

# Unintended Consequences: The Risks Of Premature State Regulation of Predatory Lending

By

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It was once commonly joked that bankers lent money only to people who didn't need it. The notion was that bankers were so worried about risk that they would lend only to individuals (or businesses) with ideal credit records – with ample and stable incomes (or revenues) and assets for collateral.

While such an attitude may have prevailed for years following the Depression – when thousands of banks failed and their depositors lost their money (until the federal government began insuring deposits) – it certainly hasn't been true in America for some time. One reason is that banks and other lenders have learned how to lend to individuals of varying degrees of creditworthiness, and to charge them accordingly. Another reason is that many loans are now “securitized”, or sold to investors in the capital markets, who are accustomed to demanding higher interest rates on securities backed by loans that carry greater risks.

In recent years, lenders – primarily non-banking institutions, but also to some degree banks -- have used these techniques to provide credit to a large segment of the American population that previously was shut out of formal credit markets: those with limited or impaired credit histories, and especially those in under-served low-income and minority communities. Lending to these “subprime” borrowers has grown exponentially.

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As in other consumer markets, however, the subprime market has attracted some unscrupulous lenders who have preyed on the lack of sophistication of subprime borrowers. These “predatory lenders” effectively commit fraud by encouraging borrowers to take out mortgages on onerous terms that they cannot realistically meet.

Federal legislators and regulators have responded to this problem through a combination of measures: mandated disclosures by subprime lenders, enforcement of existing laws against fraud, the prohibition of certain mortgage provisions that have been deemed to be inherently onerous, and certain modest incentives for banks in particular to serve low-income and minority borrowers. By and large, the approach taken so far has been designed to target and root out those loans that are clearly predatory, while ensuring that mortgage loans remain available to subprime borrowers who want them.

The current regulatory regime, however, has not prevented some states and localities from adopting or considering rules that would further regulate the terms of high-cost mortgages. Indeed, the AARP has mounted a campaign to have all of the states adopt model legislation that would place further restrictions on the terms of all mortgage loans, including those taken out by subprime borrowers.

This report argues that it is premature, and indeed unwise, for the states to adopt AARP’s proposed model legislation, for several reasons. For one thing, given the fact that the federal regulatory regime has just been put into place, it is too soon to know whether the predatory lending problem is of sufficient magnitude that it requires new legislation rather than more intensive enforcement of existing laws and regulations. In this regard, it is noteworthy that the “evidence” of predatory lending cited in the preamble to AARP’s model legislation is now several years old.

A second, related reason for not adopting the model legislation is that, while its benefits are uncertain, its risks are apparent. As the terms of mortgage loans are ever more tightly regulated in one direction – raising the costs of extending loans to subprime borrowers – the risks increase that more than just predatory loans will be reduced: lenders will not as aggressively seek out or will just refuse to lend to many subprime borrowers on terms that properly reflect their risks and thus *are not* predatory. The hard reality is that ever more restrictive loan terms, triggered by certain interest rate and fee thresholds, act as the functional equivalent of usury ceilings that have long since been abandoned because they cut off credit to many people who need it the most. Policy makers are at risk of doing the same thing when, however well intentioned, they impose further restrictions on mortgage terms, tied to interest rate and fee levels.

Policy makers instead should put much more effort into enforcing existing laws against abusive practices already on the books, as well as exploring much less risky alternatives that *target* whatever predatory lending does exist in ways that do not have the unwanted side-effects associated with even broader regulation of credit terms. These alternatives could include a federal requirement that mortgage lenders provide borrowers with their credit scores and inform them if those scores might qualify them for prime credit (if they are otherwise not borrowing from a prime lender); stepped up educational and counseling programs for subprime borrowers; and for federal bank and thrift regulators, a decision to provide even more Community Reinvestment Act (CRA) credit than is given now for depository institutions' extensions of credit to subprime borrowers, consistent with safe and sound operation of those institutions.

### **Growth of the Subprime Mortgage Market and the Banks' Role In It**

The recent and remarkable growth of subprime mortgage lending is by now well known. Total originations in this segment of the mortgage market increased nearly five-fold from 1994 to 1999 (\$34 billion to over \$160 billion), pushing the subprime share of total mortgage originations from 5 percent to over 13 percent of this period. Much of this lending -- \$11 billion in 1994, rising to more than \$83 billion in 1999 -- was securitized by the two housing Government Sponsored Enterprises, Fannie Mae and Freddie Mac. [HUD/Treasury, 2000]. Data since then underscore the further growth of the subprime market. By 2001, subprime originations had risen to an estimated \$173 billion, while 2002 was on track to produce originations in excess of \$200 billion.<sup>2</sup>

Subprime lending has become critical to allowing large numbers of American families and individuals who formerly could not have obtained mortgage credit at all -- whether because of their age, their low incomes or because they may have suffered an unfortunate economic circumstance -- to purchase or refinance homes every year.<sup>3</sup> Federal Reserve Governor Edward Gramlich credits the subprime market with playing a significant role in the dramatic increases in conventional mortgage lending extended to Hispanic and African Americans in particular in the 1990s.<sup>4</sup>

Subprime mortgage credit is made available primarily by non-banks (notably finance companies), but banks increasingly are playing a more significant role in this segment of the mortgage market. [Belsky et al]. Table 1 lists the top lenders in the

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<sup>2</sup> Estimates are from Inside Mortgage Finance, *Inside B&C lending*, Vol.7, Issue 16, August 16, 2002.

<sup>3</sup> The Comptroller of the Currency has defined a subprime borrower as having one of the following characteristics: two or more 30-day delinquencies; one or more 60-day delinquencies in the last 24 months; a judgment, foreclosure, repossession or charge-off in the prior 24 months; a bankruptcy in the last five years; a high default probability, as measured by a credit score of 660 or below; or a debt-to-income ratio of 50% or higher. See OCC Bulletin 2001-6.

<sup>4</sup> As Gramlich notes, between 1993 and 1998 conventional mortgage lending to these two groups rose by 78 and 95 percent, respectively, compared to a nationwide increase of 40 percent. [Gramlich, 2000].

subprime market as of the first quarter of 2002. Some of these lenders are depository institutions or their affiliates.

Banks have an additional non-market based incentive to provide subprime mortgage loans, since loans to low- and moderate-income neighborhoods and individuals count heavily under current Community Reinvestment Act (CRA) examination guidelines. However, at the same time most depository institutions still avoid the subprime market, either because of low risk tolerance by bank management or because of a perceived risk to the institutions' reputations if they become known as subprime lenders. Specifically, many depositories either want to avoid being known as high cost lenders to admittedly higher risk clientele, or being subject to criticism, or even possible litigation, when denying credit altogether to riskier borrowers. [Engel and McCoy].

