Predatory Lending
Attempts to Plug the Money Drain

By Stephen O'Sullivan, Federal Reserve Bank of Boston

Predatory lending continues to capture attention nationwide. Since it entered the spotlight in the 1990s, advocates, legislators, regulators, lawyers, and lenders have intensified their activities around the issue. Over the past year, the Board of Governors of the Federal Reserve System initiated amendments to the Home Mortgage Disclosure Act (HMDA); community groups, city councilors, and other lawmakers proposed additional protections to curb abusive lending practices; Georgia's predatory lending law came under scrutiny; and Household International and Citigroup settled lawsuits (worth $700 million in total) that alleged abusive lending practices.[1]

Why is predatory lending so heatedly debated? Besides the sometimes devastating consequences of predatory lending, the practice itself has evaded simple definition and detection, allowing for a lot of debate about solutions. This article reviews some of the issues involved in isolating predatory lending and describes efforts under way to curb the practice.

Predatory versus Subprime

Establishing an agreed-upon, standard definition for the term "predatory lending" has not been easy. State and federal regulators, financial institutions, mortgage industry associations, and community groups all have different views on what types of loan terms and activities they consider to be traits of abusive lending. This lack of a standard definition has made it almost impossible for regulators or legislators to determine what loans are, or are not, predatory. As former U.S. Senator Phil Gramm has commented on the issue, it is impossible to regulate something that cannot be defined. The box on page 4 describes some loan terms and practices often associated with predatory lending.

Part of the difficulty in defining predatory lending is that many people mistakenly equate it with subprime lending. In actuality, predatory lending is the rogue component of subprime lending. Regulatory guidelines describe subprime lending as the extension of credit to "borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers." To compensate for these higher risks, lenders charge higher rates and fees. Borrowers benefit by qualifying for credit they otherwise wouldn't obtain, and lenders gain access to a new and potentially profitable market.

Subprime lending started proliferating in the 1990s. Home Mortgage Disclosure Act (HMDA) data show that from 1993 to 2000, the number of subprime loans for home purchases shot up by a factor of 19, from 16,000 to 306,000. The rise in subprime loans that are home-equity loans has been less steep, increasing from 66,000


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Predator Spotlight Now Swinging to Loan Servicing

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the ratings agencies look at the front end of the transaction, "they will also review the back end." Apparently "the entire process is in


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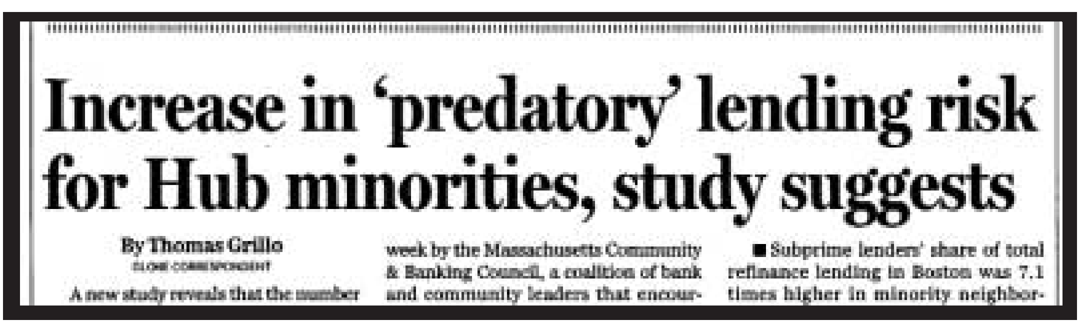
POLITICS & POLICY

Subprime Bill Aims to Mute State Laws

Republican's Proposal to Police Predatory Lending Would Set Weaker National Standards

A Helping Hand?


Increase in 'predatory' lending risk for Hub minorities, study suggests

By Thomas Grillo
GLOBE CORRESPONDENT

A new study reveals that the number

week by the Massachusetts Community & Banking Council, a coalition of bank and community leaders that encour-

■ Subprime lenders' share of total refinance lending in Boston was 7.1 times higher in minority neighborto 658,000, but these loans represent a much larger segment of the market. The subprime market continues to expand; its value in 2002 was estimated at $175 billion, or about 10 percent of the total dollar amount of the residential mortgage market, according to the *Mortgage Industry Directory*.

