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Subprime, but not Half-Bad: Mortgage Regulation as a Case Study in Preemption

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"Subprime" mortgage lending—to borrowers whose credit history or income renders them ineligible for conventional mortgages—has blossomed over the past decade. Advocacy groups, led by AARP, are agitating against the "predatory" terms and marketing of subprime loans, and states and cities have begun to crack down. The activists view state predatory lending laws as a template for aggressive federal intervention. The affected industries, for their part, are looking to the federal government to choke off state and local experimentation.

Both sides are wrong. In this corner of the economy, federalism is working more or less as intended. Let's not screw it up.

For Most, It's a Wonderful Life

Lawyers, executives, and even think tank scribblers on donkey wages typically qualify for standard or "prime" mortgages. For people with a solid credit record and reliable (even if unremarkable) earnings, mortgages have ceased to be the personal transactions of Frank Capra lore; they are a commodity.

Parallel to the commodification of prime mortgages, the financial markets during the 1990s engineered an equally beneficial extension of mortgage credit to borrowers who do *not* qualify for prime mortgages—because they have a blemished credit history; because their earnings are unpredictable, thus casting doubt on their ability to repay; or for some other reason, such as a temporary financial emergency. In 1994, these so-called subprime mortgages amounted to $34 billion, or 5 percent of the mortgage market. By 2002, subprime lending had risen to $213 billion, or some 8.6 percent of all mortgage lending. A number of factors contributed to this explosion. The downturn in interest rates brought mortgages within reach of larger classes of borrowers, as did escalating home equity values. Perhaps most important, a newfangled procedure called "securitization"—that is, the sale of mortgage portfolios in equity markets—supplied the lending industry with enormous liquidity.

The new frontier of subprime lending looks nothing like the secure hinterland of commoditized prime lending. Until very recently, national banks rarely extended subprime loans, preferring to leave the territory mainly to upstart (and sometimes fly-by-night) lending institutions. The borrowers are less affluent and often less sophisticated than prime mortgage customers. They are also more likely to be old or minorities. Likewise, the terms of the transactions differ considerably. Subprime mortgages are more expensive than prime mortgages, reflecting the higher default risk. Less predictably, subprime mortgages are vastly more complex than prime mortgages. They often involve a convoluted mix of fees and penalties that would confound even very sophisticated customers. And, subprime mortgages are often sold through different channels than prime mortgages. Mortgage brokers and other middlemen play a much larger role in the subprime market.

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"Predatory lending" is an advocacy slogan, not a description of any particular lending practice—let alone of the subprime market as a whole. If economic predation were widespread, subprime lenders should be earning abnormally high profits. That does not appear to be the case.[1] Still, when strangers encounter each other at the economic frontier, bad things sometimes happen. Obscure lenders and confused pensioners, brought together by shady middlemen, "agree" on wildly expensive mortgages, on terms too complicated for Warren Buffett. Widows listen to reckless pitches for a home improvement loan—and wind up in foreclosure. Sooner or later, the abuses attract an iron triangle of the regulatory state—AARP, state attorneys general, and the trial bar.

Push and Counterpush

In cities, states, and Washington, D.C., AARP and its nonprofit pilotfish (from the stodgy Consumer Federation to the rabble-rousers at ACORN) have waged a ferocious campaign against "predatory lending," with a fair measure of success. Chicago and other cities have vowed not to do business with firms that engage in predatory lending. North Carolina in 1999 became the first state to enact a predatory lending law. The statute imposes various disclosure obligations for loans above a certain interest rate and fee threshold, and it forbids lending practices such as loan "flipping" (that is, repeated refinancing) and the sale of single-premium credit insurance.

In 2002, Georgia followed suit with a much tougher statute. The advocacy community's chief problem is a lack of litigation targets: brokers typically have shallow pockets, and lending institutions escape liability once the original loan has been resold in the secondary market. Georgia remedied that problem by acceding to the activists' demand for "assignee liability"—that is, exposure to lawsuits and punitive damages for institutions that do not originate but merely purchase and hold (typically, securitized) mortgage portfolios. New York and New Jersey have since followed Georgia's lead and enacted statutes providing for assignee liability.