Another reason banks have not been more active players in the subprime market is that they are regulated for safety and soundness and subprime lending clearly is riskier than prime lending. In 1998 and 1999 – years before the recent recession -- subprime mortgages were *five times* more likely to be delinquent than prime mortgages (13.5 percent versus 2.8 percent) [HUD/Treasury, 2000, pp. 34-35]. Bank regulators have recognized this fact not only by warning banks about the risks of subprime lending, but also by requiring banks with subprime lending programs (those whose subprime loans total more than 25 percent of their total “Tier 1” capital), to back these loans with 1.5-3 times more capital than is required for bank loans.<sup>5</sup>

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<sup>5</sup> The January 2001 examiner guidance classifies a bank as having a subprime lending program as one in which subprime loans equal or exceed 25 percent of the bank's Tier One regulatory capital.

**Table 1**  
**Subprime Retail Volume Leaders**  
**(Data as of First Quarter, 2002, Dollars in Millions)**

Rank	Organization Name	Location	Retail Volume	Market Share
1	CitiFinancial	Baltimore, MD	\$3,255	21.62%
2	Household Financial Services (E)	Prospect Heights, IL	\$2,900	19.27%
3	Ameriquest Mortgage Corp. (E)	Orange, CA	\$1,850	12.29%
4	Countrywide Credit Industries (E)	Calabass, CA	\$632	4.20%
5	New Century Financial Corp.	Irvine, CA	\$410	2.73%
6	Well Fargo Home Mortgage	Des Moines, IA	\$399	2.65%
7	Chase Home Finance	Woodcliff Lake, NJ	\$388	2.58%
8	Aames Financial Corporation	Los Angeles, CA	\$375	2.49%
9	Key Consumer Real Estate (E)	Parsippany, NJ	\$350	2.33%
10	Option One Mortgage Corp.	Irvine, CA	\$235	1.56%
11	Centex Home Equity Company	Dallas, TX	\$225	1.50%
12	HomeGold Inc.	Greenville, SC	\$223	1.48%
13	Equity One	Marlton, NJ	\$210	1.39%
14	Aegis Mortgage Corporation (E)	Houston, TX	\$150	1.00%
15	Saxon Mortgage	Glen Allen, VA	\$134	0.89%
16	Washington Mutual	Seattle, WA	\$112	0.74%
17	Provident Funding Associates	Burlingame, CA	\$105	0.70%
18	Finance America Corporation	Irvine, CA	\$105	0.70%
19	E-Loan (1)	Dublin, CA	\$86	0.57%
20	Fieldstone Mortgage	Columbia, MD	\$76	0.50%

Notes: (E) Estimate. Results may vary because some firms would not disclose production breakdowns. (1) Represents Home Equity Loans

Source: National Mortgage News

The four federal banking regulators have also recognized that precisely because subprime mortgage loans are riskier than prime credits, they “command higher interest rates and loan fees than those [mortgages] offered to standard risk borrowers.” [Board of Governors of the Federal Reserve System, et al]. Moreover, because subprime mortgages typically are smaller in size than prime mortgages, they are more expensive, per dollar of lending extended, to originate and service. Nonetheless, as even the banking regulators have noted, subprime loans can be profitable “*provided the price charged by the lender is sufficient to cover higher loan loss rates and over head costs related to underwriting, servicing and collecting the loans.*” (emphasis added). [*Ibid.*]. Indeed, if it were not for risk-adjusted pricing of subprime loans, lenders would ration credit in order to limit risks to their own portfolios.<sup>6</sup>

### **Correction of Past Abuses in the Subprime Lending Market**

Because subprime borrowers tend to be less sophisticated or knowledgeable about finance than prime borrowers, they have also been easier prey for unscrupulous lenders who have engaged in what has since been called “predatory lending.” Although there is no single, well accepted definition of the term, predatory lending has been commonly understood to refer generally to loans extended on onerous terms that borrowers cannot realistically meet. Often, but not always, predatory lending is associated with deception or outright fraud.

In part because there is no single universally accepted definition of predatory lending, there is a paucity of hard, statistical data on the extent to which it has existed in

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<sup>6</sup> In a by now widely cited paper published over two decades ago, Joseph Stiglitz and Andrew Weiss demonstrated that it was rational for lenders to ration credit where they could not accurately identify the riskiest borrowers. See Stiglitz and Weiss (1981). With the development and refinement of credit scoring

the past, and most important for purposes of this report, currently. Nonetheless, there seems to be a rough consensus on the kinds of activities that are associated with predatory lending, centering on four specific abuses identified in a joint report by the Departments of Housing and Urban Development and the Treasury issued in 2000 [HUD/Treasury, 2000]:

--Loan flipping, or repeated financing of loans in a short period of time that enables the lender to earn high fees (and is often accomplished through large balloon payments required over short maturities):

--Excessive fees, including large up-front charges and prepayment penalties, that are not justified by the cost and/or risks posed by borrowers;

--The extension of loans based on assets, not the income, of the borrower, which makes it more likely that the borrower will default;

--Deliberate fraud or deception designed to conceal the true onerous nature of the loan from unsuspecting or unsophisticated borrowers.

Such practices not only clearly harm the individual borrowers who may be victims of predatory lending, but also can hurt the communities in which they live. This is because predatory lenders have tended to concentrate their sales efforts on low-income and minority communities. Lending that results in a pattern of defaults in these areas can destroy property values and lead to increased crime [HUD/Treasury, 24-25].

If, by definition, predatory loans have a much higher risk of default than legitimate subprime loans, why do lenders extend them? Predatory lenders that engage in these practices must believe they can profit from them either by selling the loans they

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techniques, lenders are now able to classify borrowers by their risk characteristics and thus are able to price their loans accordingly.

originate to unsuspecting buyers, or by foreclosing on the homes of subprime borrowers and reselling those properties at a gain (“stripping the equity” from the borrowers).

In principle, there are four basic ways policy makers can address the problem posed by predatory lending. First, by requiring all subprime lenders to disclose the extent and nature of their lending, as well as the interest rates at which their loans are extended, regulators and the public can help identify the most abusive lenders and take legal action to stop them. At the very least, disclosure can help shame predatory lenders into halting these practices.

Second, both borrowers and the buyers of subprime loans can be provided with more information – about loan terms and other available sources of credit (for the borrowers) and the risks of the borrowers (for the buyers of the loans) – so that truly predatory lending will be more difficult to accomplish. Furthermore, subprime borrowers – who tend to be less sophisticated in financial matters – may be able to benefit from more education and counseling about mortgage borrowing so that they can make proper use of what information is made available.