Federal Reserve Board Governor Edward Gramlich has suggested that the subprime market helped make it possible for low-income and minority consumers, groups that traditionally have had difficulty obtaining mortgage credit, to obtain housing loans at record levels. During the rise in subprime lending from 1993 to 2000, the number of conventional home-purchase mortgage loans going to lower-income borrowers nearly doubled, while those to upper-income borrowers increased at a slower pace of two-thirds. Further, conventional home mortgage loans increased 122 percent to African-American borrowers and 147 percent to Hispanic borrowers. Other factors, such as low interest rates, advances in technology, and greater competition also worked to broaden access.[2]

HUD Subprime Lender Tally

Year	Number
1993	49
1994	68
1995	100
1996	140
1997	205
1998	246
1999	252
2000	190
2001	178

The dark side of subprime lending is that it acts as the umbrella under which predatory lending finds cover. Subprime lenders have been found to target people in particular communities and groups, regardless of their ability to qualify for better loans. Fannie Mae and Freddie Mac have pointed out that between 30 and 50 percent of those who get subprime loans could qualify for prime rate loans, or at least loans with lower interest rates. In a study of the subprime market in Boston from 1999 to 2001, "Borrowing Trouble? III," Jim Campen of the University of Massachusetts – Boston finds the subprime loan share to upper-income blacks is 7.5 times greater than the subprime loan share going to upper-income whites, and three times greater than the share going to lower-income whites.

Both consumer advocates and lenders look to mortgage delinquency and foreclosure data for validation about whether loan costs and fees are warranted or excessive. For example, U.S. foreclosure data released by the Mortgage Bankers Association of America show that 0.86 percent for all conventional loans were foreclosed on during the fourth quarter of 2002. Further analysis reveals that only 0.54 percent of conventional prime loans were in foreclosure, whereas 7.79 percent of conventional subprime loans were. Consumer advocates point to this information and charge that subprime lenders are saddling borrowers with loans they cannot afford. Lenders assert these data provide evidence of the higher risks associated with subprime lending.

Detecting Predatory Lenders

Presumably, financial institutions try to avoid being linked with the word "predatory." Such a stigma would be hard to erase, and the institution would be intensely scrutinized by regulators and others, potentially resulting in consumer lawsuits that might force the company to shutter its mortgage-lending operation.

Despite the risks of running such an operation, predatory lending continues. In part, this is because a majority of total residential mortgage originations occur outside the realm of federal- and state-regulated financial institutions. Mortgage brokers, for instance, are typically licensed and examined by state agencies, but the degree of monitoring varies from state to state. At the federal level, the Federal Trade Commission, an entity charged with enforcing numerous federal antitrust and consumer protection laws, has oversight responsibility for mortgage brokers and other nonbank lenders.

Much of the information about and awareness of subprime lenders, therefore, comes from annual reports produced by the U.S. Department of Housing and Urban Development (HUD). Since 1993, HUD has identi-

Defining Predatory Lending

In general, predatory lending refers to the actions of unscrupulous mortgage lenders and brokers in taking advantage of poor, elderly, and unsophisticated borrowers. Here are some lending terms and practices typically considered predatory:

Excessive or unnecessary interest rates, points and fees, or insurance
Asset-based lending or equity stripping: lending without regard for the borrower's ability to repay the loan
"Packing" a loan with concealed or unwarranted products and fees
Financing fees, charges, or insurance as part of the loan
"Flipping" a loan by repeatedly refinancing it, charging further fees
Balloon payments
Negative amortization
Increased interest rate after default
Certain prepayment penalties; modification fees; mandatory arbitration clauses
Deceptive or overly aggressive marketing tactics; engaging in fraud
Broker fees tied to interest rates

fied lenders who appear to specialize in subprime lending. The list is primarily compiled from industry trade publications and HMDA data analyses.[3] HUD cautions against assuming that these lenders carry out predatory activities, and adds that its selection process is not systematic, leaving room for error and omissions. Regardless, many groups use the list as a starting point when attempting to uncover lenders in the predatory market. The table on the facing page shows HUD's count of subprime lenders for the past nine years.

