A Prudent Approach To Preventing "Predatory" Lending

By

Robert E. Litan
Vice President and Director, Economic Studies Program
The Brookings Institution

Washington, D.C.
February 2001

A Prudent Approach To Preventing "Predatory" Lending

By

Robert E. Litan[1]

One of the hallmarks of the U.S. financial system is that it has become increasingly "democratized." Encouraged by government policies and spurred by market forces, financial institutions and markets over time have gradually expanded credit to borrowers who in earlier times could not have qualified for credit. In mortgage markets especially, the government has played an important catalytic role: creating a secondary market in mortgages through various "government-sponsored" enterprises, extending federal insurance to mortgages for low- and moderate- income (LMI) homebuyers, and by imposing "community reinvestment" obligations on depository institutions that are aimed at encouraging lending to LMI borrowers and residents of LMI geographic areas. In the 1990s, the growth of the "subprime" lending market – among lenders and the investment banks that have "securitized" the loans – has led to a major increase in mortgage lending to low income households, and especially minorities. As a result, approximately two-thirds of Americans now own their own homes – the highest rate of homeownership in our history.

Nonetheless, increasing attention has been paid in recent years to various abusive practices in the subprime lending market that have been collectively labeled as "predatory lending." Although the term itself has not been precisely defined, it has come generally to refer to mortgages extended under terms that are more onerous to borrowers than if they were more fully informed about the loans themselves and the alternative sources of finance that may be open to them. In response, the Congress has enacted legislation cracking down on certain especially unfair lending practices, while imposing reporting obligations on both depository and non-depository lenders designed to shed sunlight on the extent of high-cost lending. In November and December 2000, the Federal Reserve – the principal federal regulator charged with collecting and publicizing this information – issued two proposals to expand the coverage of these reporting requirements.

This report highlights the potential danger to the populations thought to be most victimized by predatory lending – minority and low-income individuals and families generally – of already enacted or proposed state and local ordinances or states that extend beyond federal law. In effect, these regulatory provisions constitute a new type of "usury" statutes, which once were prevalent throughout the country, but have since been abandoned – except in this new guise as an attack on predatory lending. Moreover, the implicit connection drawn in some of these laws (or their preambles) between "high cost" lending, which appropriately reflect the risks of lending to customers outside the prime market, and "predatory" lending, which is inherently abusive and already punishable under federal law, is simply incorrect.

---

[1] The author is Vice President and Director, Economic Studies Program at the Brookings Institution. He has prepared this report on behalf of the American Bankers Association. The views are his own and not those of the Brookings Institution, its trustees, officers or staff.

While the motivation behind added legislation aimed at predatory lending is understandable and commendable, *the fact is that virtually all of the practices complained of are already against federal law.* Furthermore, federal law contains numerous disclosure requirements relating to mortgage loans generally, and especially high-cost loans. *Additional statutory measures at the state and local level at this point run a significant risk of unintentionally cutting off the flow of funds to creditworthy borrowers.* This is a very real threat and one that should be seriously considered by policy makers at all levels of government, especially in light of the multiple, successful efforts that federal law in particular has made to increase lending in recent years to minorities and low income borrowers.

The more prudent course is for policy makers at all levels of government to wait for more data to be collected and reported by the Federal Reserve so that enforcement officials can better target practices that may be unlawful under existing statutes. In the meantime, *Congress should provide the federal agencies charged with enforcing existing statutes with sufficient resources to carry out their mandates, as well as to support ongoing counseling efforts to educate vulnerable consumers about the alternatives open to them in the credit market and the dangers of signing mortgages with unduly onerous terms.* There is also an encouraging new development from the private marketplace – the voluntary release of credit scores – that potential borrowers will be able to use in improving their ability to compare mortgage terms before they assume such debt. More information provides an important market-driven way to help level the playing field between lenders and otherwise uninformed borrowers.

This report is structured in the following manner. Section I begins by documenting the growing importance of subprime lenders to underserved borrowers, as well as the efforts by the federal government to encourage lending to such borrowers – efforts that recent evidence suggests have paid off.

Section II next describes certain lending abuses in this market that have occurred or are alleged to have occurred in recent reports on predatory lending. In the process, it highlights how these abuses generally already are prohibited under existing federal law. Section II also identifies reporting requirements that now apply or that have been proposed for lenders in the subprime market. The section concludes by making clear that subprime or high cost lending – to borrowers of greater risk than prime borrowers – should not be routinely equated with "predatory" lending.

Section III summarizes some of the current and proposed local ordinances that have gone beyond federal law, and that currently or would penalize lenders for extending mortgages on terms that would not be unlawful or that would require reporting under federal law. Such legislation threatens the availability of credit to precisely those borrowers thought to be most victimized by predatory lending, and thus entail the risk of reversing the progress that federal law has made in encouraging the flow of credit to these borrowers.

Section IV concludes by suggesting that the prudent course for policy makers at all levels of government is to enforce existing law and examine the data that lenders must report before taking any further action that might threaten the availability of credit to riskier, but still creditworthy, borrowers.

I. The Importance of the Subprime Mortgage Market

In the days when deposit and lending rates were regulated or limited – as recently as 1980 – credit was rationed. Good or prime borrowers got credit, others didn't.

One of the major financial innovations over the past two decades, and especially in the 1990s, has been the development of credit rating tools that measure the relative risks of potential default of different borrowers. These credit scores are now used by a wide range of lenders, depository and non-depository institutions alike, to help determine interest rates and other terms to offer to borrowers that take account of the risks of non-payment.

