino population represents a group "in need of basic banking education at the cash economy end of the spectrum and advanced banking services at the affluent end of the spectrum."[201]

But Carrillo concluded that one characteristic of the Latino community spanned the socioeconomic spectrum: "growth, purchasing power, perceived work ethic, and perceived commitment to family and home has grabbed the attention of banking and lending industries."[202] As such, another reason to examine predatory lending in the Latino population is that banks and mortgage lenders were actively trying to capture their business.[203]

C. Trends in Predatory Lending Tactics in the Latino Community

While acknowledging that a case study only depicts a small slice of the diverse Latino population, this section describes various predatory lending tactics used on Latino victims by examining cases filed in California courts. A recently filed lawsuit in the Northern District of California, *Garvin v. Tran*, exemplifies tactics commonly used on the Latino population.[204] Nine families in San Jose, all Latino, sued local Latino brokers Norma Valdovinos, Jesus Chavez, and their company Century 21 Golden Hills, along with real estate sales agents and independent "down payment assistance" lender Pablo Curiel.[205] Valdovinos actively sought out Spanish-speaking families through

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200. Carrillo, *supra* note 133, at 6.

201. *Id.*

202. *Id.* at 7. Other studies have highlighted the real estate industry's particular interest in the growing market of undocumented Latino homebuyers. *See, e.g.*, MARTHA ARGELLA MARTINEZ, PROMOTING AND MAINTAINING HOUSEHOLD OWNERSHIP AMONG LATINO IMMIGRANTS 9–10 (2007), *available at* http://www.esperanza.us/atf/cf/%7BB793CA9C-D2B9-4E02-886B (reporting that "undocumented immigrants constitute a potential and growing market for real estate professionals and banking institutions in an environment in which other ethnic groups, particularly whites, are not growing as a market").

203. *See* Carrillo, *supra* note 133, at 6–7 (explaining various marketing techniques banks use to capture part of the growing Latino market, including "individual tax identification number" (ITIN) mortgages with a low foreclosure rate, and "adjustable rate mortgages" (ARMs) which have produced high and climbing foreclosure rates among Latinos). *Id.*

204. Second Amended Complaint, Garvin v. Tran, No. C07-01571 RS (N.D. Cal. Oct. 22, 2007) [hereinafter Garvin Complaint]. The discussion of this case throughout this comment is based on the initial pleadings and interviews with the plaintiffs' lawyers. Therefore, all the facts of the case are *alleged* facts. As this paper was published, discovery in the case was being conducted and the trial date was set for September 2009. Interview with Jessica Fry, *supra* note 140.

205. Garvin Complaint, *supra* note 204, ¶¶ 2–7. It is important to note that Pablo Curiel is not a licensed broker. He has a real estate sales license, but he does not have a mortgage broker's license. Interview with Jessica Fry, *supra* note 140.

advertisements in popular Spanish magazines promising a piece of the "American Dream."[206] Once she contacted the families, she convinced the borrowers they could buy a home with loan payments of only a few thousand dollars a month.[207] Instead, Valdovinos referred the borrowers to lenders who offered complex and disadvantageous loan packages costing much more than originally promised. Once Valdovinos found out what kind of house people wanted and what payments they could afford, she would send them to mortgage broker Linda Tran, who worked at Absolute Investment Group, Inc., which was doing business as Palacio Mortgage.[208] Tran would then falsify loan documents and sell loans to buyers which were greater than they could afford.[209] Eventually, the borrowers would default and Tran would offer to refinance their home to help them make the payments.[210] Each time they refinanced, Linda Tran would make an additional commission from the new loan.[211]

The *Garvin* case highlights two common predatory tactics utilized in California: (1) misleading borrowers about loan terms, then falsifying assets and income on loan applications, and (2) steering borrowers into expensive loans they could not afford, with the goal of profiting from refinancing the loan when the borrower was unable to meet payments.[212] The next two sections describe each of these predatory strategies in general, and the subsections use *Garvin* and other recent California cases to illustrate how predatory lenders exploit certain characteristics of the Latino population to facilitate each strategy. Because certain characteristics of the Latino population facilitate the use of several predatory tactics, the analyses of each strategy may overlap one another.

1. Lenders Misled Latino Borrowers about Loan Terms and Falsified Borrowers' Incomes or Assets on the Loan Applications

Predatory lenders often lured many borrowers with false promises about the loan terms.[213] Specifically, lenders misled borrowers about negative amortization, balloon payments, prepayment penalties, or other "creative" loan terms, and what effect these terms will have on their payments.[214] A higher-cost loan means more profit for the broker. Thus, some brokerage firms have been

206. Garvin Complaint, *supra* note 204, ¶¶ 185, 205, 327; Interview with Jessica Fry, *supra* note 140.

207. Garvin Complaint, *supra* note 204, ¶¶ 63, 196, 282.

208. By 2006, nearly all of Valdovinos's customers purchased their mortgages from Tran. Interview with Jessica Fry, *supra* note 140.

209. This would also provide Valdovinos with a higher commission on the property. *Id*.

210. *Id.*

211. *Id.*

212. Garvin Complaint, *supra* note 204, ¶¶ 2–7.

213. *See* Goffard & Delson, *supra* note 1.

214. *See* McCoy, *supra* note 41, at 731 (noting how predatory lenders highlight fast cash and initial low monthly payments, and hide looming balloon payments and prepayment penalties).

accused of teaching their employees how to entice potential borrowers and then use high-pressure sales tactics to sell loans with less favorable terms than promised.[215]

Unscrupulous brokers would also falsify loan applications, lying about a borrower's income or assets to qualify the borrower for a higher-cost loan, resulting in mortgages payments that exceeded the borrower's monthly income.[216] Such falsification was possible because the regulations on underwriting have been relaxed, allowing "stated income" loan applications, whereby borrowers simply state what they make without verification.[217] Stated income loans were created to provide credit to a limited category of self-employed people whose incomes are legitimately not reported on a W-2 tax form.[218] However, predatory lenders increasingly pushed these types of loans because they allowed lenders to take advantage of the system to falsify loan applications increasing brokers' profit.[219] In many cases, lenders made little effort to ascertain plaintiffs' ability to repay.[220] A recent study of stated income loans revealed that "90% of the stated incomes were exaggerated by 5% or more" and "almost 60% of the stated amounts were exaggerated by more than 50%."[221] Borrowers must pay a higher interest rate for a stated income loan, but brokers often do not inform borrowers of this extra charge, even if the borrower's W-2 forms are readily available.[222]

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215. Knox v. Ameriquest Mortgage Co., No. C-05-002402 SC, 2005 U.S. Dist. LEXIS 40709, at *3–4 (N.D. Cal. Aug. 12, 2005) (unpublished order); *see also* Press Release, Am. Guardian Home Loans, American Guardian Home Loans Fights Back Against Fraud: Protecting Broker Reputations and Legitimate Borrowers is Top Priority (June 29, 2007) (discussing how brokers are falsifying various documents relating to their clients' ability to pay); *see also* Online Video: Families in Crisis: Facing the Subprime Disaster (Ctr. for Responsible Lending), http://www.responsiblelending.org/issues/mortgage/subprime-crisis/families_in_crisis.html (last visited Mar. 10, 2007) (a former mortgage broker describes how he was told to refinance his clients' loan just six months later, even if it was not in his clients' best interest).

216. *Knox*, 2005 U.S. Dist. LEXIS 40709, at *3–4.

217. *See Fed Probes Predatory Mortgage Tactics*, FIN. ADVISOR MAG. ONLINE, June 19, 2006, http://www.fa-mag.com/news.php?idNews=669&id_content=4 (last accessed July 11, 2009). ("A strong appetite in the secondary market for nontraditional mortgage products may have led to a relaxation of underwriting standards."). The 2008 amendments to TILA will abolish such "stated income" loans by requiring documentation of ability to repay, but these amendments do not apply to many nontraditional subprime mortgages. *See* Press Release, Ctr. for Responsible Lending, *supra* note 106.

218. Martin Eakes, CEO of Ctr. for Responsible Lending, Statement before the Federal Reserve Board on Home Ownership and Equity Protection Act 4 (June 14, 2007), *available at* http://www.responsiblelending.org/pdfs/Fed-6-14-07-ME-Statement.pdf.

219. *See* Merle Sharick et al., *Eighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association*, 8 MORTGAGE ASSET RES. INST. 12 (2006), http://mbafightsfraud.mortgagebankers.org/mortgagefraud/mortgagefraud/images/files/MARIEighthAnnualReportonMortgageFraud.pdf.

220. *See, e.g.*, Gonzalez v. Ameriquest, No. C 03-00405 JSW, 2004 U.S. Dist. LEXIS 22705, at *6 (N.D. Cal. Mar. 1, 2004) (unpublished order denying motion to dismiss).

221. *See* Sharick et al., *supra* note 219, at 12.

222. *See* Eakes, *supra* note 218, at 4.

Certain traits of the Latino community made its members particularly susceptible to these practices. First, Latino borrowers tend to place a great deal of trust in brokers who speak their own language and have a similar cultural background.[223] Second, the language barrier gave predatory lenders an opportunity to obscure predatory terms by presenting contracts solely in English.[224]

a. Trust in Spanish-Speaking Brokers Facilitated Fraud

Many Latino borrowers prefer to work with brokers who speak their own language, and place a great deal of trust in Latino brokers.[225] As subprime lending proliferated, Latino brokers who engaged in predatory lending practices often took advantage of the trust gained through a shared language and culture to sell loans that were profitable for the broker but risky for the buyer.[226] The *Garvin* plaintiffs' accounts of their experiences with the defendant brokers highlights this type of manipulation. One plaintiff reported that when he was reluctant to sign a blank document the broker insisted it was necessary to "make the process move along faster."[227] When other plaintiffs expressed concern about not having a certain promise in writing, or not understanding something that was written in English, the broker told them they had "her word," and "[d]on't worry, I have the same type of loan."[228]

Predatory lenders often took advantage of Latino families' trust by sending brokers to visit the homes of their clients.[229] Conducting the process in the home appealed to clients who were intimidated by the formal mainstream mortgage industry,[230] but it also made it easier for a broker to convince clients to purchase loans without taking the time to consider other options.[231]

Predatory Latino brokers also attempted to gain borrowers' trust by providing personal services and recruiting potential borrowers at community events. In *Plata v. Long Beach Mortgage Co.*, a Latino broker approached

223. *See* SAVING HOMES, *supra* note 190, at 19 (describing Latino reliance on mortgage brokers to whom they have a cultural connection and over-deterred by their often thin credit files and multiple sources of household income).