Meanwhile, state attorneys general have combined to defend state predatory lending statutes in federal courts. They also launched an investigation and lawsuit against Household International, one of the nation's largest subprime lenders, over allegedly deceptive lending practices. This past December, the company settled that proceeding for $484 million and a promise to mend its ways.[2]

Amidst this ferment, advocacy groups have prevailed upon their congressional patrons, such as Senator Paul Sarbanes and Congresswoman Maxine Waters, to propose tough federal standards, while leaving states and cities free to legislate yet more draconian measures. Their agenda enjoys the support of the National Association of Attorneys General and other state and local groups, from the National Governors Association to the National Conference of Mayors. Lending institutions, for their part, are pushing for the federal preemption of state and local predatory lending laws. Their vehicle of choice is the Responsible Lending Act, introduced by Congressman Robert Ney (R-Ohio). The bill would establish a federal floor of predatory lending standards, consisting principally of prohibitions against certain balloon payment provisions, negative amortization, "oppressive" arbitration clauses, and other onerous loan terms that, while economically sensible for at least some borrowers, have incensed the advocacy community. At the same time, the Ney bill purports to bar state and local governments from enacting *more* restrictive regulations.

The demand for higher federal standards is seriously misguided. But so is the industry's demand for federal preemption. Warts and all, the existing regime is far preferable to any uniform federal scheme that Congress is likely to enact.

Uniform Rules, Dual Banking

The contending interests in the predatory lending debate paint the policy choice in stark terms: Federal Preemption—Yes or No? In fact, the subprime market is already subject to pervasive federal regulation and preemption.

Mortgage transactions are governed by a raft of federal statutes that apply to all lending institutions. Those who have recently bought or refinanced a home may have encountered such contraptions as RESPA (Real Estate Settlement Procedures Act) and TILA (Truth in Lending Act): they account for most of the perplexing "disclosure" documents in the basic mortgage package. More fatefully (we shall see), the subprime market is governed by the 1994 Home Ownership and Equity Protection Act (HOEPA), which imposes voluminous disclosure and reporting obligations for loans exceeding certain interest rate or fee thresholds.

These and other uniform laws (such as antidiscrimination statutes) overlay a "dual banking system" of "federal" and "nonfederal" institutions. The latter operate primarily

under supervision by the states. Traditional banks and thrifts operate under formal state charters. Some other firms, including mortgage lending companies, have neither a federal nor a state charter; they are treated as nonfederal institutions and are also regulated primarily by the states. Importantly, nonfederal institutions must generally comply with the laws of all states in which they do business.

Federally chartered financial institutions, in contrast, are subject to the authority of federal agencies. Depository institutions (that is, banks) operate under the Office of the Comptroller of the Currency (OCC); thrifts operate under the Office of Thrift Supervision (OTS). OCC and OTS have issued some binding standards and regulations, on top of the federal statutes that apply to all lenders, to govern "their" institutions' practices, including some carefully circumscribed subprime lending rules. These regulations preempt any and all conflicting state or local regulations.

In addition to these fairly minimal requirements, federal law imposes a mandatory choice-of-law regime: interstate transactions between federally chartered institutions and their customers are governed by the *lender's* home state law, not the *customer's*. Like nonfederal institutions, federal institutions must comply with state laws—but only with their home state's law (which they get to choose), not with fifty different state laws.

This rule is sometimes called the *Marquette* principle, after a 1978 (and since affirmed) Supreme Court decision interpreting the National Bank Act.[3] It is not a prescriptive regulatory system but a kind of contract regime in disguise. When customers choose to do business with a national bank, they choose the bank *and its home state's legal regime*. States will seek to match the largest number of buyers and sellers by permitting contract terms that customers happen to like. Thus, the system pushes toward efficient regulation. The 1978 *Marquette* decision facilitated the emergence of a highly efficient national consumer credit market during the 1980s.[4]

The Scope of Preemption

The dual banking regime has defined the warring interests' positions in the debate over preemption and predatory lending. States initially argued that all lending institutions, federal and state alike, were subject to state and local predatory lending laws in all fifty states and in local jurisdictions. That claim was never plausible, and OCC and OTS have clarified, in a string of rulings, that their regulatory regimes categorically preclude the application of state or local predatory lending laws to federally chartered institutions. So the debate over preemption (yea or nay) applies only to *nonfederal* institutions.

The regulatory garment has yet another wrinkle. Obviously, a federal institution that must comply with the regulation of only a single state of its own choice has a huge advantage over nonfederal institutions. To redress that imbalance and to revitalize the then-ailing thrift industry, Congress in 1982 enacted the first of several "parity" provisions: so long as nonfederal lenders write mortgages on terms that comply with OCC or OTS regulations, they too may in essence choose their home state. Individual states may opt out of the regime, but most have chosen to remain parity states.

OCC and OTS, however, do not actively supervise nonfederal institutions that avail themselves of the parity option. Thus, some lending institutions—those that operate under neither a federal nor a state charter—have arguably operated without *any* sustained supervision. This supervisory "vacuum" may help explain why mortgage lending companies emerged as leaders in the subprime market.[5] States, though, are predictably upset about the situation, and argue that federal parity statutes do *not* wholly preempt state consumer protections against predatory lending practices. That position is shared by OCC and OTS, whose clients do not look kindly on what amounts to a kind of "parity-plus" for some nonfederal lending institutions.

