

Draft: March 19, 2005

**Are Legislative Solutions to Abusive Mortgage Lending Practices  
Throwing Out the Baby with The Bath?  
Guidance From Empirical Research**

George Wallace<sup>\*</sup>  
Gregory Elliehausen<sup>\*\*</sup>  
Michael Staten<sup>\*\*\*</sup>

---

<sup>\*</sup> Executive Director, Center for Statistical Research, Alexandria, Virginia.

<sup>\*\*</sup> Senior Research Scholar, Credit Research Center, McDonough School of Business, Georgetown University, Washington D.C.

<sup>\*\*\*</sup> Professor and Director of the Credit Research Center, McDonough School of Business, Georgetown University, Washington, D.C.

## Abstract

Subprime mortgage lending is controversial. Its critics see excessive prices, unfair terms and "predatory" practices. Proponents see a much narrower set of problems. Legislative and regulatory solutions to perceive problems are being implemented piecemeal across states and even local jurisdictions. Unfortunately, little careful empirical work has been done to identify either extent of the alleged abuses or the costs of proposed reforms.

This article presents new evidence about how the subprime mortgage market works. It suggests that legislative "reform" efforts in some cases are reducing availability and raise the price of legitimate loans to subprime borrowers without stopping the abuse and fraud the critics decry. It also suggests that a focus on increased deceptive practices enforcement rather than significant new controls on loan terms and pricing will do less harm than the proposed reforms, while also more effectively stopping the fraud and abuse motivating reform.

After reviewing a major "model bill" that has provided a template for reform proposals across the country, the article weighs the databases available for empirical research on subprime lending. The paper then presents a profile of subprime borrowers and subprime loans to see who is using subprime credit, examines subprime loan pricing and performance to identify evidence of market failure that would justify strong regulatory intervention, and presents new evidence on the actual effect that reform legislation has had on the availability and pricing of mortgage credit in North Carolina, where "reform" was enacted in 1999. The paper concludes with a discussion of the policy implications of this new empirical evidence.

# **Are Legislative Solutions to Abusive Mortgage Lending Practices Throwing Out the Baby with The Bath? Guidance From Empirical Research**

## **I. Introduction**

The availability of mortgage and home equity loans to borrowers with blemished credit histories, high debt levels and irregular incomes (i.e., “subprime” borrowers) has soared over the past decade. Subprime mortgage lending is reported to have risen from \$34 billion of originations in 1994 to over \$500 billion in 2004.<sup>1</sup> One source indicates that subprime originations in 2004 accounted for about 18% of all mortgage originations in the United States.<sup>2</sup>

Subprime mortgage customers are primarily households for whom the cost of mortgage credit is significantly higher (from one or two hundred to several hundred basis points) than the prevailing “prime” rate in the conventional mortgage market.<sup>3</sup> One hallmark of the market that has evolved to meet the needs of these borrowers is the application of more flexible underwriting standards and loan contracts than those observed in prime markets.<sup>4</sup> This means that subprime

---

<sup>1</sup> Mortgage Statistical Annual (supply full citation).

<sup>2</sup> *Inside B&C Lending*, (citation).

<sup>3</sup> A blemished credit history is just one attribute that can tag a borrower as subprime. Weak collateral value, high loan to value, unstable income or job history, or heavy credit or support obligations can all affect a creditor's perception of likelihood of repayment. No single standard has gained widespread acceptance as the "bright line" test of subprime credit. For example, banking regulatory agencies generally designate a subprime borrower as having one or more of the following credit history characteristics: two or more 30-day delinquencies in the past 12 months; one or more 60-day delinquencies in the last 24 months; a collection-related legal judgment, foreclosure, repossession or account charge-off in the past 24 months; bankruptcy in the previous 5 years; a high default probability as measured by a Fair Isaac Co. (FICO) credit score of 660 or below; or a debt-service-to-income ratio of 50% or greater. Others view such factors as FICO scores below 680 as a factor leading to a subprime classification, while still others focus more on income stability, budget room to maintain payments, and collateral value, usually in conjunction with credit history.