224. *See id.*

225. *See id.* Sen. Robert Menendez, *Predatory Lending: Disproportionately Targeting Latinos Seeking the American Dream*, LATINO LEADERSHIP LINK, http://menendez.senate.gov/pdf/PredatoryLendingLLL.doc (last visited Mar. 10, 2009) ("More than any other ethnic group, Hispanics prefer to work with lenders who speak their own language, and tend to feel uncomfortable handling business transactions in English.").

226. *See id.* at 2; *see also Fed Probes Predatory Mortgage Tactics*, *supra* note 217 (noting many Latino brokers take advantage of the trust they receive in Latino neighborhoods).

227. Garvin Complaint, *supra* note 204, ¶ 190.

228. *Id.* at ¶¶ 106, 111.

229. *See* Bowdler, *supra* note 41, at 12.

230. *See* McCoy, *supra* note 41, at 733.

231. *Id.* at 732, 733 ("A key objective of predatory lenders is to prevent homeowners, once solicited for loans, from engaging in comparison-shopping.").

plaintiffs Plata and Mapula at a flea market in San Jose.[232] Plata and Mapula are Mexican immigrants and could not speak or read English.[233] They explained to the broker that they were not shopping for a home, but he persisted and told them they could purchase a home with no down payment.[234] The broker then drove the plaintiffs around San Jose to show them homes for sale. They found a house they liked and the broker told them they could own it for $2,700 a month.[235] Weeks later, they found out there were additional closing costs, which the broker had failed to disclose. Believing that they had already entered into a binding agreement, the plaintiffs signed the loan documents.[236]

Once the broker garnered the borrower's trust, the broker had the leeway to falsify the loan application with inflated income and assets.[237] In *Plata*, the broker had the borrowers sign documents that falsely represented their income and assets, and committed them to monthly payments that were actually $3,500, not $2,700 as initially promised.[238] Brokers also falsified the loan applications in all the transactions in the *Garvin* case. Plaintiffs in that case told the broker verbally how much they made each month and how much they could afford for a monthly payment.[239] When the borrowers signed the long document, they trusted the broker to correctly represent their income and assets. Unfortunately, the trust was misplaced; the broker had actually falsified their income and assets.[240]

Similar to the loss aversion McCoy identified in the elderly population, borrowers at a high-pressure signing do not want to question the document, or ask for more time, because they are already invested in the home purchase.[241] Testimony by Latino victims about the high pressure signing process reveals that predatory lenders employed the same tactics used to manipulate loss

232. Plata v. Long Beach Mortgage Co., No. C 05-02746 JF, 2005 WL 3417375, at *1 (N.D. Cal. Dec. 13, 2005) (unpublished order).

233. *Id.*

234. *Id.*

235. *Id.*

236. *Id.* at *2.

237. It is easy for unscrupulous brokers to include false information on the final loan documents without borrowers' knowledge because the documents are dozens of pages long and full of financial and legal terms. *See* Bob Tedeschi, *Simplification: A Complex Job*, N.Y. TIMES, July 8, 2007, at RE11 ("[R]eading a mortgage agreement is a bit like trying to decipher hieroglyphics. . . . [T]he forms. . . run to dozens of pages and often include financial and legal terms that are far beyond the ken of typical borrowers.").

238. When they could not make the payments, the plaintiffs contacted their trusted broker, who told them the solution was to refinance. *Id.*

239. *See* Garvin Complaint, *supra* note 204.

240. *Id.* ¶¶ 53, 89 (Ms. Garvin's combined income was $5,200, but the application stated that the monthly income was $10,990, that she had $31,000 in a Bank of America Account, that she had $55,000 in another account, and that she had a net worth of $90,434.). Tran also wrote letters purportedly from the plaintiffs describing fake business that did not exist and forged their signature. In one case, she went as far as making a fake business card. *See* Interview with Jessica Fry, *supra* note 140.

241. *Cf.* McCoy, *supra* note 41, at 726, 729.

aversion in the elderly population. By the time the borrower was at the signing, he or she was already psychologically committed to the sale and did not want to lose the opportunity to own a home.[242] Alternatively, the borrower may not have been aware that they were legally permitted to withdraw, and even when he or she voiced concern with continuing with the deal an unscrupulous broker may have incorrectly told the borrower it was too late to back out.[243]

This trend of Latino borrower abuse at the hands of Latino lenders so troubled the National Association of Hispanic Real Estate Professionals (NAHREP) that it responded by hosting roundtable discussions with Hispanic mortgage brokers in six key U.S. markets, including two cities in California, to discuss the causes of predatory lending.[244] Brokers discussed how many bicultural brokers who advertised themselves in the community as "trusted advisors."[245] Although bicultural brokers are in a position to bridge the gap in Latino borrowers' knowledge of the home purchase process, many bad actors have capitalized on borrowers' trust and engaged in predatory practices.[246]

b. English-Language Documents Hid Loans' Real Terms

Lack of English fluency led many Latino borrowers to sign loan documents written in English that contained terms less favorable than the terms to which they originally had agreed with their Spanish-speaking brokers.[247] The Federal Trade Commission recently filed a complaint against a broker named Daniel Martinez who used a bait-and-switch scheme to victimize Latino borrowers.[248] Mr. Martinez conducted oral business transactions exclusively in Spanish, promising his clients certain interest rates, monthly payments, APRs,

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242. *Cf.* Willis, *supra* note 176, at 245 (describing a consumer bias to "stay with whatever the status quo and or initial 'anchor' position is, even when conditions have changed or the decision maker's own needs would dictate a position far from the anchor"). Applying the psychological principle of "status quo" bias, borrowers are already used to the idea of owning the home by the time they get to the signing, and do not want to change the status quo if they find out new information or that the terms of the deal have changed. *See id.*

243. This scenario is precisely what happened to Soledad Aviles, the borrower discussed in the introduction. *See supra* note 1. At the signing he voiced concern about continuing with the closing, and the broker told him he was already committed and could not back out even though, legally under TILA, he could have. 2008 Interview with Fair Housing Council of Orange County, *supra* note 4. Sylvia Prata and Connie Der Torossian, who assisted Soledad when he was trying to renegotiate the mortgage, discussed Soledad Aviles's circumstances when he signed up for the loan that led him to foreclosure. *Id.*

244. The two cities in California were San Jose and Los Angeles. *See* SAVING HOMES, *supra* note 190, at 7.

245. *See id.* at 19.

246. *See id.* at 18.

247. C. Lincoln Combs, Comment, *Banking Law and Regulation: Predatory Lending in Arizona*, 38 ARIZ. ST. L.J. 617, 623 (2006).

248. Press Release, Federal Trade Commission, FTC Continues Campaign to Stop Fraud in the Spanish Language (Jan. 31, 2006), *available at* http://www.ftc.gov/opa/2006/01/sandiego.shtm.

and finance charges.[249] At closing, he then presented his clients with documents written entirely in English that contained much less favorable terms than verbally promised.[250]

Similar language fraud occurred in California. For example, in *Cuevas v. Atlas Realty*, San Jose resident Juan Cuevas, who spoke only Spanish, negotiated a mortgage refinancing in Spanish with mortgage broker Samantha Trevino. Cuevas later discovered Trevino had him sign papers containing markedly different loan terms.[251] Cuevas told Trevino, who worked at Atlas Financial Services, that he and his wife could not meet their monthly mortgage payments of $2,755, and Trevino promised Cuevas that she could lower his monthly payment through a refinancing.[252] Specifically, she said the refinanced loan would lower his payment to only $1,800 per month, including taxes and insurance, and the payment would only increase $100 to $200 per year for the first five years.[253] Importantly, while all of Cuevas's discussions with Trevino were in Spanish, all of the loan documents Cuevas signed were written in English.[254]

The documents Cuevas signed provided for a negatively amortized loan with a variable interest rate and a large prepayment penalty.[255] When Cuevas learned that the loan terms were different than what he agreed to, he asked Trevino to clarify. Trevio replied that "WSB [World Savings Bank] had changed the terms of the loan without her knowledge and that there was nothing she could do."[256] When Cuevas asked WSB about the situation, they told him "to speak with his broker."[257] As it turned out, Trevino had not given Cuevas the required TILA notice or right to cancel, and had forged Juan Cuevas's initials "making it appear that Cuevas was given notice."[258]

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249. *Id.*

250. *Id.* On September 14, 2006, the Court issued a stipulated order requiring Martinez to pay $10,000 in consumer redress, along with a $240,000 judgment. The order stipulates that Martinez is "prohibited from misrepresenting the terms, costs, or other conditions of any mortgage loan . . . [and] [t]he order also requires the defendant[] . . . to provide a disclosure statement and a consumer education brochure to every client to whom his business offers a mortgage loan. . . . Spanish-speaking consumers must receive their brochure in Spanish. The defendants must provide independent closing agents at no cost to the consumer." Press Release, FTC, FTC Announces New Successes in Campaign to Stop Fraud Targeting Hispanics (Sept. 27, 2006), *available at* http://www.ftc.gov/opa/2006/09/nyworkshop.shtm.

251. Cuevas v. Atlas Realty/Fin. Servs., No. C 07-02814 JF, 2008 WL 268981, at *1–2 (N.D. Cal. Jan. 30, 2008) (unpublished order denying a mortgage company's motion to dismiss a claim under Section 1632).

252. *Id.* at *1.

253. *Id.*

254. *Id.*

255. *Id.*

256. *Id.* at *2.

257. *Id.*

258. *Id.* at *1.