Third, the law can prohibit certain terms and conditions in mortgages themselves that policy makers deem to be inherently onerous. There is an important and often unrecognized tradeoff in regulating the terms of mortgage contracts, however. The more restrictive the rules, the more difficulty lenders may have covering the risks of extending credit to subprime borrowers. Lenders will rationally attempt to offset the impact of mandated restrictions in their mortgages by raising interest rates and fees. But disclosure rules may inhibit lenders from doing so if the higher rates and fees trigger reporting requirements (as is the case under current law, discussed shortly), or significant

limitations on what terms the mortgages may contain. Accordingly, as regulation of mortgage terms and conditions is tightened, lenders have greater incentives to ration credit to subprime borrowers, either by withdrawing from the market altogether, or in less extreme cases, extending credit only to those subprime borrowers with the highest credit scores and thus the lowest risks of default.

Fourth, policy makers may be able, through regulatory or other incentives, to encourage lenders to seek out and provide mortgage credit to subprime borrowers, so that borrowers will have more choices when seeking credit. If borrowers know they have alternative sources of finance, the less likely it will be that they will be victimized by abusive practices.

In fact, federal policy makers – the Congress and the relevant regulatory agencies – have used all four of these tools to combat predatory lending.

***Disclosure:*** There are two types of federal disclosure rules on the books that affect and ideally should help discourage predatory lending: those that require disclosure of the terms of *specific mortgage loans* to help consumers comparison-shop among available mortgages and legislation requiring lenders of “high-cost” loans to report *generic* data on both the volume of such loans and the interest rates they carry.

Two statutes govern disclosures of specific mortgage terms. The Truth in Lending Act (TILA) requires all mortgage lenders (including subprime lenders) to disclose the finance charge (the total cost of credit, including interest, points, fees and private mortgage insurance) and the annual percentage rate, or APR (the annualized finance charge). TILA also gives borrowers the right to rescind certain mortgages, generally within three days of closing, and authorizes them to recover actual or statutory damages

for violations. The Real Estate Settlement Protection Act (RESPA) requires lenders to disclose settlement costs, as estimated within three days after the mortgage application, and to provide an actual accounting of such costs at closing. RESPA also prohibits kickbacks and referral fees.

Some critics have attacked the adequacy of these required disclosures in the subprime lending market, where mortgage terms may be more complex and borrowers are less financially sophisticated than in the prime market. For example, it has been alleged that predatory lenders, in particular, add points and significant prepayment penalties on top of high interest rates on a take-it-or-leave-it basis [Engel and McCoy]. To the extent this occurs, however, it is not because of inadequate disclosures (unless the lenders are clearly violating TILA and RESPA) but instead due to the fact that the borrowers do not have or know about alternative sources of finance so that they need not feel pressured into signing a mortgage with onerous terms.

The key generic disclosure statutes that are designed to help expose the frequency of high-cost lending, and thus indirectly to discourage predatory lending abuses, are the Home Ownership and Equity Protection Act of 1994 (HOEPA) and the Home Mortgage Disclosure Act (HMDA). HOEPA requires mortgage lenders to disclose information about their loans if the interest rates and fees exceed certain levels. Under the most recent rules issued by the Federal Reserve, which has authority for implementing the terms of the Act, those thresholds now apply to first mortgage loans with an APR greater than 8 percentage points above the Treasury rate for loans of comparable maturity, or with points and fees (including payments on single premium credit life insurance policies) that exceed 8 percent of the loan amount, or \$400 (adjusted annually since 1994 for

inflation).<sup>7</sup> In its final rule, the Federal Reserve cites industry sources suggesting that lowering the reporting threshold increased the share of first-lien loans covered by HOEPA from 9 percent to 26 percent (and for subordinate lien loans, the share covered rose from 47 percent to 75 percent).

Meanwhile, the Federal Reserve has also issued regulations under HMDA requiring depository institutions and other covered non-depository lenders, as of the year 2004, to report the gap between the APR and the comparable treasury rate on all mortgage loans above certain thresholds, which are substantially lower than those set forth under HOEPA.<sup>8</sup> As a result, the Board soon will be able to publish information that will allow policy makers, citizens, and borrowers, to identify which institutions are high cost lenders. Although lenders may be high cost because they are serving the riskiest borrowers, a high average APR relative to other market interest rates might also signal to borrowers (and their counselors) that they should look at other sources of finance before signing a mortgage extended by those particular lenders. For the same reason, the APR information to be provided under HMDA should also enable federal regulators to better target their efforts to enforce existing laws against predatory lending.

***Information, Education and Counseling:*** The federal laws requiring disclosure of various mortgage terms are the key elements of information disclosure relating to subprime lending. Apart from the federal requirement that older homeowners obtain counseling when signing a reverse mortgage (which allow obligors to take out equity

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<sup>7</sup> The revised rules were issued in December, 2001, after an extensive comment period. The APR trigger for second mortgages is 10 points above the applicable Treasury rate.

<sup>8</sup> The reporting thresholds are for first mortgages with rates at least 3 percentage points above a comparable Treasury security, and for second mortgages, at least 5 percentage points above the comparable Treasury rate.

from their homes), there are no federal requirements that borrowers of conventional mortgage credit in the subprime market obtain counseling and education.

As discussed below, a few states have since made counseling mandatory, while a number of non-profit organizations provide it to borrowers who seek it. There is a recognized shortage, however, of trained counselors to serve this market as well as funding to support them [Engel and McCoy]. The most important aspect of counseling is likely to be the provision of information about alternative sources of finance and their cost so that borrowers can make informed and less pressured decisions before assuming significant mortgage obligations.

***Prohibition of Certain Practices:*** To the extent that predatory lending entails fraud or deception, it is well covered by federal and state anti-fraud and consumer protection measures that have been on the books for some time. Federal law, embodied in HOEPA, also bans a number of specific lending practices or mortgage terms in loans covered by the Act. Under the most recently issued regulations of the Federal Reserve, covered loans include those with an APR more than 8 percentage points above the yield on Treasury securities with comparable maturity and fees exceeding 8 percent of the loan amount, or \$400 (adjusted for inflation since 1994). In particular, the Act prohibits lenders from:

- extending mortgages that contain onerous prepayment penalties;<sup>9</sup>
- charging an interest rate after default that is higher than the rate before default;

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<sup>9</sup> HOEPA permits a prepayment penalty only if the borrowers' total monthly debt payments are less than 50 percent of his 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 is taken out; the prepayment amount at closing does not exceed two periodic payments; and the penalty is not prohibited by any other law.