<sup>4</sup> “Lenders use standards (payment-to-income ratios, loan-to-value ratios, and credit history) to limit credit and prepayment risks. Because FHA lending standards are more lenient than prime lending standards, wealth-and income-constrained borrowers are more likely to use FHA mortgage financing. Subprime financing is even less strict than FHA financing with respect to maximum front-end and back-end payment-to-income ratios. . . In total the mortgage market has the ability to provide mortgages for a wide range of borrowers, as lenders use a variety of approaches to compensate for weaknesses of an application. This flexibility is most visible in subprime lending,

loan contracts tend to contain features not typically found in prime mortgage contracts (for example, prepayment penalties; balloon payments). Another characteristic of subprime loans is that they have a higher market share among low-to-moderate income households, as well as minority households, than is the case in the overall mortgage market.<sup>5</sup>

The higher pricing of subprime loans, the high market share of subprime lenders in low-income and minority neighborhoods, and higher credit risk of subprime loan customers has elevated concerns by consumer activist groups and regulators about the performance of loans and the incidence of allegedly abusive lending tactics and contractual features. Civil rights advocates have made clear that they consider highly suspicious any lending in minority neighborhoods at subprime interest rates, or on terms that are less advantageous to the borrower than conventional terms.<sup>6</sup> Civil rights enforcement agencies have, with increasing frequency, opened investigations of subprime lending, and in various ways suggested that a higher proportion of minorities than non-minority borrowers in a subprime portfolio, relative to the population, might be a sign of discriminatory lending practices.<sup>7</sup>

---

where credit scores and down payments can compensate for unverifiable income and high debt ratios.” Anthony Pennington Cross, *Subprime Lending in the Primary and Secondary Markets*, 13 *Journal of Housing Research* 33 (Issue 1, 2002).

<sup>5</sup> Glen B. Canner, Wayne Passmore and Elizabeth Laderman, *The Role of Specialized Lenders in Extending Mortgages to Lower-Income and Minority Homebuyers*, *Federal Reserve Bulletin* 718-719 (November, 1999). The Department of Housing and Urban Development Office of Policy Development and Research has likewise done a national study using HMDA data that finds similar results. Randall M. Scheessele, *Black and White Disparities in Subprime Mortgage Refinance Lending*, (Office of Policy Development and Research, Department of Housing and Urban Development 2002), Figure 8-9. In addition, there have been a large number of studies done by or on behalf of activist groups that tabulate HMDA data to identify geographical patterns in subprime lending. A national study was done for the Center for Community Change, which describes itself as a Progressive activist group. Calvin Brandford, *Risk or Race? Racial Disparities and the Subprime Refinance Market* (May, 2002)(prepared for and published by the Center for Community Change at [www.communitychange.org](http://www.communitychange.org)). Similar studies have been done using state or city HMDA data. See, e.g., Consumers Union, *Minority Subprime Borrowers* (October 2002) (found November 2002 at <http://www.consumersunion.org/pdf/au-minority-rpt.pdf>).

<sup>6</sup> See, e.g., California Reinvestment Committee, *Predatory Lenders Feed on the Poor, Seniors and People of Color* (November 29, 2001)( press release); Calvin Bradford, *Risk or Race? Racial Disparities and the Subprime Refinance Market* (May, 2002).

<sup>7</sup> HUD's Office of Fair Housing and Equal Opportunity has generally indicated that the studies showing higher subprime lending in minority communities raise significant suspicions of discrimination. U.S. Department of Housing and Urban Development, *Fair Lending* (web page found on January 8, 2003 at

Beginning in the mid to late 1990s, critics of subprime lending claimed that subprime lending was responsible for high rates of foreclosure in low-income communities and that much of this foreclosure activity was the result of "predatory lending".<sup>8</sup> Although abusive lending has yet to be precisely defined, a consensus has developed -- at least in governmental circles -- that it almost always involves fraud, misrepresentation or manipulation which results in a borrower obtaining a mortgage loan that is, in some way, unsuitable or overpriced.<sup>9</sup>