Cuevas sued Atlas and WSB under federal and California statutes,[259] including a claim under California Civil Code Section 1632, which requires translation of contracts to the language in which they were negotiated.[260] Atlas and WSB moved to dismiss, and the court denied both motions for all claims but one, allowing the case to proceed.[261]

While the court allowed the Section 1632 claim to proceed, the law on this provision is unsettled, so it is unclear how strong this claim is. On its face, Section 1632, which requires that contracts primarily negotiated in one of five enumerated languages be translated into the applicable foreign language, exempts secured home loans from banks.[262] Nevertheless, several courts have interpreted the section to allow mortgage companies to be secondarily liable under Section 1632.[263] However, none of these cases are published opinions.[264] Given the ambiguity in the law, Professor Jo Carrillo, a leading scholar in mortgage lending law, has advocated the passage of a recently proposed amendment to Section 1632, which would codify courts' interpretation that Section 1632 allows for secondary liability claims against mortgage companies that fail to provide loan documents in Spanish.[265]

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259. Cuevas also sued for common law claims of fraud, breach of fiduciary duty, and negligent misrepresentation. *Id.* at *2. These claims survived Atlas's motion to dismiss, but Mona Motwani, one of the attorneys who represented Cuevas, explained that it is often difficult for plaintiffs to succeed on such claims. Interview with Mona Motwani, Attorney, Law Foundation of Silicon Valley (Oct. 2, 2008).

260. *Cuevas*, 2008 WL 268981, at *2–3; *see* CAL. CIV. CODE § 1632(b)(4) (West Supp. 2008).

261. The court denied Atlas's motion to dismiss in its entirety. *Cuevas*, 2008 WL 268981, at *4. The court denied WSB's motion to dismiss all claims except for the claim under California's Consumers Legal Remedies Act. *Id.*

262. *See* CAL. CIV. CODE § 1632(b)(2) (stating that translation requirement this requirement applies to "a loan or extension of credit secured *other than by real property*, or unsecured, for use primarily for personal, family or household purposes" (emphasis added)). *See also* Hernandez, *supra* note 133 (explaining that "[s]o far, secured home loans from banks, credit unions, thrifts and mortgage banks have been excluded from the law").

263. CAL. CIV. CODE § 1632(b)(4) provides an exception to the exclusion of loans secured by real property for loans used "primarily for personal, family to household purposes where the loan or extension of credit is subject to [Article 7 of the Business and Professional Code]." Recently, at least two courts in the Ninth Circuit, including the court in *Plata*, discussed above, have applied Section 1632 in the mortgage context. *See* Plata v. Long Beach Mortgage Co., No. C 05-02746 JF, 2005 WL 3417375, at *8–9 (N.D. Cal. Dec. 13, 2005) (unpublished order denying defendant mortgage company's motion to dismiss plaintiff's secondary liability claim under section 1632); Ruiz v. Decision One Mortgage Co., No. C06-02530 HRL, 2006 WL 2067072, at *5 (N.D. Cal. July 25, 2006) (unpublished order denying mortgage company's motion to dismiss plaintiff's secondary liability claim under Section 1632). Both courts held that, although Section 1632 does not allow for direct liability claims against mortgage companies, it does allow for secondary liability.

264. *Plata*, 2005 WL 3417375; *Ruiz*, 2006 WL 2067072, at *5; Marcelos v. Dominguez, 2008 WL 1820683, at *8–9 (N.D. Cal. Apr. 21, 2008) (No. C 08-00056 WHA).

265. *See* Carrillo, *supra* note 133, at 14 (analyzing the legislative history of Section 1632 and linking the statute to recent mortgage litigation to conclude that this underanalyzed, little-known statute "represents the linguistic wave of the future in consumer rights").

Language-based bait-and-switch schemes pose a particular danger to Latino residents of California who are not fluent in English.[266] The story of Plata and Mapula, the couple in San Jose in the *Plata* case discussed above, provides more detailed evidence of how bait and switch tactics are used against monolingual Spanish speakers.[267] Plata and Mapula did not speak English; they negotiated monthly payments with their broker in Spanish, but they were only provided with English documents at the time of signing.[268] Moreover, the Spanish-speaking broker was not present for the signing.[269] Instead, he had passed the documents to another employee and directed him to make sure the documents were signed.[270] The employee did not inform them of the terms of the document they signed, and they did not know they were signing documents that falsified their assets, income, employment history, and financial capacity, all in order to qualify them for a loan they could not afford.[271]

Like the broker in *Plata*, many Latino brokers who employed predatory tactics would negotiate the mortgage or refinance loans verbally in Spanish, and then send someone else to ensure that the documents are signed.[272] In *Garvin*, for example, the lenders sent an assistant to the signing who was not able to answer questions about the loans.[273] Consequently, the borrower often assumes that the broker's earlier representations are included in the confusing and long document. In *Toscano v. Ameriquest Mortgage Co.*, for example, a mortgage broker offered a fixed 6.3 percent interest rate to a monolingual borrower in Spanish over the phone.[274] That same night, the broker sent a notary who did not speak Spanish to the borrower's home to sign untranslated English loan documents that contained a variable interest rate of over 7 percent.[275] While this might seem like only a minimal misrepresentation, it actually adds tens of thousands of dollars to the total price of the loan, and this added cost could cause the borrowers to go into foreclosure. Furthermore, that

266. *See* Steven W. Bender, *Consumer Protection for Latinos: Overcoming Language Fraud and English Only in the Marketplace*, 45 AM. U. L. REV. 1027 (1996) (describing patterns of language fraud that are prevalent in various marketplaces, including the home finance arena); *cf.* Concerned Consumer and Fair Housing Advocates, *supra* note 131, at 4 (describing a study of twenty homeowners who had been issued abusive subprime home purchase loans; one-third of the participants were monolingual Spanish-speakers indicating that language could have played a role in the issuance of such loans).

267. *Plata*, 2005 WL 3417375, at *1.

268. *Id.* at *1–2.

269. *Id.* at *2.

270. *Id.*

271. The documents also included an extra loan and a spousal conveyance, of which the borrowers were not aware. *Id.* at *2–3.

272. *See, e.g.*, *Plata*, 2005 WL 3417375, at *2; Toscano v. Ameriquest Mortgage Co., No. CIV-F-07-0957, 2007 U.S. Dist. LEXIS 81884, at *1–2 (E.D. Cal. Oct. 24, 2007) (unpublished order); Garvin Complaint, *supra* note 204, ¶¶ 60, 67–70.

273. *See id.* ¶¶ 67–79 (Valdavidos promised she would be there, but she was not. The assistant who was present was not able to answer questions about the loan terms).

274. *Toscano*, 2007 U.S. Dist. LEXIS 81884, at *1.

275. *Id.* at *2.

small difference could yield a substantial profit for the broker.[276]

Using the language barrier to facilitate bait-and-switch schemes is not a tactic used solely against the Latino community. Nondisclosure through lack of translation is common to many immigrant communities, as 20 percent of people in foreclosure in California do not speak English.[277] Immigrants of all nationalities who speak English as a second language often do not know the basics of what they are agreeing to on closing day.[278] As such, the English language proficiency problem is pervasive across immigrant communities in the state.[279]

2. Lenders Often Steered Latino Borrowers Toward Expensive Loans, Then Refinanced When Borrowers Could Not Pay

Incentives such as yield spread premiums often tempted brokers to steer borrowers into high-cost loans they could not afford.[280] Such incentives gave brokers an economic interest in pushing higher-cost loans so they could earn a kickback, or YSP, for themselves.[281] For example, in addition to origination, broker, transaction, and appraisal fees, the brokers in *Garvin* earned YSPs ranging from $15,000 to $20,000 dollars.[282] In *Plata* the brokers received over $7,030 in fees and an undisclosed YSP of $4,344 for the deal.[283]

The predatory tactic of steering borrowers to loans with unfavorable terms that benefit the broker is closely related to the tactic of excessive refinancing. When borrowers agree to accept excessive interest rates and later realize they can get a better interest rate, they are more likely to refinance the loan.[284] In order to maximize debt and force customers into refinancing, some lenders would even make loans for more than the value of the home.[285] For example, in *Garvin*, the broker, Linda Tran, actually paid the seller $25,000 to $27,000 over

276. If a broker receives a higher commission, or yield spread premium, for selling a higher priced loan, then the broker profits from this slight change. *See generally* Jackson & Burlingame, *supra* note 142 (reviewing results of their empirical study of the effect of yield spread premiums and concluding that "these payments allow mortgage brokers to extract materially higher payments from consumers, most likely consumers who are less sophisticated and more vulnerable to abusive practices").

277. Interview with Kevin Stein, *supra* note 18.

278. *See Fed Probes Predatory Mortgage Tactics*, *supra* note 217.

279. Workingimmigrants.com, *Immigrant Nation – New Census Data from 2006*, http://www.workingimmigrants.com/2007/09/immigrant_nation_new_census_da.html (last visited Mar. 16, 2009).

280. *See* SAVING HOMES, *supra* note 190, at 10.

281. Bowdler, *supra* note 41, at 12.

282. Garvin Complaint, *supra* note 204, ¶¶ 90, 120, 148, 317.

283. Plata v. Long Beach Mortgage Co., No. C 05-02746 JF, 2005 WL 3417375, at *3 (N.D. Cal. Dec. 13, 2005) (unpublished order).

284. ASSOCIATION OF COMMUNITY ORGANIZATIONS FOR REFORM NOW, SEPARATE AND UNEQUAL: PREDATORY LENDING IN AMERICA 51 (2004), *available at* http://acorn.org/fileadmin/Community_Reinvestment/Reports/S_and_E_2004/separate_and_unequal_2004.pdf.

285. *Id.* at 50.

the purchase price without the consent of the borrower, and later told the borrower the extra was for the "upfront interest" owed to independent lender, Curiel.[286] Only after the closing would the broker tell the borrowers they needed to borrow an additional amount for additional fees, usually a sum of around $80,000, from Curiel.[287] In situations like this, once the borrower realized he or she cannot make the payments, the broker often offered to "help" by selling an additional loan to refinance.[288]

Purposeful and rapid refinancing, called "flipping" or "equity stripping," was also a very profitable scheme for brokers.[289] When borrowers were struggling to repay their mortgages, the predatory lenders offered to refinance to "save them." Because borrowers in this position likely experienced loss aversion, they were apt to accept any terms on the new loan.[290]

When plaintiffs in the *Garvin* case agreed to unfavorable financing, the broker gave them false reassurances. When one plaintiff was shocked to learn that his family had borrowed $121,500 for their $96,000 down payment because they were charged 27 percent upfront interest, the broker responded "[d]on't worry. I can refinance the loan for you in six months for free."[291] To an unsophisticated borrower, this may sound reassuring, because he does not want to lose his house. However, the results are extremely unfavorable to the borrower. The lender profited from a new loan origination, whereas the borrower's equity was stripped by large prepayment penalties, interest arrears, and late fees.[292]

Latino homebuyers were especially vulnerable to the predatory tactics of steering and abusive refinancing for two reasons. First, lack of credit or poor credit history makes it difficult to qualify for prime loans and, as between two subprime loan options, the broker often is the more expensive subprime loan to get the kickback.[293] Second, a general disengagement from mainstream financial institutions left many Latino borrowers vulnerable to predatory

286. *See* Garvin Complaint, *supra* note 204, ¶ 246.