In particular, borrowers with a history of always paying their utilities, credit card, and other bills on time often qualify as "prime" borrowers, and thus are eligible for credit on the most competitive terms available. Many borrowers, however, do not have perfect payments histories; others may not have significant assets to fall back upon; and others may be self-employed and have wide fluctuations in their annual incomes. Although borrowers in each of these categories may thus not qualify for credit in the prime market, they may well be eligible for credit in the "subprime" market, where because of the greater risks, interest rates and up-front fees are higher and loan amounts are typically smaller than those available in the prime market. As discussed further below, the leading credit scoring company – Fair Isaac – will be releasing credit scores to borrowers beginning in March 2001.[2] This is an important development that should enhance the competitiveness of the subprime mortgage market, to the benefit of borrowers who seek credit in that market or who will now learn that they deserve to receive credit as a prime borrower.

As it is, however, risk-related pricing of loans already has led to a considerable expansion in credit to borrowers who may once have been rationed out of the credit altogether. Many of the borrowers in the subprime market are minorities or families or individuals with low incomes – borrowers who could not in the past and still cannot qualify for credit in the prime market. The development of the subprime market has changed all that. As Federal Reserve Governor Edward Gramlich has recently noted, between 1993 and 1998 conventional mortgages extended to Hispanic-Americans and African-Americans increased by 78 and 95 percent, respectively – far outdistancing the economy-wide 40 percent increase in such lending [Gramlich, 2000].

Gramlich concludes that much of this increase is attributable to the expansion of the subprime market. As shown in Chart 1, during this same period, the number of subprime loans increased roughly ten-fold, from about 80,000 to nearly 790,000. Chart 2, indicates that from 1994 to 1999, the dollar volume of subprime mortgage originations increased by nearly a factor of five, from $35 billion to $160 billion, in the process climbing as a share of all mortgage originations from 4.5 percent to 12.5 percent.

---

[2] The Fair Isaac & Co. scores are commonly referred to as "FICO" scores.

Chart 1
Number of Subprime Refinance Loans
Reported Under HMDA*

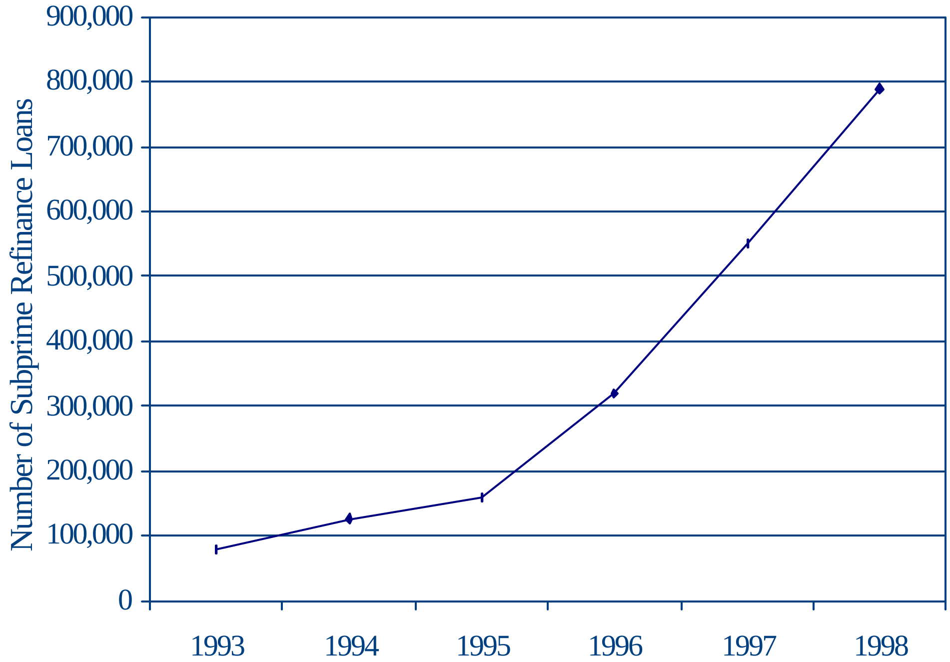
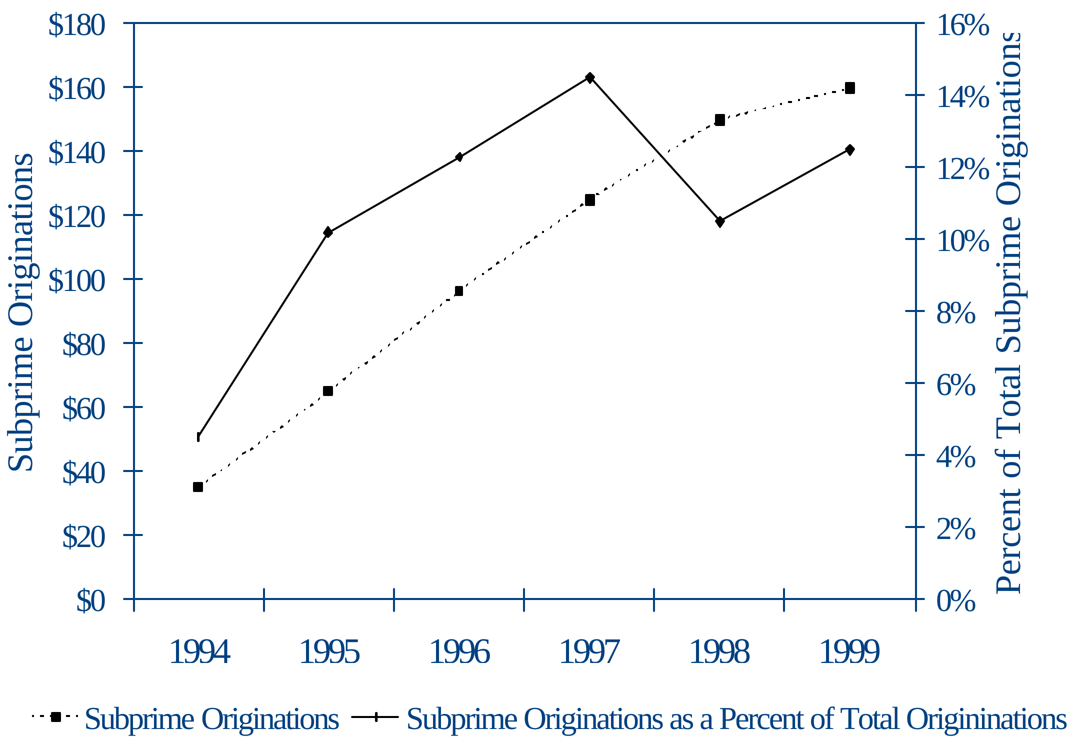