--requiring balloon payments on a loan with maturity less than five years (in most cases); and

--engaging in a pattern of extending covered loans that do not take account of the borrower's income (and thus ability to make regular payments).<sup>10</sup>

HOEPA also gives the Federal Reserve broad regulatory authority to ban other practices that it finds to be unfair or deceptive, *not just for HOEPA loans but for all consumer mortgage loans*. In December 2001, the Board formally exercised this authority with new regulations by:

-banning "loan flipping" within the first 12 months (unless refinancing is in the borrowers' interest);

--prohibiting lenders from replacing a zero or low cost loan with another higher cost loan (unless the refinancing is in the borrowers' interest);

--prohibiting lenders from evading HOEPA's restrictions on covered closed-end credit by giving consumers open-ended credit on essentially the same terms;

--establishing a rebuttable presumption against the creditor if it doesn't document and verify the borrower's income; and

--prohibiting lenders from including "payable on demand" or "call provisions" in HOEPA loans.

Predatory lending also can violate the unfair trade practice laws overseen by the Federal Trade Commission. The FTC also has jurisdiction to punish predatory lenders under other statutes, including HOEPA, TILA, RESPA, the Equal Credit Opportunity Act

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<sup>10</sup> The Act also prohibits a lender from making any direct payments to a contractor on a home improvement contract where a covered or HOEPA loan is involved.

(ECOA) and the Fair Debt Collection Practices Act.<sup>11</sup> The Commission has been using its authority aggressively to rein in predatory lending. In just the past year, the FTC has investigated and settled predatory lending investigations against a Citigroup subsidiary (Associates), the First Alliance Mortgage Company of California, and the Mercantile Mortgage Company of Illinois.<sup>12</sup> That a lender of Citigroup's stature, in particular, can be successfully investigated and punished is a testament not only to vigorous enforcement efforts of the federal government, but also provides a strong deterrent to would-be offenders in the future.

*In short, federal law already bans all or virtually all of the practices associated with predatory lending which critics have noted, and as discussed below, some still claim to be prevalent.* To the extent therefore that practices already outlawed by federal law exist, the solution lies in devoting more resources for enforcing federal law rather than in adding duplicative and supplementary state laws and local ordinances. This is especially the case where, as discussed in greater detail shortly, additional state and local laws threaten to dry up credit for the very same populations about which critics of predatory lending are most concerned.

It is also against the law for lenders to fraudulently represent to the *buyers* of their loans the risks inherent in those loans – for example, by inflating real estate appraisals or falsifying loan applications. Indeed, one of the surprising developments in the mortgage market in the past has been the ability of some originators of what clearly seem to be predatory loans to sell them to supposedly sophisticated purchasers in the secondary markets. To the extent that this has occurred, it is most likely because the originators

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<sup>11</sup> Willful violations of the TILA and HOEPA also carry criminal penalties.

have been able to successfully hide the predatory loans in a loan package containing a much larger volume of legitimate loans. In addition, because the purchasers often are not the ultimate holders of the loans, but instead package them and securitize them to other sources of capital, they may do less than a diligent job in investigating the risks of the underlying loan packages.

The two largest secondary market purchasers, Fannie Mae and Freddie Mac, have recently taken steps, however, that should significantly reduce the ability of predatory lenders to pass on their loans to unsuspecting buyers of securities. Both companies now refuse to purchase any “HOEPA loans”, or those with interest rates and fees that trigger reporting requirements under the Act. To this extent, the HOEPA triggers have much the same effect as usury ceilings by limiting the supply of any credit above the interest and fee reporting thresholds. Although this has the welcome effect of drying up capital for truly predatory loans, it is not clear to what extent the HOEPA triggers also work in the same fashion to curtail credit for legitimate, albeit high cost, mortgage loans.

***Incentives for Subprime Lending:*** Although not framed as incentives for subprime lending per se, in fact there are a number of federal programs and initiatives designed to encourage lenders to provide mortgage credit to low and moderate income income (LMI) borrowers, many of whom in fact can only qualify for loans in the subprime market because of their limited incomes or spotty credit histories.

Two well-known programs provide these incentives to both depository and non-depository lenders. The Federal Housing Enterprise Financial Safety and Soundness Act of 1992, for example, requires the Department of Housing and Urban Development

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<sup>12</sup> The Commission has obtained settlements from predatory lending investigations in previous years, including Fleet Finance (1999) and Barry Cooper Properties (1999).

(HUD) to set affordable housing goals for the two housing GSEs, Fannie Mae and Freddie Mac. These goals have been steadily raised, and currently require both GSEs to fulfill half their mortgage purchases from loans originated to LMI households. HUD also provides mortgage insurance through the Federal Housing Administration (FHA). The majority of the beneficiaries are LMI households [Merrill].

The federal government specifically encourages depository institutions – banks and thrifts – to lend to LMI households through the Community Reinvestment Act (CRA). Through such lending, depositories can raise their CRA examination ratings, which are important to regulatory approvals when the institutions desire to expand the number of their branches. There is some dispute in the literature as to how effective CRA has actually been in motivating depositories to provide more funds to LMI borrowers than they otherwise would.<sup>13</sup> Later in this report I suggest that federal policy makers could enhance CRA credit for depositories extending loans to LMI households as a way of more effectively ensuring a positive outcome.

*Summary:* A variety of federal statutes and rules are currently in place to expose and help stamp out predatory lending, while encouraging legitimate lending to subprime borrowers. Certain of the anti-predatory lending provisions, notably the rules issued under HOEPA, have only been in effect since October 1, 2002. Others, such as the HMDA reporting requirements, have been announced but are not yet effective.

One key characteristic of the existing anti-predatory lending regime – reflected in HOEPA -- is highly relevant to considering whether additional rules or legislation relating to the practice are warranted. Both the HOEPA reporting requirements and its

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<sup>13</sup> For evidence that CRA seems to be effective in enhancing mortgage lending to LMI borrowers, see Litan, et al. (2000). For contrary evidence, see Hylton and Rougeau (1999).

statutory mortgage limitations apply only to loans with rates and fees above certain thresholds. A “trigger-based” regulatory regime has the advantage of being relatively easy to administer because it draws a bright line between loans that are covered by the rules and those that are not. At the same time, however, triggers or thresholds can have the *practical effect* of acting like usury ceilings on mortgage lending, which for many years actually prohibited consumer loans in many states at interest rates above the legal limit.

It is standard economic theory, backed by considerable empirical evidence, that usury ceilings force lenders to ration credit away from all borrowers whose risks of non-payment cannot be covered by interest rates at or below the ceilings.<sup>14</sup> As a result, however well-intentioned they once may have been, state usury ceilings have since been abandoned.<sup>15</sup> The lifting of usury laws has proved instrumental since in “democratizing credit” by allowing many individuals and households who formerly would have been denied credit to obtain it.