287. *Id.* at ¶¶ 4, 116, 117, 171–180, 338–349.

288. These brokerage tactics were also reported by Soledad Aviles, who was discussed in the introduction. *See supra* note 1. This tactic began to backfire as housing prices began to decline. 2008 Interview with Fair Housing Council of Orange County, *supra* note 4 (discussing how the broker offered to "help" Aviles by refinancing his house in one year, but after one year the house was not appraised high enough to obtain the refinancing).

289. *See* McCoy, *supra* note 41, at 728.

290. *See id.* at 726, 728. Further, some scholars have theorized that due to the "time and uncertainty bias," many borrowers "think they will refinance . . . [and] they discount the logistical costs of refinancing or switching in the future." Therefore, "uncertain future costs at the time of the mortgage . . . probably do not register any weight on decisionmaking about entering into loan contracts." Willis, *supra* note 176, at 238–39.

291. Garvin Complaint, *supra* note 204, at 14.

292. McCoy, *supra* note 41, at 735.

293. *See* Moscoso, *supra* note 190 (discussing the findings of the Joint Report by the National Association of Hispanic Real Estate Professionals and the National Council of La Raza).

lenders who exploited their ignorance of home finance.[294]

a. Lack of Credit or Poor Credit History Increased Vulnerability

Many in the Latino population, especially first-generation immigrants, have limited credit histories that prevent them from qualifying for prime loans.[295] The source of the credit problem in the Latino population, particularly among recent immigrants, is complicated. In some communities, there is a cultural belief that it is simply not right to use credit to make purchases.[296] Also, although Latinos hailing from more affluent backgrounds are accustomed to advanced banking services, many poorer Latino immigrants did not have access to banking services in their home country, as Latin American countries historically have not provided banking services to the lowest income populations.[297] When these immigrant populations encounter more barriers to banking in the United States, many immigrants enter the "cash culture" economy that functions separately from the mainstream economy.[298] This "cash culture" is similar to the cash orientation that Austin found in her study of a low-income African American population.[299]

Banks give potential borrowers a credit score based on their prior experiences with credit and loans. Thus, borrowers with a low or nonexistent credit score are likely to qualify only for a subprime loan.[300] Latino immigrants seeking to improve their credit scores are often prevented from doing so by a vicious cycle: many banks require a checking account before they will issue a credit card, but without established credit it is hard to open a checking account.[301] Moreover, many Latino families also have multiple wage-earners or sources of income that can affect credit scores.[302] Thus, even if a Latino borrower with little or no credit history has a stable enough income to qualify for a prime loan, that borrower may necessarily have to take on a more expensive loan from a subprime lender with relaxed credit requirements.[303]

Because there are several grades of subprime loans, some of which are more profitable to brokers than others, brokers often exploit borrowers' lack of financial sophistication to sell the subprime loan product that is most profitable

294. *See* SAVING HOMES, *supra* note 190, at 6.

295. *See* Goffard & Delson, *supra* note 1; *see also* MARTINEZ, *supra* note 202, at 9–10.

296. *See* OFFICE OF POLICY RESEARCH, *supra* note 163, at 12.

297. "For Latino immigrants, the problem of the credit score goes deeper than just the lack of previous debt. Latin American countries have historically not provided banking services of any kind to their low-income population, many of whom migrate to the United States." MARTINEZ, *supra* note 202, at 9 (internal citation omitted); *see also* Carrillo, *supra* note 133, at 6.

298. *See* MARTINEZ, *supra* note 202, at 9.

299. *See* Austin, *supra* note 166, at 1246.

300. *See* MARTINEZ, *supra* note 202, at 9.

301. *Id.*

302. *See* SAVING HOMES, *supra* note 190, at 5.

303. *See* MARTINEZ, *supra* note 202, at 9.

for the broker, rather than the loan product most favorable to the borrower.[304] Because borrowers' credit history often limited their options to subprime loans, it was difficult to comparison shop because subprime loans are not standardized. The result was that borrowers often ended up with very disadvantageous loan terms—such as the *Garvin* plaintiffs' down payment loans, which bore 27 percent upfront interest—even when they qualified for more affordable loans.[305]

b. Disengagement from Mainstream Financial Institutions Increased Vulnerability

Because many Latino immigrants have not had access to banking services in their home countries, there is often a lack of accumulated knowledge within families.[306] Many first-time Latino homebuyers are also first-generation buyers.[307] Whereas most people get home-buying advice from family members or neighbors, such community advice is often unavailable to first-generation buyers in immigrant communities.[308] Some community organizations are helpful in educating borrowers on the mortgage system, but most Latino borrowers rely on their brokers' expertise to decide which loan is best for them.[309]

This lack of financial knowledge has made Latino borrowers more vulnerable to predatory lending.[310] Predatory brokers have used technology and publicly available data to identify people who have limited education.[311] They have reached these customers with marketing techniques such as direct mailings, telephone and door-to-door solicitation, and television commercials.[312] These advertisements have promised loans with low monthly payments, without explaining that payments may rise within months of closing.[313] Furthermore, studies have revealed that Latino families are not offered as much information on their financing options as similarly situated white families during the home buying process.[314]

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304. *See* Garvin Complaint, *supra* note 204; *see also* Jackson & Burlingame, *supra* note 142, at 357.

305. McCoy, *supra* note 41, at 734–35; *see also* Garvin Complaint, *supra* note 204, at 17.

306. *See* MARTINEZ, *supra* note 202, at 9.

307. SAVING HOMES, *supra* note 190, at 5.

308. Bowdler, *supra* note 41, at 8.

309. See SAVING HOMES, *supra* note 190, at 11–12.

310. Press Release, Nat'l Ass'n of Hispanic Real Est. Prof'ls, Hispanic Real Estate Professionals Take Action to Curb Predatory Lending Practices Against Latinos, Approve Code of Trust, *available at* http://www.nahrep.org/News/NAHREP-Code%20of%20Trust%20Release%20FINAL.pdf.

311. *See* CARR & KOLLURI, *supra* note 35, at 2.

312. Bowdler, *supra* note 41, at 11.

313. *See id.*

314. *See id.* at 8.

As subprime lending grew in popularity, predatory lenders, attempting to prey on Latino borrowers' lack of knowledge about the banking industry, often quoted low monthly repayment amounts that do not include property taxes and insurance. Subprime lenders often do not require escrow accounts, property tax, and insurance, and therefore quote monthly payments for subprime loans that do not include these substantial expenses.[315] Predatory lenders will take advantage of a borrowers' lack of understanding of these fees, and of the concept of escrow in general, to obscure these additional loan costs. This is particularly problematic in immigrant communities because, although escrow is a common concept in this country, it is not common in many others.[316] Recent amendments to TILA by the Governors of the Federal Reserve require escrow for property tax and insurance, but these new rules will not go into effect 2010, and they do not apply to many high-cost nontraditional subprime mortgage loans.[317]

The facts of *Hernandez v. Hilltop Financial Mortgage*, *Inc.* provide an example of the predatory practice of steering borrowers into a high-cost loan by excluding taxes and insurance from the quote and then pushing borrowers to refinance when they could not afford the payment.[318] The broker in that case explained to the borrowers in Spanish that their monthly payment would be $1,384.98.[319] The broker assured them the monthly payment covered everything, but did not explain that "everything" excluded property tax and insurance.[320] When the plaintiffs could not afford the taxes and insurance, the broker told them they could refinance for only $120 more per month.[321] He promised that the added monthly payment would not only cover property tax and insurance, but it would also include an additional loan to pay off $4,000 in consumer debt, as well as a $10,000 cash payment.[322] Relying on this information, the plaintiffs signed the loan documents, which actually committed them to an additional monthly payment of $473.[323] Not only was the monthly payment higher, but it did not buy as much as the lender had promised. The added loan they had purchased "only paid $1,323.00 in consumer debt (as opposed to the promised $4,000) and plaintiffs received a cash payment of only

315. Eakes, *supra* note 218, at 3 ("By routinely omitting escrows for taxes and insurance, subprime lenders have deceived borrowers into believing . . . that their mortgage will be cheaper than a responsible lender who does escrow.").

316. Telephone Interview with Chris Kukla, Director of State Legislative Affairs, Ctr. for Responsible Lending (Nov. 29, 2007) [hereinafter Nov. 2007 Interview with Chris Kukla].

317. Press Release, Bd. of Governors of the Fed. Reserve Sys., *supra* note 104; *see also* Press Release, Ctr. for Responsible Lending, *supra* note 106.

318. *See* Hernandez v. Hilltop Fin. Mortgage, Inc., No. C 06-7401 SI, 2007 U.S. Dist. LEXIS 80867 (N.D. Cal. Oct 22, 2007).

319. *Id.* at *2.

320. *Id.* at *2–3.

321. *Id.* at *3.

322. *Id.*

323. *Id.* at *4.

$4,046.15 (as opposed to the promised $10,000 cash payment)."[324]

Brokers have also taken advantage of borrowers' lack of financial knowledge by splitting mortgages into separate loan transactions.[325] For example, in *Munoz v. International Home Capital Corp.*, plaintiffs alleged that defendant brokers split their loans so that they could charge additional, undisclosed, fees and closing costs.[326] These so-called "split loans" are created when a broker makes two mortgage loans at or near the same time to the same borrower.[327] The second loan is actually used to finance points and fees of the first loan.[328] These kinds of loans are rarely beneficial to the borrower. Nevertheless, brokers will exploit borrowers' unawareness by misrepresenting the benefits of split loans, or even failing to disclose that there are actually two loans at all.[329]

Critics of stronger predatory lending regulation question why borrowers sign loans they cannot afford, claiming that paternalistic regulation would just add more cost to loan transactions.[330] Even if the brokers misrepresented loan terms, falsified assets, and promised low rates, critics ask how someone could rationally believe that a $600,000 house is attainable on a $3,500 monthly income?