Attempts to Rein in Predatory Lending

Given the infrastructure of mortgage lending today, local legislatures and regulators have been making their own attempts at limiting predatory practices. They strive for a delicate balance. If the scales are tipped too heavily in one direction with rigid regulations, legitimate subprime products could be eliminated. Some lenders might move out of particular geographic areas, crimping the availability of subprime credit. But if the scales are tipped too much in the other direction, the most vulnerable borrowers could become victims of lending scams and abuses.

Across the country, various legislatures and regulatory groups have taken different stances on the issue, resulting in a patchwork of rules and regulations. Financial institutions and mortgage lenders have criticized this hodgepodge of regulations, claiming the rules hurt the borrowers they intend to assist. So far, about a dozen states and 10 cities have laws and regulations (some pending) against predatory lending.

States have generally attempted to limit predatory lending by expanding the requirements of the federal Home Ownership and Equity Protection Act (HOEPA). HOEPA, along with HMDA, the other relevant federal regulation, have recently been revised to allow for better tracking of subprime lending activity, among other aims. (For summaries of HOEPA and HMDA, see the sidebar "Federal Regulations" on page 6.) States make HOEPA more stringent either by lowering the terms that trigger a high-cost loan , thereby requiring additional disclosures, or by classifying additional practices as predatory.

> Subprime lenders have been found to target people in particular communities and groups, regardless of their ability to qualify for better loans.

The effects of these laws vary by state, and have been interpreted differently. The Center for Responsible Lending estimates that North Carolina's anti-predatory law saved borrowers $100 million in total abusive lending costs in its first year of operation (the law was passed in 1999). It reports that the new law did not result in a mass exodus of subprime lenders from the state. It claims North Carolina ranked sixth highest among the 50 states for subprime activity by the end of 2000. Other sources, however, such as the Mortgage Bankers Association, attribute a major lender's 2001 exit from the subprime market to stricter state anti-predatory lending laws, including North Carolina's.

The Georgia Fair Lending Act (GFLA), as first issued, seemed likely to be an example of the mortgage industry's claim that firmer regulation would restrict credit overall. But the law was recently amended, and outcomes of the revised law remain to be seen. When the GFLA became effective in October 2002, it was the strictest anti-predatory law in the nation. Two specific provisions of the GFLA were especially tough. The first provision was "pass-through liability." This meant that liability for violations of the law moved with ownership of the loan, from mortgage lenders to loan servicers to investors in mortgage-backed securities. The second provision concerned penalties for violations of the law. These provisions had unintended consequences. Numerous mortgage lenders either restricted their lending activities in Georgia or withdrew outright from the state. Many of those that continued lending increased rates and fees to compensate for greater risks. In addition, lack of competition within the state may have led to increased mortgage costs.

Credit-market tightening spread outside the state as well. Standard & Poors stopped assigning credit ratings to asset-backed securitizations that included conforming mortgages originated in Georgia because it said it was unable to assess the risks. Fannie Mae and Freddie Mac stopped purchasing high-cost loans originated in Georgia. Fortunately, the growing liquidity drought was halted in March 2003, when Georgia's governor signed an amendment to the law, eliminating the detrimental provisions.

In addition to action at the state level, cities from Oakland to New York City have passed local ordinances intended to curtail predatory lending. The scope of these ordinances varies, but many take the approach used in New York City. The city establishes what it considers to be a predatory loan and then prohibits the city from doing business with lenders who originate those loans nor with the investment firms with which they are associated.

What's Next

Industry and consumer advocates are currently squaring off on federal legislation called the "Responsible Lending Act of 2003," introduced in February by Representatives Robert Ney, R-Ohio, and Ken Lucas, D-Kentucky. Consumer groups argue the legislation intends to preempt all local action against predatory lending without taking significant steps to end the practice. Industry groups argue that they cannot continue operating with different sets of rules in different places, and cite Georgia as a case study. Cities are not waiting to express their concerns. City Councils in Boston and Bridgeport, among a few others, have passed resolutions opposing federal preemption.