Chart 2
Subprime Mortgage Originations*

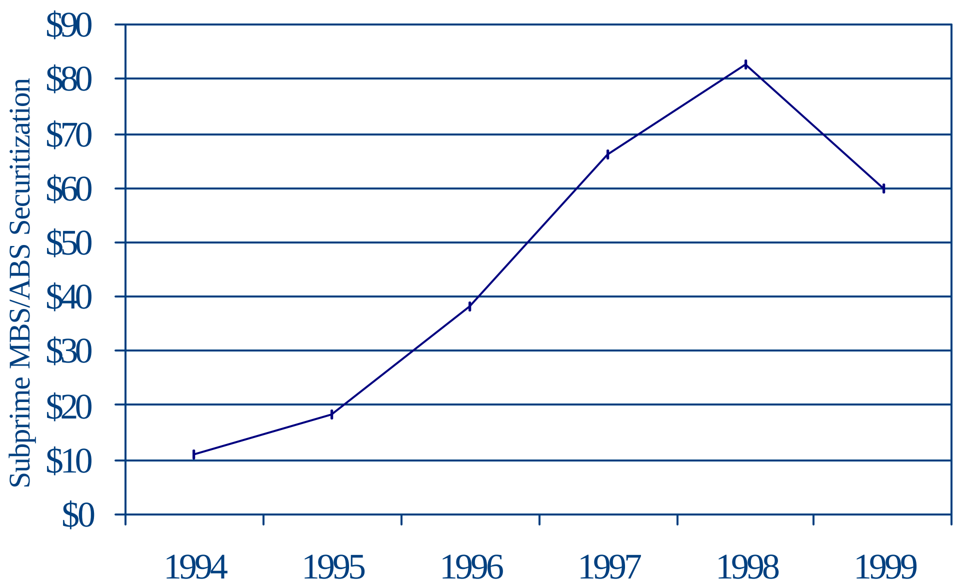


* Source: U.S. Department of Housing and Urban Development and U.S. Department of Treasury. June 2000. *Curbing Predatory Home Mortgage Lending: A Joint Report.*

Subprime loans are extended primarily by non-depository institutions, such as finance companies, that are not regulated by state or federal agencies for safety and soundness and other purposes. Depository institutions or their affiliates nonetheless have incentives under the Community Reinvestment Act, which obligates depository institutions to meet the credit needs of their local communities, to extend credit to subprime borrowers, who tend to be the LMI borrowers and residents of LMI areas whom the CRA was designed to benefit. Since 1997, there has been a small, but noticeable increase of subprime mortgage lending by depository institutions or their affiliates [Belsky, et al.].[3] Furthermore, although the two major housing government-sponsored enterprises – Fannie Mae and Freddie Mac – are not currently significant participants in the subprime market, both have begun to purchase mortgages in the upper reaches of that market (A- loans, for example) [HUD/Treasury Report, at 46]. Indeed, in June 2000, Fannie Mae announced a new product, its Timely Payment Rewards Mortgage, which is eligible to A- credits and entails an interest rate that starts out 2 percentage points below the subprime rate and drops automatically if the borrower makes 2 years' of payments on time [Raines].

Chart 3 shows that subprime lending has also been facilitated by the "securitization" of such loans – the packaging of loans into securities that are bought by institutional investors and, to some extent, by individuals.

Chart 3
Subprime MBS/ABS Securitization, 1994-1999



* Source: U.S. Department of Housing and Urban Development and U.S. Department of Treasury. June 2000. *Curbing Predatory Home Mortgage Lending: A Joint Report.*

[3] The Final CRA Report by Treasury indicates that the proportion of mortgage loans extended by CRA-covered institutions to prime borrowers fell from 99 percent in 1997 to 93 percent in 1999 [Belsky, et al].

The volume of securitized subprime loans jumped by more than seven-fold between 1994 and 1998, before falling back a bit in 1999. By enlarging the pool of potential investors in subprime loans, securitization has helped lower interest rates in this market just as it has in the market for conventional prime mortgage loans.