The answer to these critics is that hidden split loans, financed points and fees, negative amortization, prepayment penalties, and other "creative lending" products are confusing for even the most educated person, let alone someone who is familiar with neither the banking system in this country nor the language in which brokers contract to sell these products.[331] Further, because subprime loans do not have standardized cost terms, comparison shopping is almost impossible.[332] Subprime lenders can exclude certain costs from the APR so that "[e]ven when APRs are comparable, some lenders intentionally tell borrowers that only the nominal interest rate matters . . . ."[333] As one *New York Times* writer put it, "[R]eading a mortgage agreement is a bit like trying to decipher hieroglyphics."[334] For borrowers who are new to banking, new to this country, and do not speak English, it is even worse than that. These

324. *Id.* at *3.

325. Munoz v. Int'l Home Capital Corp., No. C 03-01099 RS, 2004 U.S. Dist. LEXIS 26362, at *6 (N.D. Cal. May 4, 2004).

326. *Id.* at *6 n.2.

327. MortgageBlues.com, Household International and Ameriquest Pushed Too Far, http://mortgageblues.us/news/129 (last visited Mar. 9, 2009).

328. *Id.*

329. *Id.*

330. *See, e.g.*, My Open Wallet, http://www.myopenwallet.net/2007/09/all-these-mortgage-sob-stories.html (last visited Nov. 24, 2007) (bloggers criticizing plaintiffs in the *Garvin* case for buying such expensive homes on minimal salaries).

331. *See* Mara Der Hovanesian, *supra* note 36, at 70 ("The option adjustable rate mortgage (ARM) might be the riskiest and most complicated home loan product ever created.").

332. McCoy, *supra* note 41, at 734.

333. *Id.*

334. Tedeschi, *supra* note 237.

disadvantaged borrowers tell their broker how much money they can dedicate to a mortgage payment each month and understandably assume that their broker will act in their best interest. Unfortunately, many predatory brokers have not acted in their clients' best interests. To curb predatory lending, the law needs to mandate more transparency and provide fewer incentives to act against borrowers' best interests.

IV
REFORMING THE CALIFORNIA PREDATORY LENDING LAW TO ADDRESS COMMON TACTICS USED IN THE LATINO COMMUNITY

California has a particularly compelling need for stronger state legislation. Until the credit market meltdown, most predatory lending was occurring in the subprime market,[335] and one quarter of all subprime lending in the nation took place in California.[336] Furthermore, the state has historically had one of the highest foreclosure rates in the nation.[337] As discussed previously, the Latino population, comprising 35.9 percent of the total population, has been particularly vulnerable to predatory tactics in the subprime market.[338] Nevertheless, while other states have strengthened their predatory lending laws to respond to the financial exploitation of their citizens,[339] California has not amended its predatory lending law to reflect the needs of its population.[340]

Some scholars question whether adding extra regulations would increase major market instability or further disincentivize subprime lending to the point that a whole subsection of borrowers would be unable to secure home loans.[341] One argument is that the current subprime crisis is simply a market correction, and that unintended consequences would result if legislators were to rush to impose new regulations as a "quick fix."[342] Specifically, critics are concerned

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335. ELLEN SCHLOEMER ET AL., CTR. FOR RESPONSIBLE LENDING, LOSING GROUND: FORECLOSURES IN THE SUBPRIME MARKET AND THEIR COST TO HOMEOWNERS 27 (2006), *available at* http://www.responsiblelending.org/pdfs/foreclosure-paper-report-2-17.pdf.

336. Leonard Statement, *supra* note 119, at 1.

337. In May 2008, California had the second highest foreclosure rate after Nevada. "One in every 183 California households received a foreclosure filing during the month, a rate that was 2.6 times the national average." Mark Huffman, *May Foreclosure Filing Rate Highest Ever*, CONSUMERAFFAIRS.COM, June 15, 2008, http://www.consumeraffairs.com/news04/2008/06/foreclosures_may.html.

338. *See* U.S. Census Bureau, State and County Quickfacts, *supra* note 186.

339. California's predatory lending law remains weaker than most states' laws. States that have enacted stronger legislation include Maine, Minnesota, Ohio, and North Carolina. *See* Krauss, *supra* note 110.

340. In September 2008, Governor Arnold Schwarzenegger vetoed a proposed reform to California's predatory lending law, Assembly Bill 1830. *See* Kevin Yamamura, *Schwarzenegger Vetoes Mortgage Broker Restrictions*, SACRAMENTO BEE, Sept. 26, 2008, at 3A.

341. *See, e.g.*, Willis, *supra* note 43, at 740 (noting that these unintended consequences may affect low-income, elderly, and/or minority borrowers, precisely the groups that the laws aim to protect).

342. *See* Frank A. Hirsch, Jr., *The Evolution of a Suitability Standard in the Mortgage Lending Industry: the Subprime Meltdown Fuels the Fires of Change*, 12 N.C. BANKING INST. 21,

that stronger regulation would have negative consequences, including a "rollback of positive gains made in access to credit," a higher rate of mortgage loan denials, and a disproportionate impact of those denials upon minorities.[343]

Many empirical studies have analyzed the impact of state predatory lending laws. Early studies of the North Carolina law, which protects borrowers by including broker compensation in the determination of points and fees, increases mortgage brokers' duties, and bans prepayment penalties, found that it did restrict credit to high risk consumers.[344] But more recent studies have found that the impact does not limit access to credit.[345] In fact, a 2008 study that analyzed individual provisions of predatory lending laws concluded that "expanded coverage tends to increase access to subprime credit, as do increased enforcement mechanisms."[346] On the other hand, that same study found that "[s]tronger restrictions have the opposite effect, likely by limiting the types of subprime loan products that a lender can offer."[347]

Such empirical data should be considered before adopting any legislative approach. But the trend of the results, which is that such laws generally do not restrict access to credit, bolsters the argument that regulation at the state level is an effective approach to the problem of predatory lending.[348] Thus, while acknowledging the potential peril in tightening regulations, this section outlines four recommendations under consideration by advocates and legislators. These recommendations would specifically address the predatory lending trends in the Latino community discussed above while also extending protections to other vulnerable communities across the state.

A. Count YSPs Toward Division 1.6's Points Threshold

Although Division 1.6 purports to prohibit steering borrowers into a covered loan that is more expensive than the best loan for which the borrower could qualify,[349] YSP kickbacks for selling a higher price loan still encourage brokers to sell to their clients unsuitable loans.[350] By excluding YSPs in the

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42–44 (2008) (arguing against a suitability standard in the mortgage industry); *see also* Yamamura, *supra* note 340 (describing how in Gov. Schwarzenegger's veto message to A.B. 1830 he stated that it "overreaches and may have unintended consequences.").

343. *Id.* at 43.

344. Gregory Elliehausen & Michael E. Staten, *Regulation of Subprime Mortgage Products: An Analysis of North Carolina's Predatory Lending Law*, 29 J. REAL EST. FIN. & ECON. 411 (2004) (finding that "creditors sharply restricted lending to higher risk consumers in North Carolina following passage of the law.").

345. *See* Ho & Pennington-Cross, *supra* note 134, at 226.

346. Bostic et al., *supra* note 99, at 19.

347. *Id.* at 19.

348. *See* Baher Azmy, *Squaring the Predatory Lending Circle: A Case for States as Laboratories of Experimentation*, 57 FLA. L. REV. 295, 303 (2005) (arguing that states should "experiment with solutions to predatory lending . . . to advance . . . federalism-producing good public policy").

349. *See* CAL. FIN. CODE § 4973(1) (West Supp. 2008).

350. *See* Jackson & Burlingame, *supra* note 142.

calculation of points and fees, Division 1.6's steering prohibition becomes irrelevant to the vast majority of California borrowers. Brokers selling uncovered loans may still follow the YSPs perverse incentive: to sell clients the most expensive loan they can, as opposed to the most suitable loan borrowers can afford.

The rationale for not including YSPs in the calculation of borrower fees is that the lender initially pays the broker the fee; however, since the consumer pays for this fee many times over through higher interest payments over the course of the loan, he or she does actually pay for the YSP.[351] On June 3, 2007, the Conference of Delegates of the California Bar Association passed recommendations for amending Division 1.6 to include YSPs in the calculation of the covered loan.[352] The proposed reform would also add promissory notes secured by a deed of trust to the definition of a covered loan, as YSPs typically take the form of a promissory note for the amount of the premiums paid to the broker.[353]

Adding a provision to California's predatory lending law that would require YSPs to be counted as points toward statutory coverage is not a very radical proposal, as some states have already banned YSPs altogether.[354] In California, some advocacy groups specifically opposed the last bill introduced to amend the predatory law, AB 1830, which was vetoed by Gov. Schwarzenegger, in part because it did not include a provision that addressed YSPs.[355] As the law currently stands in California, brokers can take a YSP kickback without the risk that it would trigger protection under Division 1.6. Consequently, many loans are technically outside the scope of Division 1.6, even though they are abusive. Counting YSPs in the calculations for Division 1.6 would add additional consumer protections when up-front charges, including YSPs, are too high, and it would encourage brokers to charge the same rates to borrowers with the same qualifications.[356]

351. *Hearing*, *supra* note 145 (statement of Professor Howell Jackson) (finding that YSPs ultimately increase costs for borrowers).

352. Conference of Delegates of the California Bar Association, *supra* note 140.

353. *Id.*

354. "North Carolina General Assembly became the first state in the nation to ban 'yield-spread premiums'—kickbacks that encourage brokers to overcharge—on subprime mortgages." Press Release, Ctr. for Responsible Lending, States Aren't Waiting for Feds to Clean up Reckless Lending (July 11, 2008), *available at* http://www.responsiblelending.org/press/releases/states-aren-t-waiting-for-feds-to-clean-up-reckless-lending.html.

This North Carolina Bill was signed into law by the Governor on August 17, 2008. 2008 N.C. SESS. LAWS 227 (codified as amended at N.C. GEN. STAT. ANN. § 53-243.11 (West 2009)).

355. See Consumer Fed'n of Cal., AB 1830 Opposition (unless Amended) Letter from California Reinvestment Coalition (CFC signed on), http://www.consumercal.org/article.php?id=552 (last visited Mar. 16, 2009).

356. 2006 CRL STUDY, *supra* note 81, at 24–29.