Wholesale federal preemption would level the field for everyone—federal and nonfederal lenders, parity and non-parity states. The price of uniformity, however, is more federal regulation and, correspondingly, a narrower range of operation for the *Marquette* principle. We ought to tread carefully on this front. A false step could choke off mortgage credit for millions of citizens who are disproportionately poor, minority, old, very young, or up the creek. Principles and prudence counsel tolerance for continued state regulation.

Preemption Principles for a Sane Society

Start with the basic intuition: to the extent that economic transactions and their consequences are internal to each state, there is a powerful presumption against preemption. Federalism, in this setting, offers the advantages of diversity, experimentation, and state competition for productive citizens and businesses. Conversely, when states regulate or otherwise interfere with interstate

commerce, the presumption runs the other way—*for* federal preemption.

Modern federal constitutions, as well as our own Supreme Court, typically try to assign classes of state functions to one or the other level of government. That approach is futile. Me and you and a dog named Boo withdraw cash at the "local" ATM. But the nearest ATM on any business trip or vacation may be a thousand miles from our state of residence or citizenship. Also, the transactions occur millions of times a day, all over the place, in the context of a global financial network. Distinctions between "inherently local" and "national" activities are of little help in deciding who should regulate what. One must rather look to the *costs* of regulation: first, the incidence of the costs of state regulation; second, the costs for the regulated industry of complying with the state's regulatory regime—and, in the extreme case, of exiting states.

So long as the costs of regulation accrue principally within each regulating state, states should generally be free to do as they please. Overregulated citizens and businesses tend to leave, and that threat will at some point discipline the politicians setting the rules. In contrast, when states impose the costs of their regulatory experiments on citizens in *other* states, the folks who foot the bill can neither run away nor vote the bums out of office. For that reason, state politicians are extremely creative in exporting the costs of their schemes. Preemption is a way of arresting their perennial quest for a free lunch.

Similarly, states should be free to regulate, so long as the regulated industry has an inexpensive way of tailoring its product to local law and of exiting onerous states where that proves impossible. Conversely, when an industry *cannot* exercise its exit rights—either because of product or industry characteristics, or because the state has barred the exits by regulatory means—the costs of state regulation rattle through the entire economy. Federal preemption becomes a serious option, if not necessarily an imperative.

Even with respect to a seemingly discrete set of transactions ("mortgage lending"), the preemption question admits of no categorical answer in isolation from the costs of regulation. A focus on those costs, in contrast, usually yields a clear (albeit differentiated) answer. For example, mortgage lending (as all other credit) works best when lenders possess, and can share with one another, comprehensive information about borrowers' credit histories. That objective would be defeated if a single state could enact "consumer protection" schemes to shield its citizens' financial transactions and to prevent information sharing. In this respect, then, mortgage lending requires a uniform rule. The 1970 Fair Credit Reporting Act (FCRA) established such a regime and, consequently, a credit market vastly more transparent and efficient than that of any other nation.[6] Central preemption provisions, added to FCRA in 1996, are set to expire in 2004, and a "states' rights" cabal of consumer advocates, state attorneys general, and trial lawyers is mobilizing to prevent an extension, in the name of "privacy protection." The answer they deserve is a no-brainer: get lost. And yet, the calculus shakes out differently with respect to regulating the terms and conditions of mortgage lending. Here, the case *against* preemption is persuasive.

Experimentation

Justice Louis Brandeis was a socialist at heart. When he famously described the states as "laboratories of democracy," he meant to empower them to "experiment" with other people's money and, to that end, on a particular species of guinea pigs—national corporations, whose shareholders and workers live mostly outside the regulating states.[7] Still, the metaphor has a good sense when states experiment with their own citizens' money and the animals can escape at low cost: under those conditions (and *only* those conditions), state experimentation teaches us lessons we cannot learn on a blackboard. That need is particularly urgent in new industries and economic sectors—such as subprime lending.[8]

Neither the lending institutions, nor the instruments (such as securitization), nor for that matter the borrowers existed in the market ten or fifteen years ago. As in every emerging market, there are lots of false starts, errors, and reckless players in search of a quick buck (before long-term players whittle away the economic rents). The abuses, though, have come along with the stupendous democratization of mortgage credit, and even predatory lending demagogues concede that the extension of subprime credit, to individuals who would otherwise have to turn to loan sharks and pawnbrokers, is generally a good thing. The regulatory question, then, is this: how can we reduce errors and abuses without compromising the gains? No one knows for sure. Under conditions of ignorance, it is unwise is to suppress the information that comes from state experiments.