How can triggers or thresholds tied to interest rates and/or fees have similar practical effects as the old and now discredited usury ceilings? Depository institutions, fearful of being labeled high cost lenders under a particular state or local threshold, or worse, potentially subject to litigation and penalties for including mortgage terms or practices that are prohibited or limited for loans at rates and fees above the applicable thresholds, can find it much easier simply not to extend any loans at all at rates and fees above the triggers. Just as important, and perhaps even more so, it is already the

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<sup>14</sup> A sampling of the studies finding that usury ceilings applicable to mortgages have significantly curtailed residential purchases include Austin and Lindsley (1976); France (1978); and Robins (1974).

<sup>15</sup> Congress preempted the states from enforcing the ceilings in 1980, when market interest rates were at or even above some state ceilings.

announced policy of the two largest secondary market purchasers of mortgages – Fannie Mae and Freddie Mac – not to purchase loans with rates and fees above the HOEPA triggers. In this way, then, statutes or rules that effectively lower the rate and fee thresholds can expand the pool of loans that Freddie and Fannie are not likely to securitize. This, in turn, risks curtailing credit supplied by the capital markets for loans with rates and fees above any threshold levels (federal or state). In short, predatory lending legislation resting on a threshold approach can operate in very much the same way as the old usury ceilings.

That triggers or thresholds have effects similar to usury ceilings does not necessarily mean they are ill-advised. Whether they are very much depends on the extent to which the thresholds are weeding out truly predatory loans versus the degree to which they are preventing lenders from extending legitimate loans to higher-risk borrowers. Given the short time in which the HOEPA and HMDA reporting requirements, as well as the mortgage restrictions required under HOEPA, have been in effect or merely announced, *it clearly is too early to tell how the balance between benefit and cost has been struck under the various trigger based statutes and regulations.*

### **State and Local Predatory Lending Initiatives**

This is not the lesson that some states and localities have drawn from current federal efforts to rein in predatory lending, however. In fact, many states and many local governments have considered or enacted their own predatory lending statutes or

ordinances in the past several years, all based in one form or another on the threshold or trigger approach embodied in HOEPA.<sup>16</sup>

Table 2 provides an illustrative list of some of the key features of statutes enacted in eight states in 2002. For the most part, the rate and fee triggers in the state statutes are identical to the new thresholds in HOEPA. In some jurisdictions, notably the District of Columbia, the rates and fees thresholds are even lower than the HOEPA triggers.

The state statutes also generally prohibit the same kinds of practices or mortgage terms as the Congress has done in HOEPA and the Federal Reserve has since implemented pursuant to the same act. Some of the state statutes, however, go further than the federal law in certain respects: in encouraging or requiring borrowers to notify or make available to borrowers financial counseling; in placing tighter restrictions against prepayment penalties, and in banning or limiting single premium credit life insurance. In addition, for the most part, the state statutes add their own penalties for violations: fines, criminal penalties, and denial of business opportunities with the state.

Given the short time the state statutes have been in effect – most have been in place only for several months, at this writing – there clearly has been insufficient time to assess their impacts. Thus, just as policy makers must be uncertain about the net impact of the federal rules embodied largely in HOEPA, they have reason to be equally uncertain about the net impact of the state statutes enacted so far.

One of the only states to have enacted predatory legislation or rules before 2002 was North Carolina, which adopted its measure in 1999.<sup>17</sup> The North Carolina statute

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<sup>16</sup> Engle and McCoy suggest that a major reason why the states have used this approach is that it is difficult, time consuming and expensive for resource-strapped states to prosecute fraud actions against predatory lenders.

**Table 2  
Illustrative List of State Predatory Lending Statutes Enacted in 2002  
(and by date bill was signed)**

State	Rates/Fee Trigger	Loan Flipping	Fees	Counseling	Rates/Fees Prohibitions	Other
Colorado (6/7/02)	APR: 8 points above treasury for first liens; ten points for second Fees: 8% of loan or \$400	No refinancing within one year	Limits	Lenders must provide "cautionary notice"	Call provisions, increases in rates after default	Limits on sale of single premium credit life insurance
District of Columbia (3/5/02)	APR: 6 points above treasury for first lien, 7 points for second Fees: 7.5% of loan		Prohibits	Notice of right to obtain	No financing of points/fees > 3% of loan, or \$500; No increase in rates after default; no call provisions	No single premium credit life
Florida (4/9/02)	APR: 8 points above treasury on first mortgages, 10 points on second Fees: 8% of loan or \$400	Prohibits within 18 months	Limits	Notice	Limits late fees, call provisions, increases in rates after default; charging it to modify, renew and extend high cost loans	Prohibits financing of debt cancellation agreement; limits foreclosures
Georgia (4/22/02)	APR: 8 points above Treasury on first mortgage, 10 point on second Fees: 5% of loan if \$20,000 or more; lesser of 8% of loan or \$1000 if loan is less than \$20,000	Prohibits	Limits	Required	For all loans, limits charging of late fees, charging for loan balance information, for high cost loans; prohibits rate increases after default; charging for loan modification or renewal and call provisions	
Maryland (5/16/02)	APR: 8 points above Treasury for the first mortgage, 10 points for the second Fees: 8% of loan or \$400			Lender must recommend counseling		Limits sale of single premium life
Minnesota (4/17/02)	Any residential loan		Limits prepayment penalties		Prohibits financing lenders fees > 5% of loan	
New York (10/4/02)	APR: 8 points above treasury on first mortgage, 9 points on second Fees: 5% of loan greater than \$50,000 or 6% of loan is less or \$1500	Prohibits		Required	Maximum fee limit of 3%; lenders can't solely increase debts, raise rates after default, finance points and fees > 3% of loan	No financing of single premium credit life
Ohio (2/22/02)	APR: 8 points above Treasury on first mortgage, 10 points on second Fees: 8% of loan or \$400	Limits refinancing within a year; limits replacement of a zero interest loan with a covered loan	Limits		Prohibits increase of interest rates after default, call provisions	

retained the old HOEPA rate trigger of 10 points above the Treasury rate, but changed the points and fees threshold from 8% or \$400 (adjusted for inflation) to 5% for total loan amounts greater than \$20,000 (or the lesser of \$1000 or 8% of loan amounts below \$20,000). The Act also contained more restrictions on mortgage terms than were required under HOEPA at the time. Much controversy has since ensued over the impact of the North Carolina law on subprime lending generally and predatory lending in particular.