B. Impose a Stronger Duty on Mortgage Brokers to Act in Borrowers' Best Interests

As discussed above, Latino borrowers have tended to place a great deal of trust in their brokers. This has been common among groups of subprime borrowers, as brokers have had a significant informational advantage given the complexity of risk-based loan products.[357] But there has been a fundamental contradiction in the mortgage broker's role: the mortgage broker has acted simultaneously as the lender's agent and the borrower's fiduciary.[358] The broker has been working to sell the lender's products at the same time he or she has been making recommendations to borrowers regarding appropriate loans, given their financial situations. This is a classic "conflict of interest, [but] it is resolved through disclosure to both the borrower and lender, usually in separate contracts."[359]

Courts in California have applied a common law fiduciary duty to mortgage brokers by applying a section of the California Business and Professional Code, but the remedy is not significant.[360] Consequently, breach of fiduciary duty cases are rarely litigated because they are expensive, can rely on subjective determinations, and are hard to prove.[361] Further, in general, "[c]ourts resolve the issue most often against the borrower finding no distinction in the broker's obligations and holding in essence that contract terms waived the duty."[362]

Thus, amending Division 1.6 to impose a clear statutory duty on brokers would provide more protection to buyers.[363] Like the YSP proposal, a stricter statutory duty on brokers has been implemented in other states. North Carolina includes a duty to "secure a loan that is reasonably advantageous to the borrower,"[364] and as discussed above, studies indicate that the North Carolina

357. *See* Cassandra Jones Havard, *"Goin' Round in Circles" . . . And Letting the Bad Loans Win: When Subprime Lending Fails Borrowers: The Need for Uniform Broker Regulation*, 86 NEB. L. REV. 737, 751 (2008).

358. *Id.* at 778.

359. *Id.* at 779.

360. *See, e.g.*, *Acebo v. Real Estate Educ. etc. Fund*, 202 Cal. Rptr. 518 (Cal. App. 1984) (in an action under California Business & Professions Code § 10471, plaintiff was entitled to only the amount of his actual loss and not punitive damages or indirect damages (such as attorney's fees) incurred after the transaction).

361. Havard, *supra* note 357, at 777 (explaining that courts determine breach of fiduciary duty on a "case-by-case basis" and "courts seem more likely to recognize a fiduciary duty when there is also some egregious factor present").

362. *Id.* at 779 (describing how the dual agency role of a mortgage broker complicates the fiduciary role of the mortgage broker).

363. "These affirmative duties establish a clear legal precedent that the broker has a statutory responsibility to their client, a point that some mortgage brokers have tried to refute in recent years." NC Mortgage FAQs, *supra* note 138; *see also* Havard *supra* note 357, at 765 (arguing that statutory fiduciary duties should be placed on mortgage brokers).

364. For a list of broker's duties in North Carolina, see *supra* note 138.

predatory lending law has been effective.[365] Other states with similar duties include Illinois, Washington, and Connecticut.[366] Further, some scholars have suggested that, whereas courts' application of common law fiduciary duties for mortgage brokers serve as a remedy for aggrieved borrowers, "[t]o *prevent* abuses of borrowers' trust, a fiduciary relationship between mortgage brokers and borrowers should be formally recognized by codifying fiduciary duties in the licensing statutes."[367] Other commentators point out that, without any affirmative duty, "[m]ortgage brokers, generally, have no incentive to act in the best interest of borrowers, nor do they have much risk in the case of default."[368]

One shortcoming of this proposal, however, is that imposing a stricter duty on mortgage brokers would not regulate the many lenders who are not licensed mortgage brokers, such as Pablo Curiel in the *Garvin* case discussed above.[369] Because "[b]rokers account for 48 percent of subprime originations, versus 28 percent of conventional loans," and because most predatory lending occurs in the subprime market, the regulation would protect a large percentage of vulnerable borrowers.[370] However, it would be even more effective if the duty applied to other lenders, as in North Carolina, where the law also covers "[m]ortgage bankers (mortgage lenders)" who make mortgage loans and "[l]oan officers [who] are employees of mortgage bankers or brokers, and may accept mortgage applications."[371]

Another proposal that would reach even lenders who are not licensed mortgage brokers is the importation of the "suitability standard" imposed on stockbrokers by the Securities and Exchange Commission.[372] The suitability

365. *See* Hauser, *supra* note 113, at 1523–24.

366. *See* 815 ILL. COMP. STAT. ANN. 137/25 (West 2008) (requiring a lender to act in good faith and barring any deceptive practices); WASH. REV. CODE ANN. § 19.146.0201 (West 2007) (requiring lenders to make disclosures to loan applicants as required by RCWA 19.146.030, including but not limited to full written disclosure containing an itemization and explanation of all fees and costs); CONN. GEN. STAT. ANN. § 36a-760a (West Supp. 2008) (imposing a "duty of good faith" on lenders and mortgage brokers when dealing with nonprime home loans, making the duty of good faith coextensive with CONN. GEN. STAT. ANN. § 42a-1-304, its general provision relating to good faith and contracts).

367. Lawrence Hansen, Comment, *In Brokers We Trust – Mortgage Licensing Statutes Address Predatory Lending*, 14 J. AFFORDABLE HOUS. & COMMUNITY DEV. L. 332, 347 (2005) (emphasis added).

368. *Id.* at 335.

369. *See supra* note 207.

370. *See Subprime Lending: Defining the Market and Its Customers: Joint Hearing Before S. Subcomms. on Financial Institutions & Consumer Credit and Housing & Community Opportunity*, 108th Congress 10–11 (2003) (testimony of Eric Stein, Senior Vice President, Center for Responsible Lending, *available at* http://www.responsiblelending.org/pdfs/SteinStatement033004.pdf ("In part, rate-risk disparities in the subprime market are due to the increased use of brokers in making loans and compensation methods that encourage brokers to take advantage of less savvy customers.").

371. NC Mortgage Broker FAQs, *supra* note 137.

372. Patricia McCoy advocates the imposition of this sort of standard to those who extend home loans. McCoy, *supra* note 41, at 739 (suggesting the imposition of the securities "duty of suitability" standard to subprime lending, which was originally applied to keep securities brokers

standard requires stockbrokers to evaluate a client's financial circumstances and sophistication before recommending a stock.[373] In the mortgage arena, a similar standard would require a lender to evaluate various loan products and make a recommendation based on the borrower's situation; that is, even if a borrower could afford many of them, the lender would be required to discuss which products make more sense with borrowers.[374]

Those opposed to the suitability standard warn that the "adoption of a broad suitability standard might . . . [result in] the rollback of positive gains made in access to credit and homeownership for minorities."[375] The concern is that subjective standards of discerning "suitability" would bring the market back to the era of reverse-redlining and arbitrary denial of credit. Thus, it is important to calibrate the standards carefully. This concern must be balanced, however, with the benefit of preventing predatory practices by regulating the relationship in which they occur.[376] Intuitively, reports of the prevalence of brokers pushing loans more expensive than those for which borrowers should be able to qualify[377] indicate that more regulation is necessary.[378]

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from recommending securities that were unfavorable for the customer). McCoy also favors extending the duty to securitized trusts, which is an important suggestion considering that many brokers may not have deep enough pockets to provide remedies. *See* Engel & McCoy, *supra* note 16, at 2042) (suggesting that the law impose full assignee liability on securitized trusts that fail to adopt controls sufficient to filter out predatory loans). However, this suggestion is out of the scope of this Comment.

373. Hansen, *supra* note 367, at 345; *see also* Kenneth Harney, *Suitability is New Hot Word in Mortgage Market*, S.F. CHRON., Jan. 28, 2007, at K12.

374. For example, if a person wants to stay in the home long term, a thirty-year fixed loan would make more sense than a 2/28 ARM, even if the lender would make more money on the ARM. Oct. 2008 Interview with Chris Kukla, *supra* note 138.

375. Hirsch, *supra* note 342, at 43 (providing an analysis of suitability standards in recent state legislation, as well as litigation seeking the judicial imposition of suitability standards). Other arguments against the suitability standard include the concern that disputes with stockbrokers are routinely decided in arbitration, and that may not be the best arena for mortgage loan disputes. Also, some distinguish the stockbroker's role from the lender's role because a stockbroker *takes* the investor's money, whereas a lender *gives* the borrower money. The counter argument to this concern is that, despite being on the receiving end of the loan, a borrower is still investing in his or her home; and often, it is the borrower's most significant investment. Oct. 2008 Interview with Chris Kukla, *supra* note 138.

376. Hansen, *supra* note 367, at 349 (comparing the North Carolina anti-predatory lending law and the Georgia mortgage broker licensing requirements, ultimately concluding that these alternatives have the potential to be effective).

377. *See* Brooks & Simon, *supra* note 47.

378. Further, imposing a stricter duty on mortgage brokers and lenders is not unheard of, as a "duty of responsible lending" exists in other countries. See John A. E. Pottow, *Private Liability for Reckless Consumer Lending*, 2007 U. ILL. L. REV. 405, 422–23 (2007). This duty gives rise to liability for "reckless lending," and at least one scholar has suggested creating such a cause of action in the United States. *Id.* "Specifically, the envisioned liability would impose legal consequences on a lender who . . . extends credit when it knows, or should know with reasonable inquiry, that the debtor will be unable to service that debt in the ordinary course of his affairs." *Id.* at 420–21.

C. Require Translation of Loan Documents

One of the most common predatory tactics is a language-based "bait-and-switch" on loan terms discussed in Part III. The language barrier faced by much of the Latino population facilitates this tactic because borrowers sign loan documents in English after the negotiations have occurred in Spanish. While this is a particular problem for the Latino population,[379] any immigrant who is not fluent in English faces challenges of access to financial services.[380]

As discussed above, California Civil Code Section 1632 requires contracts to be translated, but excepts home loans from this requirement. This exception is ironic, as a home loan constitutes the most important financial contract that most American families will ever enter.[381] Recently, at least three cases in the Ninth Circuit have applied Section 1632 in the mortgage arena. However, none of the decisions has been officially published; as such, these decisions have not created any precedent.[382] Given the uncertainty in the application of Section 1632, Professor Jo Carrillo, a leading scholar in mortgage lending law, has advocated the passage of a recently proposed amendment, Assembly Bill 512, which would codify the recent court decisions.[383] AB 512, which passed in the California Assembly and was considered by the Senate, would have required all mortgage originators to translate key terms prior to closing, but the bill met industry opposition and was held off until next year.[384]

An obvious counterargument to this proposal is that the cost of hiring translators and providing loan documents in other languages would drive up the cost of the loans. However, until a translation requirement is placed on mortgage brokers, unscrupulous brokers will be able to continue to obscure loan terms by enticing borrowers to sign documents in a language they cannot

379. *See* MARTINEZ, *supra* note 202, at 12.