II. Abuses in the Subprime Market

The benefit of the subprime market is that it has widened access to credit for many who previously could not qualify for it. However, according to recent reports, certain subprime lenders have taken advantage of some borrowers, inducing them to agree to mortgages with onerous terms that the borrowers cannot realistically meet. When the borrowers do default, they lose the equity in their homes to the lenders. Moreover, since the abusive practices appear to be targeted at the elderly and residents of minority and low-income communities, a pattern of defaults can destroy property values and lead to increased crime in affected areas [HUD/Treasury Report, at 24-25].

These "predatory lending" practices are easier to condemn than to define, however. As the joint HUD/Treasury report noted in its analysis [at 17]:

"Defining the practices that make a loan predatory, however, is a problematic task. Any list of predatory practices is destined to be incomplete because bad actors are constantly developing new abusive practices, sometimes to evade government regulation. Furthermore, a list does not consider the context in which the alleged abuse has occurred. Some practices may be considered abusive in the context of high-cost subprime loans; other practices may be deemed unacceptable in all contexts; and others – while not necessarily abusive for all high cost borrowers – are abusive in the borrower's situation or because the borrower was misled or deceived."

The joint report nonetheless identifies four specific practices that seem to be characteristic of predatory lending:

- Loan flipping, or the repeated refinancing of loans in a short period of time in order for the lender to earn high fees (loan flipping is often accomplished through large balloon payments required over short maturities);

- Excessive fees, including large up-front charges and prepayment penalties, which are not related to the risks posed by the borrowers;

- The extension of unaffordable loans based on the assets, and not the income, of the borrower, a practice that frequently leads to default and foreclosure;

- Outright fraud or deception designed to conceal the true, onerous nature of the loan contract, typically from unsuspecting or unsophisticated borrowers.

In short, predatory loans are those that would not have been made in more competitive markets and where borrowers are more fully informed about the credit alternatives available to them. Put differently, borrowers are more likely to be victims of one or more of the practices just listed in geographic areas where there may be relatively few lenders and where the borrowers themselves are not financially sophisticated and thus relatively easy prey for unscrupulous lenders.

It turns out, however, that most of the practices that are identified with predatory lending are already illegal under federal law. In addition, although there is anecdotal evidence that these practices have occurred, there is no evidence indicating how frequent they are and how effectively enforcement of existing laws is addressing any problem.

A. Current Laws Governing Predatory Lending Practices

It is easy to overlook the fact that most, if not all, of the practices associated with predatory lending *already are against federal law or are being addressed by the Federal Reserve.*

The broadest federal response is reflected in the Home Ownership and Equity Protection Act (HOEPA), enacted by Congress as part of the Riegle Community Development and Regulatory Improvement Act of 1994. Beyond the disclosure requirements embodied in HOEPA that are discussed below, the Act also prohibits certain terms in mortgage loans covered by the Act: those carrying an annual percentage rate (APR) of more than 10 percentage points above the yield of Treasury securities of comparable maturity or points and fees exceeding 8 percent of the loan amount or $400, adjusted for inflation since 1994.[4] In addition, covered loans may not: (1) contain certain onerous prepayment penalties;[5] (2) charge an interest rate after default that is higher than the rate prior to the default; and (3) in most cases, require a balloon payment on a loan with a maturity less than five years. Furthermore, a lender may not engage in a pattern of extending loans covered by HOEPA ("HOEPA loans") that do not take account of the borrower's ability to pay (income); and where a home improvement contract is involved, the creditor may not pay the contractor directly.

HOEPA also gives the Federal Reserve Board broad regulatory authority to prohibit additional practices it finds to be unfair or deceptive, not just for HOEPA loans but all consumer mortgage loans. In late 2000, the Fed outlined a series of major regulatory proposals pursuant to its HOEPA authority. The proposals would ban loan flipping within the first twelve months of a HOEPA loan (unless refinancing is in the borrowers' interest); prohibit lenders from replacing a zero or low cost loan with another higher cost loan (unless the refinancing is in the borrowers' interest); strengthen the existing prohibition on loans based on homeowners' equity (rather than income) by establishing a rebuttable presumption against the creditor if it doesn't document and verify the borrowers' income; and prohibit lenders from including "payable on demand" or "call provisions" in HOEPA loans.

In short, apart from outright fraud or misrepresentation – which already is punishable by state law – *federal law either addresses or proposes to address each of the elements of*

---

[4] The current dollar threshold is about $465. As discussed below, the Federal Reserve Board may adjust the APR threshold up or down by 2 percentage points.

[5] A prepayment penalty may be imposed only if the borrowers' total monthly debt payments are less than 50 percent of his or her income; the prepayment is not made with funds borrowed through a loan made by the same creditor or its affiliates; the penalty does not apply more than five years after the mortgage was taken out; the prepayment amount at closing does not exceed two periodic payments; and the penalty is not prohibited by any other law.

predatory lending listed above and cited by the joint HUD/Treasury Report and other critics of predatory lending practices. A key challenge, therefore, as the joint HUD/Treasury Report recognizes [at 113], is for the Administration and the Congress to provide the federal agencies with responsibility for enforcing HOEPA and other related mortgage laws – the Federal Reserve Board, the Departments of Justice and Housing and Urban Development, and the Federal Trade Commission – with sufficient resources to carry out their mandates. In this regard, it is noteworthy that the FTC in particular has worked with the Justice Department to bring and successfully settle a number of cases in the past two years alone against various unscrupulous lenders for violating HOEPA and the Equal Credit Opportunity Act (ECOA), which bans discrimination against applicants for credit on the basis of their age, race, sex or other prohibited factors [Medine].