One initial study, by Professors Michael Staten and Gregory Elliehausen [2001], concluded on the basis of data supplied by nine major lenders that both first and second mortgage originations fell substantially after 1999, relative to originations in two neighboring states without their own predatory lending restrictions (South Carolina and Virginia). Using a different and more complete data set, that supplied under HMDA which includes all major mortgage lenders, Ernst, Farrow and Stein [2002] found the opposite: that subprime lending continued to thrive, although even this study showed that subprime lending in North Carolina after 1999 did decline relative to such lending in the rest of the country.

Elliehausen and Staten have since updated their earlier analysis, also adding data from a third control state, Tennessee [Elliehausen and Staten]. The conclusions from their original analysis still hold: subprime mortgage originations dropped substantially after the passage of the North Carolina statute, by 14 percent. A similar conclusion emerges from a study by different authors, Keith Harvey and Peter Nigro, who like Ernst, Farrow and Stein use the HMDA data, but who also apply more sophisticated statistical

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<sup>17</sup>In 2000, the New York Banking Board lowered HOEPA's triggers for covered loans, as to which balloon payments were prohibited (except after seven years). The City of Chicago also enacted an ordinance, with

techniques to their analysis. Like Staten and Elliehausen, Harvey and Nigro also find that mortgage lending declined significantly in North Carolina relative to the other states, but that this was due to a large decline in *mortgage applications* rather than a relative increase in denial rates. While they found no reduction in the number of subprime lenders in the state after the statute became law, they interpreted their findings as indicating that subprime lenders were less aggressive in seeking out subprime borrowers after the passage of the North Carolina law.

In fact, the results in the Harvey and Nigro study help explain why even if statutory restrictions do not induce lenders to pull out of a particular locality or state, the net impact of such laws can still be to reduce overall lending to subprime borrowers. As already discussed, this is because depository institutions may refuse to extend credit on, or secondary market purchasers may refuse to buy mortgages with, terms above the statutory rate and fee thresholds. This is why threshold-based anti-predatory lending regimes can operate very much like the now abandoned usury ceilings: discouraging the supply of credit to higher risk borrowers.

To the extent these laws cause subprime lenders to pull back -- and they are more likely to do so the lower the triggers -- a debate nonetheless continues over whether that outcome is socially desirable. Critics of predatory lending and supporters of the various state statutes argue that most, if not all, of the credit reduction would have been predatory in any event, so this outcome is a good thing.

But the experience with the usury laws points the other way. In that arena, the judgment ultimately was made that the government should not be so paternalistic in preventing higher risk borrowers from gaining access to the formal credit markets, which

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significantly lower rates and fees thresholds than HOEPA.

is what has happened since the usury ceilings were lifted. To be sure, the net impact of usury-type laws or rules depends on the level at which the ceilings (or triggers) are set. Statutes that effectively cut off very high cost credit to the riskiest borrowers are more likely to have a net positive impact because it may not actually be in the best interests of many of those borrowers to incur much debt. But the presumption in favor of government paternalism of this sort surely weakens as the triggers or effective usury ceilings are lowered. For as this happens, creditors are induced to deny an ever larger fraction of would-be borrowers access to formal credit; in the process, an increasing fraction of riskier, but still creditworthy borrowers will be shut out of the legitimate credit market. In essence, the lower the trigger, the more likely it is that the net impact of any purportedly “consumer protection” lending legislation will be negative than positive.

#### **The AARP Model Bill: A Premature and Potentially Counter-productive Response**

Notwithstanding the federal legislation aimed at predatory lending already on the books, as well as the flurry of state initiatives recently enacted, the AARP is advancing a “model statute” designed to address the practice in states that have not already enacted legislation [Calhoun, 2001]. The model statute has three basic characteristics, which if adopted, would make it the most restrictive of all predatory lending legislation – state or federal – now in place.

First, and perhaps most important, it has the lowest rate and fee thresholds of any statute currently on the books: for rates, 6 points above the five-year Treasury rate (for first mortgages); and for fees and points, 3% of total loans of \$30,000 or more, or the lesser of \$900 or 6% of total loans less than \$30,000.

Second, the AARP statute contains more restrictions on high-cost mortgages (those with rates and fees above the thresholds) than either the federal or virtually any state statute on the books. Of special significance are the limitations on prepayment penalties (which are to be no higher than 2% of the loan amount in the first 12 months or 1% in the second year) and the prohibition on all balloon payments. The Act would impose limits on late fees and prohibit single premium credit life, disability, or property insurance (or other life and health insurance).

Third, the Model Act would also place various restrictions on *all mortgages*, not just those extended to subprime borrowers. Certain of these restrictions – such as those relating to loan flipping, limits on late fees, prohibitions of call provisions – are currently in place under federal law for HOEPA loans, but under the model AARP statute would be among those added to all mortgages under the laws of the states where the statute is enacted.

A threshold question for policy makers considering the model statute should be: how serious is the problem that it purports to address? The working presumption in other areas of economic and social activity is that legislators or regulators do not interfere with private decisions unless there are good reasons to do so: for example, to require some parties to internalize the costs they impose on others; to ensure that adequate information is available to all parties so that some are not at a disadvantage; and where because of imbalances in bargaining position, or lack of sophistication on the part of consumers, additional information may not be sufficient to assure fair bargains, certain practices or contract terms are prohibited outright.

As this report has noted, federal policy makers have determined that the predatory lending problem calls for a series of responses, including disclosure requirements and limitations on certain mortgage terms that have been determined on their face to be unduly onerous, *but only on mortgages with terms above certain cost thresholds*. Federal law does *not* dictate mortgage terms for mortgages with rates and fees below the HOEPA thresholds, out of the apparent conviction that borrowers in this segment of the market can be assumed to be sufficiently knowledgeable to understand the nature of their obligations, and to seek out and find sufficient alternatives so that they need not be victims of any single lender and the terms it may attempt to impose.

How much further, beyond the federal laws already on the books, should states go in seeking to regulate the subprime lending market in an effort to stamp out predatory lending? The preamble to the AARP, which purports to justify the additional restrictions – and especially the lower rate and fee thresholds – cites reports and evidence that pre-date the 2001 anti-predatory lending rules issued by the Federal Reserve and the recent settlements obtained by the FTC. The same is true of a widely cited estimate that consumers allegedly have paid over \$9 billion in excess charges on predatory loans [Ernst 2001]. *There simply is no evidence, in either the AARP model statute or its preamble or in the professional literature, of how extensive the predatory lending problem remains in light of the most recent federal initiatives*. Thus, asking state legislatures to enact a more restrictive regime governing subprime loans is asking them to take on faith the existence of a problem that federal policy makers have recently and aggressively addressed.