Werewolf? There Wolf![9]

North Carolina's predatory lending statute has become the subject of several econometric studies. Some studies purport to show that the statute squeezed out lousy lending practices without leading to the credit withdrawal predicted by the industry; other analysts have found the opposite.[10] Inconclusive though they may be, the studies would be altogether unavailable without the actual experiment.

In response to Georgia's more drastic statute—specifically, the exposure of assignees to unlimited damage awards—all major financial rating agencies (such as Moody's) declared that they would no longer rate portfolios with mortgages originated in Georgia. The liability risk had become incalculable. Lenders promptly withdrew from the state, and the mortgage credit market collapsed. Seven months later, Georgia effectively repealed its statute. Washington, D.C., experienced a similar credit withdrawal after enacting a predatory lending law, and likewise suspended its statute.

If nothing else, we have learned what kills subprime lending. While the industry may have been crying wolf in North Carolina, in Georgia it met the real wolf. AARP and Co. continue to push for assignee liability laws, and they have prevailed in such socialist citadels as New York. One may hope, however, that the Georgia market collapse will prompt sober thoughts among politicians elsewhere, including Congress.

We have also learned that subprime mortgages can be tailored to varying state regulations. Exit–in fact, instantaneous exit—is possible. The costs of Georgia's experiment fell where they belong: the market keeled over in Georgia, and nowhere else. The error, moreover, was reversed in a mere seven months, largely because the consequences appeared in sharp relief against the other states' continued good fortunes. A comparable error at the federal level would be for keeps: Congress never repeals anything. Arguably, preemption might forestall Georgia-style regulatory disasters. But we do not have a choice between state errors and error-free preemption; we only have a choice between state and national error. (More in short order.) Relative to a comparable national experiment, letting the Georgians learn from their own mistakes leaves most of us better off, and no one worse. We have here in clear view one of federalism's true virtues: the Pareto-optimal regulatory debacle.

Finally, interest groups can be held to account more easily in the states than in Washington. At the national level, the wide range of interest-group conflict dictates compromise and an attendant diffusion of responsibility. At the end of the day, the demagogues for this or that scheme will be able to blame the ensuing ill effects on the failure to implement their design to the full extent, rather than its partial adoption. Within (though not across) the states, the range of interest-group conflict is much tighter, and pro-regulation forces will concentrate on the states where they can win hands-down. Georgia adopted the advocacy community's model policy on predatory lending in its pristine stupidity—and paid the price. Allow that to happen over a wider range of issues, and self-appointed "consumer groups" may eventually pay the price.

Wouldn't Be Prudent, At This Juncture

To those observations, the subprime lending industry responds, reasonably enough, that no state is an island. (Even Rhode Island is no island, nor for that matter a road.) Varying and conflicting state mortgage lending regulations impose frictional losses, compliance costs, and diseconomies of scale. Short of exiting particularly oppressive states, lenders must either design and implement fifty-plus different compliance programs, or else a single program that will conform to the demands of the strictest state or local jurisdiction. Either way, the costs will be spread across borrowers nationwide. States in an entire region may induce or compel lenders to withdraw; in that event, securitized mortgage portfolios would become less diverse, and hence riskier. Such diseconomies, too, may warrant federal preemption. And in any event, preemption is already the rule for federally chartered institutions. Why not subject state and federal lending institutions to a level preemptive regime?

Because it cannot be done. The industry quest for federal preemption is a proffer: give us uniformity and a prohibition on state impositions, and we shall accept more federal regulation (for all lenders). That sort of bargain is a mug's game.

Stipulate that Congressman Ney (the preemption guy) can write a perfectly fine bill for the lending industry, or it for him: if his initiative is to become law, he will write, at most, half of it. The other half will be written by the AARP, working with Senator Sarbanes (whose predatory lending bill contains a ton of regulation and zero preemption).[11] The half-loaf will be worse than no loaf. The added regulation—by definition, more than the industry bargained for—will apply in every state, to every lending

institution. In other words, the rules will stick. Preemption, in contrast, operates not on private firms but as a bar to additional impositions by state or local governments. At least some of those bodies have every incentive and inclination to evade the federal restrictions. Preemption rules, then, cannot stick unless they are ironclad—which they will not be. Upon inspection, the industry's regulation-for-preemption proffer proves likely to produce a lot more regulation and very little preemption.

Affirmative Mistakes

Existing federal regulations have caused considerable harm, and possibly more harm than good, in the subprime market. In that light, the industry's demand for additional restrictions is unlikely to prove beneficial for efficient markets, for consumers, or for the lending industry itself.