B. Disclosure and Reporting Requirements Designed To Expose Predatory Lending

Federal law not only prohibits certain practices associated with predatory lending, but also contains numerous disclosure and reporting requirements relating to mortgage loans generally and to subprime HOEPA loans in particular.

The disclosure requirements are designed to make consumers aware of the true cost of credit so that they can better comparison shop among alternative providers of credit. The Truth in Lending Act (TILA), for example, requires all lenders of closed-end credit, including mortgage loans, to disclose, among other things: the annual percentage rate (APR) charged on the loan, the amount of the loan itself, and the total of all payments required. TILA, which is administered by the Federal Reserve Board under its Regulation Z, also gives borrowers a right to rescind certain mortgages, generally within three days of closing, and authorizes individuals to recover actual or statutory damages. The Real Estate Settlement Procedures Act (RESPA) supplements the TILA disclosures with a requirement that lenders of "federally-related" mortgage loans disclose settlement costs when borrowers are applying for a loan and again at the time of closing. RESPA also prohibits kickbacks and referral fees.

Federal law also requires mortgage lenders to provide information about their loans to the federal government, which enable it and the press to shine a spotlight on potentially onerous lending. Notably, HOEPA requires mortgage lenders to disclose information about their loans if they have an APR greater than 10 percentage points above the Treasury rate for loans of comparable maturity, or the points and fees paid by the borrower exceed 8 percent of the loan amount, or $400 (adjusted annually since 1994 for inflation). HOEPA gives the Federal Reserve Board, which is charged with collecting the data, the authority to vary the APR reporting trigger 2 percentage points either way. In late 2000, the Fed proposed lowering the HOEPA reporting trigger by the maximum amount, to 8 percent, as well as mandating that lenders alert consumers in advance of loan closing that the amount they borrow may be substantially higher than requested (due to the financing of insurance, points, and fees).

One criticism of the HOEPA reporting requirements is that the "APR trigger" is too high. As the HUD/Treasury report indicates (at 85-86), very few subprime loans at least as of late 1999 – less than 1 percent – exceeded the statutory reporting requirement, loans with an APR in excess of 10 percentage points above the comparable Treasury rate. Based on the same data, this percentage would go up substantially, to roughly 5 percent, under the 8 percentage point trigger proposed by the Fed.

Those urging that the reporting threshold be lowered still further should recognize that the Federal Reserve already, as a practical matter, has addressed this issue with its recent proposal unveiled in November 2000 to amend its Regulation C, issued pursuant to The Home Mortgage Disclosure Act (HMDA). Among other things, this proposal would require an expanded group of mortgage lenders (both depository institutions and covered non-depositories) to report the APR on *all* their mortgage loans and whether the loans are covered by HOEPA. [6] With this information, the Board will be able to identify and report the distribution of mortgage loans by interest rate, so that policymakers, citizens and advocacy groups will have a clearer idea of how many high-cost mortgage loans are being made. The enforcement agencies should also be able to use this information to better target their investigation efforts against those lenders with a consistent practice of making very high cost loans (and thus where predatory lending may exist).

C. Subprime Lending is *Not* the Same as Predatory Lending

Recent reports on predatory lending have documented that subprime lending is concentrated among minority and low-income borrowers [HUD/Treasury Report, at 46-47; ACORN; U.S. Department of Housing and Urban Development]. Because the practices said to constitute predatory lending are concentrated among subprime lenders, a strong inference of these reports is that minority and low-income borrowers are disproportionately the victims of unscrupulous lending practices.

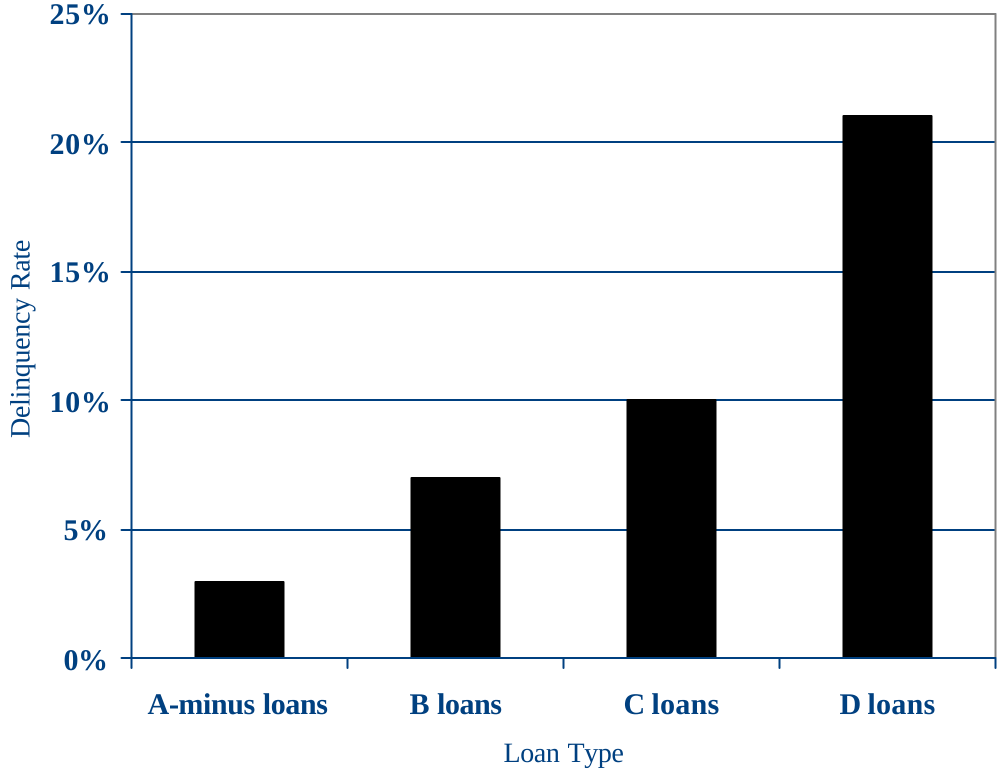
While this inference may be true, it is also important for policymakers and citizens *not to equate subprime or high cost lending with predatory lending*. The same joint HUD/Treasury study that highlighted the abuses among some subprime lenders also documented that, as a class, subprime mortgages *are more risky* than prime loans or mortgages insured by the Federal Housing Administration (FHA) – which is the reason they are subprime. In 1998 and 1999, for example, subprime mortgages were 5 times more likely to be delinquent (loan payments past due) than prime mortgages (13.5 percent versus 2.8 percent) [HUD and Treasury, 2000, pp 34-35]. Similarly, Chart 4 shows that the "serious" delinquency rate (loans past due 90 days where foreclosure proceedings have started) rises significantly as credit scores decline, underscoring a central feature of the subprime lending market: *that interest rates reflect the risks posed by borrowers with different financial characteristics.*