If there weren't risks in adopting the AARP's model statute, then perhaps policy makers might have some reason to at least seriously consider its specific provisions. But that is not the case. As noted earlier, the short time with which the federal anti-predatory lending restrictions have been in effect makes it difficult to know to what extent even the federal rules have successfully weeded out the truly predatory loans from the market and to what extent they have deprived borrowers of finance on otherwise legitimate terms. In effect, there is uncertainty, even under existing federal law, and especially the HOEPA rates and fees thresholds, about the extent to which that law operates like usury ceilings before they were abandoned.

There has to be even greater uncertainty – and risk – surrounding the much lower rates and fees thresholds embodied in the AARP proposed model statute. Just as lower usury limits are likely to deny even larger numbers of worthy borrowers access to credit, lower thresholds that trigger more restrictions on the terms mortgages can contain – to the detriment of lenders – are likely also to reduce the availability of mortgage credit to similar groups of borrowers for reasons already outlined. *In other words, the lower the thresholds, the greater the risk that policy makers will do more damage to legitimate subprime borrowers than to root out additional predatory lending.*

Moreover, the AARP's preamble contains no evidence that borrowers who are in the *prime* market are being victimized by practices that are not already covered by the mortgage restrictions announced by the Federal Reserve in December 2001 (discussed earlier). Imposing these new restrictions, such as limitations on prepayment penalties, can have no other effect than to raise the risk to prime lenders. Higher risk, in

turn, can only lead to higher interest rates. Where is the evidence of a problem that would call for such a result?

Finally, certain of the restrictions the Act would impose on just high cost loans – those with rates and fees above the triggers -- also could hurt some borrowers in the subprime market, assuming some lenders extend those loans. A good example relates to what has become the “poster child” of critics of predatory lending: single premium credit life insurance. Critics of single premium policies attack them because at some point after taking out the insurance but well before the term of the mortgage has expired, insureds may refinance the mortgage or move, and thus not benefit from the extended term of the insurance for which they paid up front.<sup>18</sup>

The critique of single premium credit life insurance – which effectively insures the lender against default if the borrower meets an untimely death – ignores the fluctuations in the earning power of many subprime borrowers, however. As these borrowers often do not have extended employment histories, they are likely to experience unemployment more frequently than the general population. If they are laid off, individuals in these circumstances are likely to put payment of a life insurance policy as one of their last financial priorities, even though if the premiums lapse, the borrower may lose the protection of the policy, and in the process put the lender at greater risk.

Accordingly, an outright ban on single premium credit life insurance (or including it in the finance charge) will raise the risks for lenders in the subprime market. In the absence of other restrictions, lenders can compensate for the added risk by raising interest rates. But if the interest rate on a subprime loan is already at or near a trigger (HOEPA or

state), then the lender may for reputational and other reasons (notably, an inability to sell the loan into the secondary market) decide it is better to deny some borrowers' applications altogether and ration credit rather than extend loans at interest rates over the applicable rate threshold.

It is most likely for this reason that, after considering comments on what to do about single premium credit life insurance during its HOEPA rulemaking in 2001, the Federal Reserve Board decided *not* to impose a ban or prohibit financing of credit life insurance as part of a mortgage (as the AARP model statute would do). Instead, the Board included the cost of the policy in the points and fees threshold under the Act.<sup>19</sup>

A similar story can be told about limitations on prepayment penalties. On the one hand, it can seem unfair to penalize a borrower for wanting to take advantage of a decline in interest rates to reduce his or her mortgage obligation by replacing a higher cost mortgage with a lower one. But on the other hand, the lender of that higher cost mortgage takes a risk when extending the loan that precisely such an outcome may occur, and that an asset thought to have one maturity turns out to have a shorter one if prematurely paid off. Lenders attempt to cover that risk by imposing some penalty on prepayment.

The Federal Reserve has struck a balance between these offsetting considerations, especially for subprime borrowers who are paying higher-than-normal interest rates in the first place, by imposing some limits on lenders' abilities to set prepayment penalties. But again, even tighter restrictions on prepayment penalties raise lenders' risks, for which

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<sup>18</sup> Unlike other insurance policies, where insured pay premiums on a regular (typically annual) basis, single premium policies charge the borrower up front in a lump sum, which in turn is often added to the principal of the mortgage.

<sup>19</sup> Under current federal law, lenders can require borrowers to purchase credit life insurance with a mortgage, but when doing so, they must include and disclose the premium in the finance charge and annual percentage rate. Failure to do so violates the TILA.

lenders can only compensate by raising rates and/or fees. However, for those subprime loans already at or near any threshold ceilings, lenders may choose not to cross the ceilings but instead may opt to ration credit. In short, what may seem on the surface like a borrower-friendly measure – curtailing prepayment penalties beyond the limitations already provided under federal law – could harm the very population, subprime borrowers, the measure ostensibly would be designed to help.

### **Prudent Alternatives to the AARP Model Legislation**

Policy makers concerned that predatory lending is still too pervasive, even in the wake of recent federal efforts to stamp it out, can pursue certain measures that do not have the risks of cutting off credit to subprime borrowers that are posed by the AARP's model statute or proposals like it.

One of the best ways to disinfect the subprime lending market of its worst practices is to add the equivalent of more sunlight: more information about alternative sources of finance. Ideally, one would like to see the mortgage interest rate charts that are now published regularly in newspapers and on the Internet for prime borrowers also include the same information for subprime mortgages. Were this to occur, then subprime borrowers could just as easily “comparison-shop” among mortgage providers as prime borrowers do now.

Policy makers must take account of several significant hurdles, however, in seeking to make available the functional equivalent of a mortgage chart for subprime borrowers. For one thing, unlike prime loans that are readily standardized and generally offered by the same lender to all qualified borrowers at the same interest rate, subprime loans tend to be customized, with interest rates, fees and other terms tied to the credit

score and other risk characteristics of the borrower. Since subprime (or even prime) borrowers typically do not know their credit scores (although this information is now available for a fee) and other information that lenders may use to quote an interest rate to a subprime borrower, they cannot look up an interest rate for which they would qualify even if such information were readily available, which it is not.

Subprime borrowers also typically do not have access to, or understand how to use, the Internet and so cannot easily gain access to mortgage information were it provided on line. Furthermore, again because subprime lending is customized, newspapers do not regularly publish mortgage rate charts containing rates and fees for subprime loans.

