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North Carolina's Anti-Predatory Lending Law: Still A Problem Despite New Study

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Executive Summary

A recent, widely cited study of North Carolina's anti-predatory lending law conducted by three analysts at the University of North Carolina purports to show that the law has been effective in curbing undesirable lending abuses while having essentially no negative side-effects on the volume of legitimate subprime lending to borrowers unable to qualify for prime credit. These findings are in stark contrast to the findings of earlier studies. This essay suggests one reason for the discrepancy: The UNC study relies on a database that does not contain the information properly required to address these issues, namely data on mortgage originations. The database instead contains information on the volume of loans that have been securitized, which for reasons argued here, are not likely to represent accurately the trends in mortgage originations. For this and other reasons discussed below, until a thorough analysis of mortgage originations demonstrates otherwise, policy makers throughout the country should remain concerned about the unwanted side-effects of laudably intended state legislation aimed at stamping out predatory lending.

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Introduction

In 1999, the state of North Carolina was one of the first states in the country to enact supplemental legislation – beyond that already provided under federal law – aimed at curbing predatory lending, or lending characterized by several abusive practices that tend to harm low-income, often minority and aged, unsophisticated borrowers.[1] The law was implemented over a two-year period and imposed various restrictions or prohibitions on "high-cost mortgages," as defined by the statute, which were not mandated by federal law.

In June 2003, three analysts from the University of North Carolina – Robert Quercia, Michael Stegman, and Walter Davis – released a study (the "UNC Study") of the North Carolina law that, among other things, concluded that while overall subprime originations in North Carolina fell by 17 percent in the aftermath of the law, the volume of mortgage loans extended to the riskiest category of subprime borrowers actually *increased* (by 31 percent), in line with the experiences of neighboring states that did not have their own anti-predatory lending statutes.[2] This study was the first to conclude that mortgage loans with abusive terms had declined, but its conclusion that subprime lending to the highest risk borrowers was not impaired – and indeed even increased – directly conflicted with other notable studies that had concluded just the opposite, namely that subprime credit

[1] There is no well accepted definition of predatory lending. I have previously defined the term to cover effectively fraudulent lending aimed at encouraging borrowers to take out mortgages on onerous terms that they cannot realistically meet. Others have identified various specific practices associated with predatory lending, such as "loan flipping," loans with excessive fees, loans extended on the basis of the assets but not the income of borrowers, and various forms of fraud [HUD/Treasury, 2000; Engel and McCoy, 2001].
[2] Quercia et al.

generally had dropped in the wake of the North Carolina statute [Elliehausen and Staten; Harvey and Nigro].

It is not surprising, therefore, that the UNC Study has attracted significant attention in the media: from the time of its publication until late August, 2003, the study had been mentioned in over 300 press stories in a Nexis search. Supporters of anti-predatory lending state statutes are pointing to the study as evidence that states can enact tougher restrictions than are imposed at the federal level without unintentionally impairing the availability of credit to subprime borrowers generally. Relatedly, on the surface, the UNC Study would also seem to support critiques of the recent proposal by the Comptroller of the Currency to preempt certain features of the anti-predatory lending law enacted in Georgia.[3]

This essay examines the basis of the UNC Study and compares it with the earlier studies cited. While the objective of the UNC Study – to determine the impact of the North Carolina law on mortgage *originations* – is certainly worthwhile and the data that underlie the study are the most recent that are available, the entire analysis rests on a database of mortgage *securitizations* (the volume of mortgages pooled together to back issues of mortgage securities), not originations. This would be appropriate if the volumes and behavior of subprime mortgages originated and securitized were roughly identical, but that is not the case during the time period of the UNC Study. For this and other reasons, this essay argues that the findings of the UNC study are not well substantiated and should not serve as the basis for reaching policy conclusions.

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[3] Statement of the Comptroller of the Currency John D. Hawke, Jr. regarding National City Preemption Determination and Order, July 31, 2003.

The North Carolina Law: Brief Background

The North Carolina Anti-Predatory Lending Law, enacted in 1999, was implemented in two phases, in the fourth quarter of 1999 and July 2000.[4] It contained five key features:

First, the law banned prepayment penalties on loans up to $150,000.