In fact, federal banking regulators have warned banks about the risks inherent in subprime lending. In an interagency guidance released in March 1999, the four federal regulators -- the Federal Reserve, the FDIC, the Office of the Comptroller of the Currency and the Office of Thrift Supervision -- noted that "due to their *higher risk*, subprime loans command higher interest rates and loan fees than those offered to standard risk borrowers. These loans can be profitable, *provided the price charged by the lender is sufficient to cover*

---

[6] Under current Board regulations, a non-depository lender is covered by the HMDA reporting requirements if its home purchase originations (including refinancings) equaled or exceeded 10 percent of its total loan volume. The proposed rule retains the 10 percent test but adds an alternative test: if the total annual volume of mortgage lending exceeds $50 million. Since the average dollar amount of a mortgage loan reported under HMDA is about $120,000, this dollar threshold applies to institutions that originate between 400 and 500 loans per year.

Chart 4
Serious Delinquency Rate for Subprime Borrowers,
Third Quarter 1999



* Source: U.S. Department of Housing and Urban Development and U.S. Department of Treasury. June 2000. *Curbing Predatory Home Mortgage Lending: A Joint Report.*

higher loan loss rates and overhead costs related to underwriting, servicing and collecting the loans." (emphasis added) [Board of Governors of the Federal Reserve System, et al.]. On January 31, 2001, the federal banking agencies officially recognized this fact by imposing significantly higher capital requirements on depositories that have above-average concentrations of subprime loans, or those with qualifying subprime loans collectively greater than 25 percent of the institution's Tier I capital (essentially shareholders' equity). These institutions must hold capital that is 1.5 to 3 times higher than the amount typically required for prime loans [Blackwell, 2001].[7]

[7] According to the new regulatory guidelines, a subprime loan is one which a borrower has a FICO score of 660 or below; at least two 30-day delinquencies in the past year; a debt service-to-income ratio of 50 percent or more; a declaration of bankruptcy within the past five years; or a foreclosure, repossession, or chargeoff in the preceding 24 months.

III. Recent Local and State Initiatives Aimed At Preventing Predatory Lending

Notwithstanding the panoply of federal laws that already deal with predatory lending, a number of local and state governments have adopted ordinances and statutes aimed at the problem. Although these interventions have many common elements, they differ in key respects, which not only complicates the legal landscape for national lenders, but increases uncertainty in the market, to the potential detriment of the *very population of minority and low income individuals* these local and state laws are designed to protect. This danger is especially worrisome given the evidence indicating the positive effects that federal antidiscrimination laws and the Community Reinvestment Act have had on lending to minorities and low income households and neighborhoods [Litan, et al, 2000; Belsky et al, 2001].

Generally speaking, the state and local provisions apply or propose to apply stiff penalties – fines, imprisonment, and prohibition of city or state business with the offending institution – for either "high cost" or "predatory loans", which are defined by a combination of some numerical threshold (based on APR and points/fees) plus at least one specifically identified practice. Table 1 summarizes the thresholds and the penalties in some of the currently enacted and proposed statutes. Table 2 provides a list of offending practices, which most (but not all) of the laws and proposals identify. As illustrated by the asterisks in Table 2, virtually all of the practices punishable (now or potentially) at the state and local level are already prohibited under federal law.

What is the harm in having state and local governments add their own enforcement efforts to those of the federal government? Aren't these lower levels of government supposed to be "laboratories of democracy", where different and potentially innovative practices can be tried out, so that perhaps federal policymakers can learn from best practice and then copy?

In many areas of policy, these arguments for devolution are quite valid, especially where the problems being addressed vary in nature across the country. But in other areas of social policy – social insurance, broad areas of regulatory policy, energy and transportation policy, among others – federal policy predominates, and often appropriately so. Market failures that are common across the country may deserve a uniform response. Varying state and local responses can also drive up costs of addressing social problems where they interfere with the functioning of national markets.

