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...
to 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.

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fied lenders who appear to specialize in subprime lending. The list is primarily compiled from industry trade publications and HMDA data analyses. HUD cautions against assuming that these lenders carry out predato-

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

ry 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 expand-

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.

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 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 & Poor’s 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 oper-
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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’ origination. 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.)