Second, for "high cost" loans – those with fees in excess of 5% of the principal amount and interest more than 8 percentage points above the comparable rate on U.S. Treasury securities – lenders could not include fees in the principal of the mortgage, require balloon payments, allow negative amortization, or lend to such borrowers without regard to their ability to repay the loan (taking into account instead only the assessed value of the home). The statute's lending restrictions are somewhat tighter than those mandated under the Home Ownership and Equity Protection Act of 1994 (HOEPA).

Third, as under federal law, the North Carolina statute prohibits consumer home loan refinancings if they fail to provide a "reasonable, tangible net benefit" to the borrower (the "no flipping" provision).

Fourth, the statute prohibits the financing of single premium credit life insurance (which is more restrictive than federal law).

Finally, the North Carolina law requires would-be borrowers of high-cost loans to receive financial counseling before signing such mortgages.

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[4] N. C. Session Law 1999-332, Section 5.

Prior Studies Of The North Carolina Law

As the North Carolina statute was the first state law that went beyond the federal requirements – there are others, but they are more recent – it has attracted the most study.[5] The UNC study authors identified four prior studies of the impact of the law on subprime mortgage lending generally, and thus whether or not it had unintended consequences (good or bad).

One of the studies, by Morgan Stanley (2002), found that the law had no effect on subprime residential lending volumes, but reached this conclusion by surveying subprime branch managers rather than looking to actual lending data. The other three studies examined different databases – since there is no single, comprehensive database for subprime lending by state – and all reached the conclusion that, to at least some degree, subprime lending volumes in North Carolina did drop unusually, compared to similar lending in neighboring states, after the law was enacted.

In particular, Elliehuasen and Staten (2002 and 2003) used subprime mortgage origination data supplied by nine subprime lenders belonging to the American Financial Services Association (AFSA), who accounted for a substantial volume of such lending in the three states examined: North Carolina, South Carolina and Virginia. Employing standard statistical techniques, these analysts found that overall subprime mortgage originations and those made especially to low-income borrowers in North Carolina had declined after the law, relative to borrowers in other two states. Specifically, the authors concluded that the North Carolina statute caused the overall volume of subprime loans to

[5] For one listing of other state laws, as of early 2003, see my earlier piece on this subject, released in February 2003.

drop by 14 percent.[6] A key drawback of the Elliehausen-Staten studies, however, is that they are based on data running only through mid-2000 and thus could not capture the long run impact of the North Carolina law.

A second study, by Ernst, Farris and Stein (2002), also suffered from the same data shortcoming, being based on mortgage originations in 1999 and 2000 only, as compiled by data filed under the Home Mortgage Disclosure Act (HMDA). One important advantage of the HMDA dataset, however, is that it includes all mortgage lenders and thus is more representative of what is happening in the marketplace than the database used by Elliehausen and Staten. Yet the Ernst, Farris and Stein study, too, found that North Carolina subprime originations declined relative to the experience in the rest of the nation, and that this decline occurred across borrowers of all income classes. At the same time, this study calculated that North Carolina borrowers saved $100 million over the study period, as a consequence of the law.

The third study, by Harvey and Nigro (2002), also used HMDA data, but over a longer, three-year period, 1998-2000. This study also found that subprime lending volumes declined in North Carolina relative to four neighboring states (Georgia, Tennessee, South Carolina and Virginia), but that the drop was due to a decline in subprime loan applications, not in a change in denial rates.[7]

Despite the various shortcomings of each of these prior analyses of the North Carolina statute, their main conclusion – that subprime lending generally had suffered in its

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[6] The studies found that originations of lower-risk subprime loans actually increased after the North Carolina law was implemented.

[7] Harvey and Nigro also used HMDA data to study the impact of anti-predatory lending ordinances enacted by the cities of Chicago and Philadelphia. The authors found that while these laws probably reduced or eliminated some predatory practices, they also were associated with a significant drop in the volume of subprime lending generally. Keith Harvey and Peter J. Nigro, "How do Predatory Lending Laws Influence Mortgage Lending in Urban Areas? A Tale of Two Cities," unpublished manuscript, March 2002.

wake – seems consistent with economic theory and what one would have expected from the law *ex ante*. That is, however much the law may have reduced the volume of subprime loans that contained the abusive features the statute targeted (a subject taken up shortly), there were also unintended consequences for subprime borrowers generally. That is because one or more of the following effects probably were in evidence: a reluctance by lenders to run the risks and/or costs of extending subprime credit in states with anti-predatory lending curbs, or an inability by subprime lenders to sell the loans originated in such states to buyers in the secondary market (OCC, 2003).