There are several reasons why an exclusive federal response is appropriate for dealing with predatory lending. First, as is highlighted in Table 2, virtually all of the lending practices that the states and localities have condemned or would condemn, already are punishable by federal law. The "laboratory" argument, therefore, does not apply in the case of predatory lending. The "experiment" has been run at the federal level and federal laws have been passed and agencies have been charged with their enforcement.

Table 1

Key Features of State/Local Ordinances on Predatory Lending

Location	APR and Point/Fee Trigger	Penalty
Ordinances Enacted:		
Chicago	APR >6% above Treasury for first mortgages; APR >8% over Treasury for second mortgages; or Points/fees >5% of loan if $16,000 or greater; or $800 otherwise	No business with the city
North Carolina	Points/fees >5% of loan if less than $20,000; otherwise >8% of loan amount or $1000 (whichever is lower)	
Ordinances Proposed:		
Baltimore	APR >6.5% over Treasury; or Points/fees >4% of loan; or $800 (if loan < $20,000)	Fine/imprisonment No city deposits/investments with offending institution
Philadelphia	APR >6.5% over Treasury for first mortgages; APR >8% over Treasury for second mortgages; Points/fees >4% of loan or $800	Loss of business license and any city business
Oakland	APR >8% above Treasury; or points/fees >6% of loan amount	No business with offending institution
Washington, D.C.[8]	APR substantially greater than that justified using borrowers' credit score and underwriting criteria of the federal housing GSEs or other agencies; or points/fees >2% of the loan, or $400	Damages; reformation of the loan; punitive damages; other penalties

[8] At this writing, the D.C. Council had passed and the Mayor had signed an ordinance addressing predatory lending, but the Congress had not yet voted on the measure (as it is required to do for laws enacted governing the District of Columbia).

Table 2

State and City Predatory Lending Offenses, Proposed or Enacted
(* Denotes Practice is Addressed or Proposed to be Addressed Under Federal Law)

* Unfair and deceptive practices

* Prepayment penalties above some threshold

* Balloon payments at less than certain maturities
Baltimore: 15 years
New York: 7 years
Oakland: 7 years
Washington, D.C.: 7 years, 3 months

* Loan flipping

Single premium credit life insurance (already unlawful if not disclosed to the borrower*)

* Loans to borrowers without regard to capacity to repay (typically, statutes presume a borrower's ability to pay if his or her total debt repayments are less than 50% of monthly income)

* Loans with proceeds going directly to home contractors

Even so, not much is known about the true extent of remaining predatory practices, beyond the anecdotes that have been provided in testimony that have served as the basis for various reports. The federal disclosure rules, both under HMDA and HOEPA, should change that. If it eventually emerges that the predatory lending problem is more extensive or is of a different nature than currently envisioned, then history demonstrates that a federal response – either from regulators acting under existing law or from Congress – will be forthcoming.

Second, various state and local ordinances in the meantime can chill legitimate subprime lenders from channeling credit to the borrowers in that market, which as the critics of predatory lending have noted, are disproportionately minorities or low income households. This is especially the case where the triggers defining predatory lending are vague and the penalties for engaging in the practice – however state and local officials may define it – are severe. A good example is the Washington, D.C. ordinance, whose proposed trigger is an APR that is higher than one justified by the borrower's credit score, using the underwriting criteria of the federal housing GSEs (Fannie Mae or Freddie Mac) or other federal agencies. Such a verbal test, by definition, contains no bright lines, and therefore can easily discourage perfectly legitimate lending, especially given the harsh penalties lenders would face for violation – actual and punitive damages, and fines.

Third, even bright line tests can have the same chilling effect – discouraging perfectly lawful lending. A staff memorandum prepared for the Federal Reserve's Board of Governors, for example, noted in connection with the Board's recently proposed lowering of the HOEPA reporting trigger that while covering even more loans under the Act would extend the Act's protections, "greater coverage could have a chilling effect and raise regulatory costs in a segment of the subprime mortgage market. This might deter interest of some predatory lenders in the market. *It seems unlikely this effect would be restricted to predatory lenders alone, however, and it could cause some potential legitimate competitors to forego entry into this market where competition currently is alleged to be low.*" (emphasis added) [Durkin and Canner, at 3-4]. In fact, one major subprime lender – Countrywide Credit – withdrew from the North Carolina market in January, citing the state's law against predatory lending [Bergquist]. Another major lender – EquiCredit, a subsidiary of Bank of America that is the largest bank-owned subprime lender in the United States – told the Federal Reserve during the summer of 2000 that the North Carolina statute would reduce its lending volume by roughly 30 percent in the state and predicted that the Chicago ordinance could cause as much as a 60 percent drop in its lending in that city [Eggers, 2000].

There is a danger that other ordinances – especially those with lower numerical thresholds than those proposed by the Federal Reserve for reporting under HOEPA – could also ration out creditworthy borrowers, especially those to whom federal law (through the Community Reinvestment Act) now encourages depository lenders to serve. After all, usury laws used to be widespread in this country until policymakers realized that limits on lending interest rates had the effect of rationing credit. With securitization of subprime lending having become a national market, subprime lenders have thus far been able to expand the supply of credit to those borrowers by developing uniform products that apply equally to borrowers wherever they live. A balkanization of laws affecting the subprime market – with differing standards on the fringes of that market, predatory loans – threatens that uniformity and should make it more expensive for national lenders to extend credit in a perfectly legitimate way to subprime borrowers.