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1. Household settled a suit alleging predatory lending practices brought by a group of attorneys general and regulators from more than two dozen states on October 11, 2002. Citigroup settled a case brought by the Federal Trade Commission (FTC) that alleged predatory lending practices by the Associates, a lender purchased by Citigroup in November 2000 and merged into the CitiFinancial unit. Household and Citigroup settled their cases without admitting any wrongdoing in the amounts of $484 million and $215 million, respectively. The $215 million settlement is the largest in FTC history.
2. Information in this paragraph (and HMDA statistics in the prior one) are from a speech on predatory lending made by Federal Reserve Governor Gramlich before the Housing Bureau for Seniors Conference on January 18, 2002. The speech is available at www.federalreserve.gov/boarddocs/speeches/2002.
3. This information was collected from the website, www.huduser.org/datasets/manu.html. HUD used a number of HMDA analyses to screen potential subprime lenders. First, HUD assumed subprime lenders typically have higher denial rates and lower origination rates than prime lenders. Second, HUD assumed that home refinance loans generally account for higher shares of subprime lenders' total originations than prime lenders' originations. To verify this belief, HUD then called the lenders or reviewed their web pages to determine if they specialized in subprime lending. A large number of lenders told HUD they offer subprime loans, but that these loans do not constitute a large percentage of their overall conventional mortgage originations. In cases where lenders offered both prime and subprime loans, HUD identified lenders as subprime lenders if they reported at least half of their conventional originations as subprime loans. This criteria eliminated some lenders who have very large (but not chiefly) subprime businesses. Most lenders identified themselves as primarily a subprime or a prime lender.

Federal Regulations

Home Ownership and Equity Protection Act (HOEPA)

In 1994, Congress passed the Home Ownership and Equity Protection Act (HOEPA) in an attempt to curtail loan abuses stemming from excessive costs. When the law passed, one of the biggest misconceptions was that HOEPA abolished high-cost loans. HOEPA does not eliminate high-cost loans or make them illegal. HOEPA was implemented as part of Regulation Z, Truth in Lending, which establishes four requirements for these types of loans:

* First, HOEPA establishes two separate thresholds for determining what type of loan is considered a high-cost loan. One trigger is the annual percentage rate (APR), and the other is the amount of points and fees.
* Second, if a loan is determined to be high cost, the lender must provide written notice informing the borrower of a mortgage on his home, and of the possibility that the borrower could lose his house.
* Third, if high-cost provisions are triggered, certain loan terms are not permitted. These include balloon payments, negative amortization, prepayment penalties, increased interest rate after default, and rebates made by a method less favorable than the actuarial method.
* Fourth, three practices are not permitted with these types of loans: (1) making asset-based loans, (2) directly paying loan proceeds to home-improvement contractors, and (3) selling or assigning the loan without providing a notice informing the purchaser or assignee that the loan is subject to "special rules under the Truth in Lending Act."

In 2001, the Federal Reserve Board amended Regulation Z to broaden the scope of loans subject to HOEPA's regulatory protections. The Board adjusted the two triggers that define high-cost loans: APR and points and fees. It lowered the APR threshold for first-lien loans from 10 percentage points over the rate of a Treasury bond of comparable maturity to 8 percentage points. (The trigger for subordinate lien loans remained at 10 percentage points.) In addition, the Board amended the method of calculating points and fees. The new regulation classifies optional single-premium credit insurance as a fee that must be included in the calculation of total points and fees. The amendments, which became effective on October 1, 2002, also prohibit these loans from being refinanced within a one year period.

Home Mortgage Disclosure Act (HMDA)

The Federal Reserve Board also amended Regulation C, which implements the federal Home Mortgage Disclosure Act (HMDA). The focus of the amendments (effective January 1, 2004) is to allow for more effective collection and monitoring of subprime and potential predatory lending trends. The changes require lenders to collect additional data for potential high-cost loans. The amendments:

* set thresholds for determining the loans for which financial institutions must report loan pricing data. Institutions must report loan-pricing data if the rate spread (the difference between the APR on a loan and the yield on comparable Treasury securities) equals or exceeds 3 percentage points for first-lien loans or 5 percentage points for subordinate-lien loans.
* require lenders to report the lien status of applications and originated loans.
* require lenders to ask applicants their ethnicity, race, and sex in applications taken by telephone. (This became effective January 1, 2003.)