380. *See id.* ("Fluency in English affects the likelihood that individuals will have access to financial services.").

381. *See* CAL. CIV. CODE § 1632(b)(2) (stating that translation requirement applies to "a loan or extension of credit secured *other than by real property*, or unsecured, for use primarily for personal, family or household purposes." (emphasis added)). Hernandez, *supra* note 133 (explaining that "[s]o far, secured home loans from banks, credit unions, thrifts and mortgage banks have been excluded from the law").

382. *See* Plata v. Long Beach Mortgage Co., No. C 05-02746 JF, 2005 WL 3417375, at *7 (N.D. Cal. Dec. 13, 2005) (unpublished order denying defendant mortgage company's motion to dismiss plaintiff's secondary liability claim under Section 1632); Ruiz v. Decision One Mortgage Co., No. C06-02530 HRL, 2006 WL 2067072, at *5 (N.D. Cal. July 25, 2006) (unpublished order denying mortgage company's motion to dismiss plaintiff's secondary liability claim under Section 1632); Marcelos v. Dominguez, 2008 WL 1820683, at *8–9 (N.D. Cal. Apr. 21, 2008) (unpublished opinion acknowledging that Section 1632 does apply to "certain loans secured by real property that are negotiated by a real estate broker" but dismissing plaintiffs' claim under 1632 for failure to allege sufficient facts).

383. *See* Carrillo, *supra* note 135, at 14 (analyzing the legislative history of Section 1632 and linking the statute to recent mortgage litigation to conclude that this underanalyzed, little-known statute "represents the linguistic wave of the future in consumer rights").

384. Telephone interview with Kevin Stein, *supra* note 18; *see also* Roy, *supra* note 30.

read.[385]

An alternative means of requiring translation of documents would be to amend Division 1.6 itself to include a translation requirement. The inclusion of such a requirement is appropriate since Division 1.6 is supposed to promote transparency in lending, and transparency is not possible if borrowers are unable to read the language of the loan document. However, this should not be a substitute for amending Section 1632, as that provision would cover all transactions by any home loan originators. Additionally, although providing loan documents in the borrower's native language does not ensure that the borrower will understand potentially complicated loan documents, this revision, when combined with other provisions such as loan counseling, discussed below, will minimize the number of loans closed through the deliberate exploitation of borrowers' ignorance.

D. Require Lenders to Consider Borrowers' Ability to Repay

In many California predatory lending cases, brokers falsified the borrower's assets and income so they could sell high-priced loans despite the borrowers' limited ability to repay. This problem often occurred because borrowers took out a "stated income" loan, which only required them to state their income rather than provide proof of it. Although Latino borrowers were particularly vulnerable to this tactic because of the high level of trust they placed in Latino brokers, falsification of loan applications occurs in many vulnerable populations.[386]

To prevent this predatory practice, lenders and brokers should be required to verify income sources and evaluate loans based on a borrower's ability to repay. The Federal Reserve Board recently amended the TILA to require the lender to verify the borrower's income and assets to evaluate ability to repay.[387] This new rule, which becomes effective October 1, 2009, does not cover "nontraditional or exotic loans that had a major role in today's massive foreclosures, such as payment-option ARMs, or interest-only loans that don't meet the subprime definition."[388] California could fill in this gap by requiring verification of ability to pay for more types of loans.

385. *See generally* Bender, *supra* note 266 (describing patterns of language fraud that are prevalent in various marketplaces, including the home finance arena).

386. One Oakland resident described her experience with predatory lenders who did not fully disclose loan terms: "'I told the lender I was making a certain income, but he put a higher income on the loan papers,' Hicks said. 'They can put anything on those papers they want. I would not have signed those papers if I knew the payments would go up every two or three years. I was told that it would be one rate.'" J. Douglas Allen-Taylor, *Oakland City Attorney Announces Predatory Lending Fight*, THE BERKELEY DAILY PLANET, Oct. 19, 2007, http://www.berkeley dailyplanet.com/article.cfm?storyID=28255 (quoting Dorothy Hicks, "a homeowner for 39 years in the Havenscourt community of East Oakland.").

387. Press Release, Bd. of Governors of the Fed. Reserve Sys., *supra* note 104.

388. Press Release, Ctr. for Responsible Lending, *supra* note 106.

Some states already have laws that extend the verification requirement to nontraditional mortgages and payment options. North Carolina, Maine, and Minnesota have already passed legislation that requires such documentation for subprime loans.[389] Ohio implemented similar requirements for both subprime and prime loans.[390] The three main features of this type of legislative provision are: (1) an obligation on the loan originator to verify an ability to repay, (2) verification of income and assets, "by any reasonable verification method," and (3) a requirement that lenders underwrite the loan to the fully indexed rate.[391] This last requirement addresses the recently popularized practice of lenders selling adjustable rate mortgages in which borrowers can only afford to pay the initial teaser rate.[392] While this practice became a popular resource for subprime and prime homeowners during a time of rising home prices, predatory lenders also used the practice to trick unsuspecting borrowers into loans they would only be able to afford in the short term.[393]

Some legislative experts are especially concerned about whether this requirement would actually stymie a portion of the Latino population's access to credit, as many recent immigrants who work on a cash basis do not have adequate records of employment.[394] This is a valid concern; however, the "any reasonable verification method" language described in the proposed legislation above would mitigate the risk of blocking access to credit for borrowers without official income records such as W-2 tax returns.[395] This language only ensures that *some sort* of verification takes place.[396] This could be verification other than the traditional mechanisms such as tax return forms, including other pay stubs, proof of ownership of assets, et cetera.[397] Lenders and brokers would still evaluate the loan at the fully indexed rate, but they would have leeway to use other forms of income and asset documentation to confirm the borrower's ability to repay. This creates a compromise between "stated income loans" and traditional loans that may block access to people whose W-2 tax returns do not reflect all of their income. As long as some substantiation takes place, the

389. N.C. GEN. STAT. § 24-8 (2009); ME. REV. STATE. ANN. 9-A § 8 (2008); MINN. STAT. §§ 58.02, 58.13, 58.137 (2008).

390. The amended Ohio predatory lending law is codified at OHIO REV. CODE ANN. § 1349 (2008).

391. Nov. 2007 Interview with Chris Kukla, *supra* note 316.

392. *See* Schloemer et al., *supra* note 335, at 26–27 (citing the example of Option One, a large subprime lender, who would underwrite loans based on a low interest rate to qualify borrowers, when the real cost of the loan was bound to rise greatly over the course of the loan, causing borrowers to face unexpected increases in their monthly payments of up to 40 percent).

393. *See* Allen-Taylor, *supra* note 386.

394. Telephone interview with Katherine Ferlic, Legislative Counsel, N.M. State Legislature (Oct. 15, 2007).

395. It is common among many Hispanic workers, and any group that does primarily service or piecemeal work, to lack sufficient tax records. Nov. 2007 Interview with Chris Kukla, *supra* note 316.

396. *Id.*

397. *Id.*

abusive cycle of lenders extending credit to people who will not be able to repay the loan should decrease significantly.[398]

E. Require Escrow Accounts for Property Taxes and Insurance

Predatory brokers often took advantage of borrowers' lack of experience in banking by quoting monthly payments that were within the borrower's ability to pay, but did not include the price of property taxes and insurance.[399] One proposal that would directly address this growing predatory trend is to require escrow for property taxes and insurance.[400] The Federal Reserve Board's recent amendments to TILA require lenders to escrow for taxes and insurance, however this requirement will not go into effect until 2010,[401] and it does not apply to many nontraditional loans, such as payment-option ARMs or interest-only loans.[402] Therefore, as with the requirement to document ability to repay, California should fill the regulatory gap by requiring escrow for nontraditional loans, as well. New York and Connecticut have already passed similar laws.[403]

The requirement of escrow is somewhat controversial because of a general reluctance in the United States to *force* people to place their money in escrow. Nevertheless, requiring funds for insurance and property tax to be placed in escrow is a longstanding tradition of sound personal finance. It would obligate brokers either to include the cost of insurance and property tax in the repayment analysis or to disclose up front that these costs are excluded from the repayment analysis. Furthermore, it is already an accepted practice for most prime loans;[404] therefore, the practice of requiring escrow accounts for these costs would not be completely new and imposing the same requirement in the subprime market is a good risk management practice.

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398. When lenders put people in loans that do not fit their ability to repay, by falsifying assets, they are known in the industry as "Liar Loans," or "NINJA loans," because lenders extend large lines of credit to people with "No Income, No Job, and No Assets." *Id.* The new Federal Reserve Board Rules would eliminate these loans by requiring documentation, but this rule would not apply to nontraditional loans such as payment-option ARM's, interest-only loans, and Alt-A loans. *See* Press Release, Ctr. for Responsible Lending, *supra* note 106; Press Release, Ctr. for Responsible Lending, CRL Release Report "Indymac: What Went Wrong?" (June 30, 2008), *available at* http://www.responsiblelending.org/press/releases/crl-reports-indymac-what-went wrong.html.

399. *See* Nov. 2007 Interview with Chris Kukla, *supra* note 316.

400. *See* Sharick et al., *supra* note 219, at 12.

401. Press Release, Bd. of Governors of the Fed. Reserve Sys., *supra* note 104.

402. Press Release, Ctr. for Responsible Lending, *supra* note 106.

403. CONN. GEN. STAT. ANN. § 36a-760d(1) (West Supp. 2008) ("With respect to nonprime home loans that are first mortgage loans originated on or after January 1, 2010, the lender requires and collects a monthly escrow for the payment of real property taxes and homeowner's insurance."); N.Y. BANKING LAW § 6-m(2)(o) (McKinney 2009) ("No subprime home loan shall be made after July first, two thousand ten unless the lender requires and collects the monthly escrow of property taxes and hazard insurance."); *See* Press Release, Ctr. for Responsible Lending, *supra* note 354.