Many "irregularities" of subprime lending are readily explained by market characteristics. Prepayment penalties are far more common in the subprime than in the prime market because prepayment *rates* are higher. That is a risk for the lenders, who must price their product accordingly. Transaction fees are higher, relative to mortgage values, because the fees tend to be flat and mortgage amounts are smaller in the subprime market. In addition, subprime mortgages involve far higher monitoring and servicing costs.[12] Undoubtedly, however, the subprime lending market also features numerous regulation-induced distortions. For example:

- AARP and Co. observe that incomprehensible fee arrangements are much more prevalent in the subprime market than in the prime market. That, as noted, is true. They allege that those arrangements reflect lenders' intent and ability to prey upon less-sophisticated borrowers. That is most likely false. The disclosure and reporting obligations under the aforementioned Home Ownership and Equity Protection Act (HOEPA) are expensive. Moreover, Fannie Mae and Freddie Mac, the two largest secondary market purchasers, refuse to buy HOEPA loans. For these reasons, HOEPA has the effect of a usury ceiling:[13] subprime lenders seek to stay below the interest rate that would trigger the statute. That, though, forces the lenders to price their products on noninterest rate margins, such as fees. HOEPA regulates some of those terms, too, and so lenders resort to ever-more esoteric (but unregulated) fee arrangements.

  The displacement effect of usury laws is amply documented in the credit card market. Suppress competition on interest rates, and offerors will compete on some other, less efficient margin. (If the terms were efficient, parties would choose them even in the absence of regulation.) Suppress the evasions, and two things happen: lenders ration the product (principally, to more credit-worthy customers) and, within that narrowed range, structure the transactions on terms that *nobody* wants. When interest rates on savings accounts were regulated, banks gave away toasters. Another round of subprime lending legislation will bring less credit, though perhaps better breakfast.

- The Community Reinvestment Act of 1977, an activists' crown jewel, effectively compels financial institutions to hold lending portfolios with acceptable minority ratios. That mandate applies to purchased mortgages, not just the ones originated by a given institution. Secondary-market purchasers basically do not care whether the original loans were extended at gunpoint; they just want to hold the notes. In effect, sharp lenders and extortion artists may be assisting the financial sector in satisfying a federal mandate.[14]

- Community activists complain about allegedly disproportionate foreclosure rates in the subprime market. But to the extent that foreclosure rates are abnormally high (which is by no means clear),[15] that may have to do with the fact that the federal government insures many mortgages that are attractive candidates for subprime refinancing. When the borrower defaults, the lender forecloses, sells at an auction (at any price), and collects the difference between the sale price and the (often inflated) assessed value from the feds. When that happens, lenders are playing with someone else's money. Again, federal policy may be subsidizing and therefore increasing an abusive practice.

The regulated industries understand that existing regulations may have done more harm than good. But they will not say so. They know better than to attack the advocacy community's sacred cows, and they know that no regulation is ever repealed. Above all, they wish to signal their acceptance of additional regulation in exchange for federal preemption. That preemptive surrender might be wise if the expectation of obtaining the reward were realistic. But it is not.

Preemption? You Wish.

Federal preemption, we have noted, must be airtight. The Ney bill is about as airtight as modern prejudices will permit. In other words, it is a sieve.

At first inspection, the Ney bill broadly preempts any state law that "imposes any requirement, limitation, or prohibition on any mortgage lending activities," that "attempts to regulate" such activities, or "that directly or indirectly limits a creditor's ability to extend new credit." But the bill promptly muddies the preemption waters with a "clarification" of the states' role as the "primary enforcement authority with regard to any person domiciled in such State or chartered by such State." This states' rights sop invites litigants to argue, and courts to infer, that Congress meant to preempt the states only so far as the statutory language compels that conclusion. In borderline cases—meaning virtually all cases likely to wind up before an appellate court—the judicial presumption runs against preemption.

To illustrate the importance of that point: the Ney preemption provisions apply to "any [state or local] statute, rule, regulation, or ordinance." That may include common law "rules"—or it may not. Federal preemption will give clever lawyers, AGs, and state judges an incentive to recast a "predatory loan" as a garden-variety tort. The Ney bill does not clearly close that window.

In escaping preemption, state enforcers need no windows. They will slip through cracks and bore through mortar. In response to hyperventilation in the usual (consumer group) quarters, states and even cities have attempted to regulate the ATM fees charged by national banks, even though federal law and literally hundreds of precedents absolutely forbid local interferences that affect, let alone regulate the prices of, federally chartered banks. Similarly, predatory lending laws plainly constitute direct regulations of banking transactions; and yet, the states have insisted on their authority to impose such laws on national banks.

With respect to federally chartered institutions, it is true that the preemption dams have held. Federal preemption operates the way it *ought* to operate: it is exclusive, clear with respect to its scope, and rigorously enforced by agencies and courts. Those achievements, however, flow from long-lost sensibilities.