Finally, there is an implicit assumption running through some of the local ordinances that high cost lending, by itself, is somehow predatory. As already shown, subprime loans carry interest rates that are higher than those that are charged prime borrowers because subprime borrowers are riskier. This is not only recognized in the marketplace, but federal regulators have cautioned banks about such risks in subprime lending and required depository lenders with high concentrations of such loans to maintain higher capital than other banks, precisely because of the risks involved. It is therefore a mistake for policymakers to equate high cost lending with predatory lending.

Fortunately, not all localities that have considered or are considering predatory lending ordinances are doing so in ways that threaten the availability of subprime credit. A resolution in Cleveland, for example, while reflecting similar sentiments against predatory lending as have been expressed in other existing or proposed ordinances, departs from the emerging pattern by urging more education of consumers about predatory lending practices and more cooperation between local officials and community based organizations to accomplish that objective. Such an approach complements existing efforts at the federal level.

IV. Recommendations and Conclusion

There is already ample federal legislation on the books aimed at exposing and curbing predatory lending. The great danger now is that further measures, before the dimensions of any remaining problems are known and however well intentioned such additional steps may be, could nonetheless impede the normal flows of credit to the very borrowers who are claimed to be most vulnerable to predatory practices. In particular, the proliferation of different state and local lending rules threatens to balkanize the lending market and make it very costly, and potentially impossible, for lenders to offer nationally uniform mortgage loan contracts. If lenders are unable to do so, their costs will be higher and those costs are certain to be passed on to the consuming public, especially underserved borrowers.

Under these conditions, the prudent course is for governments at all levels to refrain from adopting additional legislation until the data the Federal Reserve collects under HMDA and HOEPA can be fully analyzed. This will permit an assessment of both the prevalence of high-cost lending and the effectiveness of existing enforcement efforts against predatory lending. A cautious approach to predatory lending does not counsel inaction, however. Congress and the states should appropriate sufficient funds to ensure that the agencies charged with enforcing existing statutes designed to stop specific predatory lending practices have the financial means to do so. The same is true for counseling efforts to continue educating consumers about their credit alternatives and the dangers of entering into mortgage loans that have terms characteristic of predatory loans.

The market for subprime loans is also about to become significantly more competitive because the leading credit scorer, Fair Isaac, has announced plans to make available individuals' scores over the Internet, together with interpretations of their meaning, beginning in March 2001 [Kingson]. The disclosure of credit scores will help level the playing field when borrowers apply for mortgage credit. In the process, it should go a long way, if not all the way, toward eliminating the practice of lenders failing to channel qualified borrowers into the prime market. Furthermore, armed with their credit scores, borrowers will be better able to comparison shop before they sign any mortgage.

In sum, federal law is now about to be reinforced by market forces to help curb predatory lending practices. Moreover, federal policymakers have put in place a data reporting and collection system that will shed light on the workings of the mortgage market. It is vital that policymakers, therefore, not rush to judgment and enact "laws of unintended consequences" that will harm the very group of people they are most trying to help.

Sources

ACORN, *Separate and Unequal: Predatory Lending in America*, October 2000.

Belsky, Eric S., et al., *The Community Reinvestment Act After Financial Modernization: A Final Report* (U.S. Department of the Treasury, January 2001).

Bergquist, Erick, "Industry Hits Back On Lending Abuse Laws," *American Banker*, January 26, 2001, pp. 1, 9.

Blackwell, Rob, "Regulators Define What They Mean By Suprime," *American Banker,* February 1, 2001, pp. 1,5.

Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Office of Thrift Supervision, *Interagency Guidance on Subprime Lending*, March 1999.

Durkin, Thomas A. and Glenn B. Canner, Memorandum to the Board of Governors, Federal Reserve System, Regulatory Analysis of Proposed Revisions to Regulation Z Concerning Predatory Lending Practices, December 6, 2000.

Egger, Helen, Testimony on behalf of Equicredit Corporation before the Federal Reserve Board, July 27, 2000 [www.federalreserve.gov/Events/PublicHearings/20000727.htm].

Gramlich, Edward M., Remarks at the Federal Reserve Bank of Philadelphia Conference on Predatory Lending, December 6, 2000.

Kingson, Jennifer A., "Fair Isaac Credit Scores: Seller Beware", *American Banker*, January 31, 2001, pp. 1, 13.

Lim, Paul J., "Credit Scoring: Secrets Are Soon Revealed," *US News and World Report*, February 5, 2001, pp. 54-56.

Litan, Robert E., Nicholas Retsinas, Eric Belsky, Susan White Haag, *The Community Reinvestment Act After Financial Modernization: A Baseline Report* (U.S. Department of the Treasury, April 2000).

Medine, David, Testimony before the House Committee on Banking and Financial Services, May 24, 2000.

Raines, Franklin D., Remarks Delivered at a CitiMortgage/Fannie Mae Announcement, June 22, 2000 [www.fanniemae.com/news/speeches/speech_128.html].

U.S. Department of Housing and Urban Development and U.S. Department of the Treasury, *Curbing Predatory Home Mortgage Lending: A Joint Report*, June 2000 [HUD/ Treasury Report].

U.S. Department of Housing and Urban Development, *Unequal Burden: Income and Racial Disparities in Subprime Lending in America*, 2000.