404. *See id.*

F. Require Mandatory Loan Counseling and Increase Funding for Community Education Initiatives

Because many predatory tactics depend on borrowers' ignorance of complicated home-financing rules, improving financial literacy would both combat predatory practices and empower individuals to be less dependent on broker advice. One way to educate consumers is to require mandatory loan counseling before taking out a loan secured by one's home.[405]

As of June 2005, nine states had a provision in their predatory lending law that required the borrower to have loan counseling prior to taking out a loan.[406] Counseling requirements can also appear in the mortgage broker licensing statute; "the National Association of Mortgage Brokers includes borrower counseling as a duty in its proposed model licensing statute."[407] Currently, California's state law only requires that lenders disclose that loan counseling is available, but it does not mandate counseling.[408]

The advantage of requiring pre-loan counseling is that the consumer is necessarily interested and motivated to learn more about the borrowing process at that point in time. Merely telling the borrower that such a program is available, which is all that is required by California law, is less effective than requiring the counseling, as borrowers have to take the extra initiative to seek counseling. Further, it is unclear how conspicuous the disclosure of counseling availability must be under California law, so a borrower facing a volume of paper at closing could potentially never realize that such an option is available.

Some experts question the effectiveness of pre-loan counseling in general because they doubt that sufficient financial resources will be devoted to ensure high-quality, neutral counseling opportunities.[409] If homeowner education is provided before a marketing pitch, for example, it may be too early in the process to be effective.[410] Similarly, if the person providing the loan counseling also has a financial stake in the loan, then it may not be entirely neutral advice.[411]

The concerns described above could be allayed by increasing funding for both pre-loan counseling and for organizations that provide broader community

405. *See* Willis, *supra* note 176, at 269 (arguing that one alternative approach to a faulty financial literacy education model is to provide affordable expert advice to consumers akin to pro bono legal advice. *But see* McCoy, *supra* note 41, at 738.

406. The states that have such a provision include Arkansas, Georgia, Indiana, Massachusetts, New Jersey, New Mexico, New York, North Carolina, and South Carolina. *See* Ho & Pennington-Cross, *supra* note 134, at app. A.

407. Hansen, *supra* note 367, at 348 (arguing that "counseling duty should be included as part of the duty to disclose so that borrowers will be aware of the meaning of the mortgage term").

408. As of June 2005, Colorado, Connecticut, Illinois, Kentucky, and Maryland had similar provisions. *See* Ho & Pennington-Cross, *supra* note 134, at app. A.

409. MCCOY, *supra* note 33, at 95.

410. *Id.*

411. *Id.*

education programs on the subject. Funding for such a project might be obtained by amending Division 1.6 to include a funding provision.[412]

Programs that offer such education have reported positive results in the communities they serve.[413] For example, the California Reinvestment Coalition (CRC) is a coalition of nonprofit organizations that advocate for fair and equal access to banking and financial services. The CRC has extended homeownership counseling to many communities through its broad network of grassroots organizations.[414]

Another successful program actually formed as an outgrowth of the plight of Soledad Aviles, the borrower discussed in the introduction of this Comment. After spending countless hours advocating for Aviles, Syliva Prata and Connie Der Torossian decided that something needed to be done to help others in this situation, and they started the Foreclosure Prevention Class at the Fair Housing Council of Orange County. Der Torossian is the Director of Marketing and HUD Programs at the Fair Housing Council, and Prata is a realtor who had volunteered at Fair Housing for five years.[415] Fair Housing had provided first-time homeownership counseling for years, but Aviles's situation highlighted the need to reach more people, so they decided to train a network for volunteer realtors through the Foreclosure Prevention Class.[416]

After securing funding from HUD and the Orange County Association of realtors, the Foreclosure Prevention Class now provides a network of volunteers from the realty industry that act as counselors throughout Orange County.[417] The system is working because realtors also have extensive contact with the clients.[418] After receiving training on how to help the clients with the home loan process, the realtors act as expert counselors who guide clients when

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412. *See* PEW CHARITABLE TRUST, DEFAULTING ON THE DREAM: STATES RESPOND TO AMERICA'S FORECLOSURE CRISIS (2008), *available at* http://www.pewcenteronthestates.org/uploadedFiles/PCS_DefaultingOnTheDream_Report_FINAL041508_01.pdf (discussing various ways in which different states are securing funding for borrower counseling programs such as one-on-one counseling and 24-hour hotlines).

413. Government agencies, such as the U.S. Department of Housing and Urban Development, provide counseling, as do local chambers of commerce and independent nonprofits. *See* U.S. Dep't of Hous. and Urban Dev., Consumer Information, http://www.hud.gov/consumer/index.cfm; *see also* Nehemiah Corporation, http://www.nehemiah corp.org/ (a nonprofit organization providing homeownership education courses and down payment assistance).

414. *See* California Reinvestment Coalition, http://www.calreinvest.org/ (last visited Mar. 16, 2009).

415. 2008 Interview with Fair Housing Council of Orange County, *supra* note 4.

416. So far, the program has trained 151 realtors and they estimate that they have reached over 800 households in Orange County. *Id.* The success of this network of volunteer realtors may provide a successful example of the pro-bono-like service that Professor Lauren Willis proposes in her work. *See* Willis, *supra* note 176, at 269.

417. HUD provided a $23,000 starter grant for the class, and the Orange County Association of realtors gave $20,000. 2008 Interview with Fair Housing Council of Orange County, *supra* note 4.

418. *Id.*

they are taking out a loan.[419] The realtors also assist clients who are already struggling with ballooning subprime loans to negotiate a loan modification with lenders.[420] As of February 2009, the Fair Housing Council has provided Foreclosure Prevention Counseling services to a total of 124 clients.[421] Out of those clients, 108 were able to avoid foreclosure.[422]

Broader community counseling programs, such as the Foreclosure Prevention Class, would complement a mandatory loan counseling provision in Division 1.6. Not only would broader community counseling reach people who are not quite at the point of signing loan documentation, but it would also empower communities with knowledge. This is particularly important in immigrant communities, as one of the most difficult hurdles of becoming assimilated in this country is navigating its financial institutions.

CONCLUSION

The United States is currently in the grips of a market meltdown that was triggered partly by aggressive subprime lending. As the nation grapples with how to deal with the aftermath of the subprime crisis and how to avoid a similar crisis in the future, it is important not to ignore the role predatory lending had in causing this situation. While subprime lending has provided access to credit and, in turn, access to homeownership for many families who were previously denied this opportunity, it has also spawned a new breed of predatory actors who preyed upon people like Soledad Aviles.

Unfortunately, Soledad's story did not have a happy ending. When Aviles was unable to refinance his house as the broker had promised, he went to the Fair Housing Council of Orange County. At Fair Housing, he made contact with Connie Der Torossian and Sylvia Prata, who worked with him and found him a buyer to purchase the house. However, the buyer was only willing to pay $417,000, which was almost $200,000 less than what Aviles had paid. Der Torossian and Prata spent hours attempting to arrange a short sale with Washington Mutual, but ultimately were unsuccessful. In the end, Aviles went into foreclosure. Washington Mutual had agreed to give him a sum of money if he moved out early and left the house in good condition. But he never received the money, even though he held up his end of the bargain.[423] When Aviles was forced to find a rental apartment on short notice, he encountered resistance from landlords because of the foreclosure on his record. Fortunately for Aviles, Prata and Der Torossian advocated for him, and they eventually convinced a

419. *Id.*

420. *Id.*

421. 2009 Interview with Fair Housing Council of Orange County, *supra* note 4.

422. *Id.*

423. 2008 Interview with Fair Housing Council of Orange County, *supra* note 4. When Washington Mutual subsequently became aware of Avilas's treatment, they began to use his case in their training programs as an example of what not to do. *Id.*

landlord to rent him an apartment after providing a double security deposit.[424] However, without such persistent advocates on their side, others in his situation may not have landed on their feet.

Homeownership is a crucial step to building wealth and providing opportunities for families; predatory lenders target the very families that are seeking upward mobility at the very moment they are about to take that step. The strong desire of unsophisticated, minority, or first-time homebuyers to achieve the American dream places them in a particularly vulnerable position. They often rely on their mortgage brokers to lead them through the labyrinth of laws and details of obtaining a home loan, and if the broker is unscrupulous it is easy to take advantage of this trust. Predatory lending will remain a problem regardless of initiatives taken at the federal level to correct the market after the subprime crash, and the toothlessness of federal legislation such as HOEPA has effectively shifted the onus to states to protect their own citizens from such bad actors.[425]

California has one of the nation's highest foreclosure rates,[426] and its predatory lending law remains weaker than most states. After *American Financial*, local municipalities may not pass stronger regulations to protect communities that are particularly vulnerable to predatory lending. Therefore, the state law must be revised to protect the populations that are most susceptible to predatory practices. This Comment has explored a number of predatory patterns common in California; legislators can and should craft amendments to the state law to address such patterns.

The time is ripe to propose such amendments. The recent flood of foreclosures and the resulting strain on the economy has put the need for more front-end regulation at the forefront of the national agenda. Not only have other states begun to strengthen their predatory lending laws, but the public has become vigilant and concerned about the issue.[427] The gold-rush mentality that led to the housing bust may have been a nationwide mistake, but California's lack of affordable housing and large minority and non-English-speaking populations also contributed to an inviting climate for predatory actors who took advantage of many in the subprime market.

Even though the economy has taken a downturn and "in light of the current mortgage crisis there is little [investor] appetite to take on what appears to be a risky asset,"[428] we should learn from the numerous reports of fraud that

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424. 2008 Interview with Fair Housing Council of Orange County, *supra* note 4.

425. *See supra* note 108 and accompanying text.

426. In May 2008, California had the second highest foreclosure rate after Nevada. "One in every 183 California households received a foreclosure filing during the month, a rate that was 2.6 times the national average." Huffman, *supra* note 337.

427. Krauss, *supra* note 110.

428. *See* Carrillo, *supra* note 133, at 4 (quoting Miriam Jordan, *Unlikely Mortgage Winner-Illegal Immigrant Loans Have Been Solid Bets*; *Threats are Looming*, WALL ST. J., Oct. 9, 2007, at C1).

occurred during the housing boom in order to avoid repeating the same mistakes.[429] The California legislature must seize this opportunity to strengthen the predatory lending law to protect people like Soledad Aviles and promote our American dream of homeownership.

429. Of course, it is difficult to predict what effect any economic bail-out plan will have on this situation as, at the time this Comment went to press, the situation was in flux.