Congress enacted the National Bank Act in 1864 against a backdrop of "dual federalism": things belonged either in the federal or in the state domain, but not in both. Congress was clear-eyed about its objectives: it wanted to create national banks as instruments for a national economy and currency. The events of that time gave Congress a vivid sense of the states' centrifugal tendencies (to put it gently). And so, Congress readily concluded that national banks needed a total prohibition against state regulation. A federal charter is not a preemptive "floor" above which states are still permitted to regulate. Rather, it truly excludes any state law that materially affects the operation of national banks.

Exclusivity has survived through countless statutory amendments, reforms, and revisions because it is fortified by potent institutional incentives and traditions. The OCC has ruthlessly defended its authority to preempt state law, while exercising great caution in imposing excessive regulatory burdens on "its" chartered banks. Bureaucratic empire-building has been put to splendid use here: if the OCC wants to expand its regulatory fiefdom, it must make it attractive for financial institutions by offering a safe haven from state assault.

Moreover, the Supreme Court has doggedly defended national banks and OCC authority against "the hazard of unfriendly legislation by the States" (to quote an early case). The Court has consistently sustained the choice-of-law regime established by the Bank Act. And, it has paid great deference to the OCC's preemption claims: when the Comptroller designates a state regulation as a "significant" interference with federal prerogatives, that is the end of the matter.[16]

Modern preemption doctrine, in contrast, reflects a preemption-defeating respect for "cooperative federalism" and "states' rights." (As noted, even the Ney bill's preemption provision bows to that sentiment; it is ominously entitled "Coordination With State Enforcement.") Preemption, under those presumptions, falls well short of National Bank Act–style exclusivity. Institutionally, the determination as to whether a particular state statute is preempted would be committed in the first instance to the Federal Reserve Board—a fine institution, but one that lacks, with respect to state lenders, the proprietary interest that the OCC has in "its" banks. More fatefully still, the Supreme Court construes preemption provisions in the light of "tradition"—specifically, the question of which level of government has "traditionally" regulated the subject matter at hand. That canon of construction stabilizes the exclusive preemption regime that governs federally chartered institutions. But the "tradition" canon *corrodes* federal attempts to preempt the application of state predatory lending laws to nonfederal institutions.[17] Those outfits

have traditionally been regulated by—well, the states. And away, or rather down, we go.

The Promise and Perils of Preemption

Regulated industries routinely demand federal preemption, and they propose or accept additional regulation as a quid pro quo. As Pietro Nivola of the Brookings Institution has put it, corporations would rather deal with one federal "gorilla" than with "fifty monkeys on steroids."[18] The states' increasingly aggressive posture renders that strategy altogether understandable and, sometimes, the only available course of action. More often, however, the preemption strategy will backfire, for reasons discussed at excruciating length.

What then (wise guy) is the alternative? One small step might be to resist the urge for preemption, and to live with an imperfect status quo, when federalism works—where the monkeys operate in a cage of state competition. Predatory lending regulation fits that description. More ambitiously, corporate leaders could demand an extension of the *Marquette* principle—that is, an extension of the choice-of-law provision of the National Bank Act to state-chartered and -supervised lending institutions. Unlike affirmative federal regulation, that principle affirms the states' control over industries within their borders. A "states' rights" Supreme Court may find that brand of federalism more acceptable than pure preemption.

The predatory lending debate, however, illustrates why such a reorientation from preemption to state competition may be too much to ask. Even in the financial sector, where the *Marquette* principle operates over some range and where it could easily be extended by clarifying the preemptive force of federal parity laws, industry lobbies are demanding a *contraction* of that principle, not an extension. Unfortunate but understandable political calculations explain that strategy.

An industry demand to extend state competition would face fierce opposition not only from advocacy groups, but also from state and local governments. If states like Georgia truly believed their predatory lending laws to be in consumers' interest, they could simply repeal their parity statutes. In-state companies, alone among all lenders, would be subject to predatory lending laws, and presumably consumers (perhaps assisted by the sort of publicity campaign that states often conduct on behalf of home-state industries) would flock to the domestic lenders—right? Wrong. Consumers would run straight to national or out-of-state lenders (those whose home-state regulators have not been captured by AARP), and the domestic industry would be out of business. For all their "states' rights" protestations, states do not hate federal regulation; they positively demand federal minimum standards as a means of curtailing deregulatory competition from sister-states. If the price of federal standards is partial preemption, states will take the sweet (TILA, HOEPA, ETCETERA) and then denounce the bitter preemptive medicine as an egregious interference with states' rights. In short, the states might "buy" a preemption-for-regulation bargain, in the hope of pocketing the gain and disputing the concession. They will never buy a proposal for enhanced state competition.