The UNC Study: A Critique

The UNC authors had two major objectives in their study of the North Carolina statute. One goal was to examine the impact of the law on subprime lending generally, as did the other studies just reviewed. But a second goal was to assess the law's impact specifically on those subprime loans with the abusive characteristics that the law was designed to eliminate or at least curtail (such as high prepayment penalties; balloon payments required over relatively short maturities; and loans with high combined loan-to-value ratios, as proxies for loans that do not reasonably offer net tangible benefits to borrowers). To accomplish these objectives, the authors used a database supplied by Loan Performance, Inc. that contained 640,000 securitized subprime loans extended in North Carolina and neighboring states during the 1998-2002 (third quarter) period. The authors noted that the LP database was more than twice as large as the one used in the Elliehausen and Staten papers, which contained 300,000 mortgages originated by nine subprime lenders.

The UNC study reported a number of significant findings, but for the purpose of this essay, I focus on just two:

> Although total subprime loans in North Carolina fell by 17 percent after passage of the law (far more than the 2.8 percent drop nationally), loans to the highest risk borrowers in the state (defined in the study as borrowers with " Fair Isaac" or FICO scores below 580) rose by 31 percent.[8] The increase in loans to these high risk borrowers was similar to the rise in neighboring states. The authors conclude from this that the North Carolina statute did not have unintended negative impacts on subprime lending to high risk borrowers, a result directly in conflict with the thrust of the earlier studies.
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> A second conclusion is that subprime refinance originations with at least one "abusive" characteristic that was targeted by the North Carolina law dropped substantially after the statute was enacted. For example, the study reports that refinance loans with prepayment penalty terms of three years or greater declined by 72 percent. By comparison, such loans increased in volume in neighboring states and in the nation as a whole.

In short, the UNC study appears to document that the North Carolina has worked precisely as intended – causing a major drop in undesirable predatory lending – while having essentially no negative side-effects.

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[8] FICO scores have become the benchmark by which the credit quality of borrowers is assessed by banks and other lenders.

In the view of this author, however, it is premature to reach this sanguine conclusion for one major reason: the database used by the UNC authors consists only of mortgages that were *securitized*; it does not purport, nor can it be legitimately interpreted, to be a database of mortgage *originations*. This is a critical distinction, since the aim of the North Carolina statute was to halt undesirable mortgage originations. If the patterns of securitizations and originations of subprime loans were roughly similar during the period analyzed by the UNC study, then the use of a securitization database could be defended. But this was not the case: According to other sources, securitizations rose at a far faster pace during this period than originations. Notably, between 1999 and 2002, whereas the volume of subprime originations nationwide increased by 33 percent (from $160 billion to $213 billion), the volume of securitized subprime loans increased almost four times more rapidly, 121 percent (rising from $60 billion to $133 billion).[9] As a result, there is no way to draw legitimate inferences from sub-prime loan securitizations about the pattern of subprime mortgage originations. This is the case not only for subprime loans in general, but also for subprime loans with the abusive characteristics targeted by the North Carolina statute.

The UNC authors' use of the LP securitized loan database can be further criticized on at least two other counts. One is that during the period covered by the study, there was a significant drop in the numbers of loans with missing FICO scores. For this reason alone, rapid growth in the volume of securitizations will overstate the growth of originations (assuming originations actually grew during any part of the period). Furthermore, more than a quarter (28 percent) of the loans in the LP securitized loan database are "Alt A"

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[9] The source for the 1999 data is *Inside MBS&ABS*, August 10, 2001; for the 2002 data, it is *Inside MBS&ABS*, August 15, 2003.

loans. These loans are made to borrowers with lower risks than those typically associated with subprime borrowers and thus should not be treated as subprime loans.

If these criticisms of the UNC authors' use of the LP securitization database are so readily transparent, one may ask why the UNC authors did not use another LP database, one that specifically contained only information about originations. One presumes that the answer to this question is that this particular database did not contain sufficient detail about the terms of the loans for the authors to determine what happened to North Carolina mortgages with features they categorized as abusive after the statute was implemented. While this is a perfectly good reason for not using the LP originations database to examine this question, it remains for future researchers to use the database to address the more general issue that previous authors have examined: whether the North Carolina statute had unintended negative (or positive) consequences.

In the meantime, however, there is no basis for rejecting the conclusion drawn in earlier studies that subprime lending generally dropped in the wake of the North Carolina statute.

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