Ensuring that subprime borrowers not only have access to, but can make reasonable use, of information about alternative sources of finance is therefore a significant challenge to policy makers. One way of addressing the problem is to require all lenders at least to provide borrowers, before they sign their mortgages, with their credit scores and other information relevant to their credit ratings that lenders may obtain directly or through credit bureaus. Borrowers could then use this information to determine from a counselor or another lender whether they may qualify for prime mortgages. Such a requirement, which should be federal, would help ensure that borrowers who may otherwise be tempted to sign a subprime mortgage at least have the opportunity to qualify for a lower cost mortgage.

As for other borrowers who do not qualify for prime mortgages, the recently adopted federal rules requiring all mortgage lenders covered by the HMDA to report their Annual Percentage Rates (APRs), even if only once a year, should enable private sector

firms to develop lists of mortgage suppliers in various geographic areas that will enable borrowers to determine the identities of those lenders that tend to be lower cost than others.<sup>20</sup> To be sure, annual information is not a substitute for weekly or even daily mortgage rate data that are available to borrowers in the prime market. But at least the annual data would allow borrowers to have much more information about alternative sources of finance than they do now.

States and localities concerned about predatory lending also could make a constructive dent against the problem by compiling lists of mortgage suppliers and their average APRs and requiring all subprime lenders in their jurisdictions to provide them to borrowers before they sign any mortgage. Such efforts would supplement the existing financial education efforts mounted by many federal departments and agencies, including the Department of Treasury and the FDIC. More broadly, states and localities should reinforce and upgrade existing efforts to teach basic financial education as part of the high school public school curriculum so that all adults in the future, regardless of income, will have the requisite ability to seek out relevant information when taking out a mortgage and to understand the choices available to them and the consequences before they incur debt of that magnitude (or any loan, for that matter).

In principle, stepped up educational and counseling programs for subprime borrowers should also reduce their susceptibility to unscrupulous practices. The critical questions are who should provide this assistance and how should it be funded? As it is

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<sup>20</sup> Initially, the Federal Reserve Board proposed covering nondepository lenders only if their prior year home purchase loan originations equaled or exceeded \$50 million, which as a practical matter would cover institutions making approximately 400-500 mortgage loans annually. After receiving comments, the Board lowered this threshold in its final rule (issued February 15, 2002) to \$25 million. However, since most subprime lending is extended by nondepositories, the Board would do well to reconsider the reporting threshold for nondepositories, to something on the order of \$5-10 million.

now, education and counseling is typically provided by non-profit organizations, if it is available. Rather than spend scarce resources attempting to enforce more restrictive predatory lending statutes, states could more productively spend even a portion of the money they otherwise would expend on enforcement of those statutes (if they existed) instead on expanded education and counseling programs, perhaps administered by existing credit counseling agencies or non-profits specializing in these activities. States might also consider requiring lenders at least to notify borrowers where they might obtain counseling if they so desire. Even if counseling is of uncertain benefit for some subprime borrowers, there can be no objection to ensuring its availability to those borrowers who want it (and thus believe they can profit from having it).

Further, while it is one thing to encourage borrowers to seek out alternative sources of subprime funding, it is quite another to ensure that those sources are indeed available. As this report has documented, while there are a few large bank lenders (or their affiliates) in this segment of the mortgage market, the vast majority of the number and dollar volume of subprime mortgage lending is supplied by *non-bank* lenders. This is so despite the fact that federal banking law – specifically the Community Reinvestment Act – encourages depository institutions (banks and thrifts) to meet the convenience and needs of the communities in which they are chartered, including the credit needs of low- and moderate-income neighborhoods and individuals, many of whom are likely to be in the subprime credit market.

It was noted earlier in the report that there is some dispute as to how effective CRA has been in encouraging depositories to meet this challenge. Furthermore, there may be several reasons why, despite the regulatory incentives, banks and thrifts may be

hesitant to become too heavily engaged, if at all, in supprime lending, which would help them fulfill their CRA obligations.

One factor is the concern among some banks about the adverse publicity associated with lending to subprime borrowers. Ironically, this concern probably has deepened in the wake of the recent FTC settlements, which although limited to claims of abusive practices, may darken the image of any lender charging risk-adjusted and entirely lawful, but above-prime, interest rates to borrowers in the subprime market. A second factor is that because subprime lending is riskier than prime lending, bank and thrift regulators for safety and soundness reasons have been actively *discouraging* depository institutions from extending subprime loans. Again, as noted earlier, regulators already require these institutions to back subprime credits by 1.5 to 3 times the capital required of other loans.<sup>21</sup>

In short, any incentives that CRA may now give depository lenders to extend subprime appear to be offset to a significant extent by reputational and regulatory factors that work in the opposite direction. Accordingly, if policy makers truly want depository institutions to be more active in the subprime market, they must implement *additional incentives* – beyond those already provided in the current administration of the CRA – to bring about that result. Since it is unlikely, given federal budgetary difficulties, that federal authorities would provide those incentives in the form of subsidies, the only alternative left is for the regulators to provide even more CRA credit, or additional CRA reward, than they do now for banks that extend loans to LMI (and thus, as a practical

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<sup>21</sup>In addition, in the summer of 2002, the Financial Institutions Examination Council issued draft guidance to lenders with subprime credit card portfolios that has the effect of tightening the availability of this particular form of credit to subprime borrowers.

matter, subprime) borrowers, provided that such lending is consistent with the institutions' safety and soundness. Regulators could accomplish this under current law by changing the weights they accord to the different kinds of community activities for which CRA is credit is customarily given.

Finally, federal policy makers should increase the resources available to the relevant regulatory agencies for enforcing federal laws against predatory lending. The FTC, in particular, has accomplished much on a very limited budget —apparently about \$1.2 million in FY 2002.<sup>22</sup> This level of funding could easily be increased, even doubled, without significantly adding to the federal budget deficit.

## **Conclusion**

Federal law not only addresses predatory lending through various means, but recent enforcement activity indicates that the authorities are taking the problem very seriously. In addition, the data collection and reporting efforts that are now under way should help shed light on how serious a problem remains, while providing consumers with some additional information about the lenders who operate in the subprime mortgage market more generally.

It would be premature in the current circumstances for states and localities to adopt additional restrictions on mortgage terms aimed at further reducing predatory lending. While such legislation may be well intentioned, it carries with it significant risks of curtailing legitimately supplied credit to subprime borrowers, in the same way that usury ceilings once hurt the same populations for which they were designed to help. There are better, and more targeted, ways of attacking predatory lending, to the extent it

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<sup>22</sup> The FY 2002 budget figure is from a press release issued by the office of Sen. Stabenow dated September 19, 2002.

may exist. Policy makers should pursue those alternatives rather than restrict the mortgage market in ways that could do more harm than good.

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