In addition, and in contrast to the alliance between states and advocacy groups, regulated industries confront a high likelihood of internal conflict. The first predatory lending ship sailed into North Carolina—not a socialist haven, but a responsible state that is home to a slew of big national banks. Its predatory lending law was not an AARP product but rather resulted from negotiations among lenders, community organizers, and state officials. Only one group was not represented: national subprime lenders, such as Household International.

The phenomenon is quite common: once a few entrepreneurial upstarts (mortgage lending companies) have explored the risks and shown a way to make money in a new market, and once that market blossoms from niche play into serious business, bigger, more risk-averse players (national banks) wish to enter. They do so in a number of ways—by buying up smaller firms (as is happening in the subprime lending industry), and by squeezing them through the regulatory process. They did so in North Carolina. At the national level, national banks and thrifts were initially supportive of wholesale federal preemption, but they cooled to the Ney bill once the OCC and the OTS ruled that national institutions are immune against state predatory lending laws in any event. Now, the national banks' incentive is to lobby for regulation that would crimp their upstart competitors, and against preemptive rules that would put all lenders into a federal straitjacket.

In proffering a regulation-for-preemption bargain, then, subprime lenders are playing against the house and its favored customers, with a hopelessly stacked deck. The industry would rather play that game than be excluded from the table, as happened in North Carolina. At a minimum, though, it will have to compromise on preemption with its industry rivals long before having to compromise with its enemies. Under a worse scenario, Citigroup and

advocacy flaks will agree on a division of the spoils and crush the boisterous newcomers—Household Finance and its pesky, poor, unorganized customers.[19]

Two Cheers for Federalism

For a change, let us end an *Outlook* on an optimistic note: however the preemption fight shakes out, subprime lending is here to stay.

American federalism permits a wide range of parochial state action and interest group wheedling, including corporatist deals of the North Carolina variety. At the same time, though, our federalism permits a whole lot of creative activity in the states, while making it very hard to arrange a national deal that would close the economic frontier before it is settled. European countries, in contrast, have a handful of government-controlled banks and one federally financed consumer group. Together, those institutions would shut down an emerging credit market after the first subprime loan. Lo, there is no such market anywhere on the old continent.

For our part, we have to live with nonprofit cowboys, egomaniacal sheriffs (a.k.a. state AGs), and the trial lawyer posse. But those characters cannot actually restrain much of anything. For the most part, they wave their arms, fire random shots, and collect ransom long after the entrepreneurs have settled Dodge City.

The Europeans are wrong: we do not have “cowboy capitalism.” What we have is cowboy socialism. We would rather make do without it, but it is way better than the real thing—and it is the price we pay for federalism’s advantages.

Notes

1. An instructive discussion paper published by the Office of the Comptroller of the Currency suggests that subprime lenders’ returns are roughly commensurate with lending risks. “Economic Issues in Predatory Lending,” *OCC Working Paper*, July 30, 2003 (available at http://www.occ.treas.gov/ workingpaper.pdf).

2. “Multistate Actions: States Settle With Household Finance: Up to $484 Million for Consumers,” *National Association of Attorneys General* (available at http://www.naag.org/issues/20021011-multi-household.php). For details of the settlement, see the FAQ posted at www.household-beneficial-settlement.com/faq_english.htm.

3. *Marquette National Bank of Minneapolis v. First Omaha Service Corp.*, 439 U.S. 299 (1978); *Smiley v. Citibank (South Dakota)*, 517 U.S. 735 (1996).

4. The point was demonstrated in 1986 by a young lawyer-economist who has since moved on to still-greater accomplishments. Christopher C. DeMuth, “The Case Against Credit Card Interest Rate Regulation,” 3 *Yale Journal on Regulation* 201 (1986). For a more recent discussion and review of the evidence see Todd Zywicki, “The Economics of Credit Cards,” 3 *Chapman Law Review* 79 (2000).

5. Robert E. Litan, *Unintended Consequences: The Risks of Premature State Regulation of Predatory Lending* (prepared on behalf of the American Bankers Association, 2003), 5 (available at http://www.butera-andrews.com/legislative-updates/directory/Background-Reports/Litan%20PredReport%202003.pdf).

6. The essential role of FCRA preemption is demonstrated by Michael E. Staten and Fred H. Cate, “The Impact of National Credit Reporting Under the Fair Credit Reporting Act: The Risk of New Restrictions and State Regulation,” Credit Research Center Working Paper No. 67 (available at http://www.msb.edu/prog/crc/pdf/WP67.pdf).

7. For a thorough trashing of Brandeisian federalism see Michael S. Greve, “Laboratories of Democracy: Anatomy of a Metaphor,” *Federalist Outlook* No. 6 (May 2001) (available at http://www.aei.org/publications/pubID.12743/pub_detail.asp).

8. Because even seemingly horrendous loan terms are perfectly sensible for some borrowers, there is no agreed-upon definition of what constitutes a “predatory” loan. In a fundamental sense, we have no idea what we are regulating.

9. With apologies to Marty Feldman and the late Warren Zevon.

10. The positive assessments include Roberto G. Quercia, Michael A. Stegman, and Walter R. Davis, *The Impact of North Carolina’s Anti-Predatory Lending Law: A Descriptive Assessment* (Center for Community Capitalism, UNC Chapel Hill, 2003) (available at http://www.kenan-flagler.unc.edu/assets/documents/CC_NC_Anti_Predatory_Law_Impact.pdf); and Keith Ernst, John Farris, and Eric Stein, *North Carolina’s Subprime Home Loan Market After Predatory Lending Reform* (Center for Responsible Lending, August 13, 2002) (available at http://www.mbaa.org/state_update/2002/nc/nc_study_0814.pdf). For the opposite view see Gregory Elliehausen and Michael Staten, “Regulation of Subprime Mortgage Products: An Analysis of North Carolina’s Predatory Lending Law,” Credit Research Center Working Paper No. 66 (November 2002) (available at http://www.msb.edu/prog/crc/pdf/RevisedWP66.pdf).

11. For an overview of congressional predatory lending bills, including the Sarbanes proposal (S. 2415), see http://www.butera-andrews.com/legislative-updates/directory/Federal/Congress/Bills/fedbillchart.pdf.

12. *OCC Working Paper*, 12. For additional examples of widely criticized but economically sensible pubprime lending terms, see Litan, *Unintended Consequences*, 27–28.

13. Litan, *Unintended Consequences* 16.

14. Community activists and their academic supporters themselves harbor that suspicion. See, for example, Kathleen C. Engel and Patricia McCoy, "The CRA Implications of Predatory Lending," 29 *Fordham Urban Law Journal* 1571, 1604 (2002) ("CRA and federal subsidizes [sic] to regulated lenders can inadvertently facilitate predatory lending. . . .") Their response, of course, is not to question the mandate but to demand another layer of regulation, barring the counting of "predatory" loans towards CRA ratios. In addition to Engel and McCoy, see ACORN's "Recommendations" (available at http://www.acorn.org/acorn10/communityreinvestment/reports/HMDA2002/recommend.htm); and National People's Action (at http://www.npa-us.org/issues/predatory-lending/what-is-predatory-practices.htm).

15. *OCC Working Paper*, 9.

16. The "hazard" language appears in *Tiffany v. National Bank of Missouri*, 85 U.S. 409, 413 (1874). For the remainder of the paragraph in the text, see the *Marquette* and *Smiley* cases cited in note 3 and, most recently, *Beneficial National Bank v. Anderson*, 123 S.Ct. 2058 (2003) (complete preemption; deference to OCC determinations concerning "significant" state interferences with national banking).

17. The canon is, to my mind, absurd because the question of who has "traditionally" regulated what has nothing to do with the constitutional text, logic, or federal-state equilibrium. To illustrate the point (and the gulf that separates the modern Court from the constitutional perspective): a century ago, employers challenged the first federal tort statute (the Federal Employers Liability Act) on the grounds that torts were the "traditional" province of the states. The Supreme Court rejected that plea, on the correct theory that a congressional failure to exercise some power by no means indicates a *lack* thereof. *Second Employers' Liability Cases (Mondou v. New York)* 223 U.S. 1, 55 (1912). Nowadays, trial lawyers invoke the states "traditional" authority over torts, and the Supreme Court listens.

18. Pietro Nivola, "Does Federalism Have a Future?" *The Public Interest* (Winter 2001) (available at http://www.brook.edu/views/articles/nivola/2001pi.htm).

19. Symbolically, this has already happened. CitiFinancial (a Citigroup subsidiary that entered the subprime market through its acquisition of The Associates, a target of a since-settled Federal Trade Commission proceeding over abusive lending practices) has entered a "fair lending" agreement with National People's Action. (*Who*?? According to its website, NPA "builds the power of neighborhood residents through issue-based organizing and direct action.") The deal was sealed at NPA's 2003 Annual Conference with corporate gifts of mugs and t-shirts and with a CitiFinancial representative's autograph of a placard-sized fair lending "commitment." Subprime mortgage lobbyist Wright Andrews, in contrast, refused to comply with NPA's demands. He was escorted from the room and followed home by an angry mob. See "NPA Issues" *NPA* website (available at http://www.npa-us.org/issues.htm); "NPA Continues to Harpoon the Sharks," *Online Disclosure* (June 2003) (available at http://disclosure-us.org/disc-june2003/harpoonsharks.html).