How frequently do these abusive practices occur and where do they occur? Advocates of legislation strengthening regulation of the subprime market claim they occur frequently. But what is surprising is the lack of statistically representative data which demonstrates a widespread pattern of abusive practices. Allegations that abusive tactics were being targeted at consumers in lower income, minority and elderly communities rely almost entirely on studies of geographic differences in prime as opposed to subprime lending that were prepared by community activist groups and by researchers in the Department of Housing and Urban Development. These geographic studies have found a pattern in which minorities and the elderly use subprime

---

<http://www.hud.gov/offices/fheo/lending/index.cfm>). The United States Department of Justice's Civil Rights Division has moved against a few subprime lenders alleging discriminatory practices in subprime mortgage lending arising from disparities in pricing or treatment of protected classes. See *Hargraves v. Capitol City Mortgage Corp* (D.D.C. Civ No. 98-1021)(complaint); *United States v. Delta Funding Corp* (E.D. N.Y. CV 00 1872)(settlement agreement). The pattern or practice of allowing salesmen or brokers to charge minority subprime mortgage borrowers more in points and fees than non-minorities was attacked in three cases. *United States v. Fleet Mortgage Corp.* (E.D.N.Y. CV 96 2279)(settlement agreement); *United States v. Huntington Mortgage Co.* (N.D. Ohio)(settlement agreement); *United States v. Long Beach Mortgage Company* (C.D. Cal. 96-6159)(settlement agreement). Related claims have been made in an automobile sales finance case. *Cason v. Nissan Motor Acceptance Corp.* (M.D. Tenn. No. 3-98-023)(amicus brief).

<sup>8</sup> Much of the early impetus for reform came from legal aid lawyers defending low-income borrowers facing foreclosure. Community activist groups, responding to perceived community instability and dislocation occurring when a significant portion of low income community owner occupied housing was involved in the foreclosure process, joined the call for reform. See, e.g., NTIC, *Preying on Neighborhoods: Subprime Mortgage Lenders and Chicagoland Foreclosures* (May, 2000); Abt Associates Inc., *Analysing Trends in Subprime Originations and Foreclosures: A Case Study of the Atlanta Metro Area* (February, 2000).

<sup>9</sup> See, e.g., U.S. Department of Housing and Urban Development and U.S. Department of the Treasury, *17-18 Curbing Predatory Home Mortgage Lending: A Joint Report* (June, 2000).

mortgage credit more often than other groups of borrowers.<sup>10</sup> Of course, such findings, as some of the researchers involved have recognized, do not in and of themselves demonstrate that anything is wrong in the subprime market. It is widely accepted that higher risk borrowers rightly pay higher credit prices, and studies of geographic patterns of subprime lending generally do not explore whether those who obtained subprime loans could qualify for cheaper prime or near prime credit. In other words, higher use of subprime loans by minorities, the elderly and borrowers with lower incomes may simply reflect other factors impacting creditworthiness of these populations, such as asset accumulation, size of income, income stability, and so on.

In the absence of statistically representative data on the features of subprime loan contracts and the subsequent performance of loans in neighborhoods, critics have relied almost entirely on anecdotal examples from a relatively small number of cases (in which borrowers undoubtedly had suffered hardship) to argue that subprime borrowers generally are at risk and need protection in the form of new laws and regulations.<sup>11</sup> “Predatory” tactics allegedly targeted at borrowers in these neighborhoods include loan attributes that the consumer advocates have long urged be barred from the credit marketplace: repeat refinancings (called “flipping”); “excessive” rates and fees which lead to “equity stripping”; and lending without regard to ability to repay (with the intent to foreclose and seize the property).<sup>12</sup> The activists’ proposals for reform typically involve restrictions on these loan attributes.

---

<sup>10</sup> U.S. Department of Housing and Urban Development, *Unequal Burden: Income and Racial Disparities in Subprime Lending in America* (April, 2000). This study summarized a number of studies in individual cities, including Atlanta, Los Angeles, New York, Baltimore and Chicago.

<sup>11</sup> U.S. Department of Housing and Urban Development and U.S. Department of the Treasury, 17-18 *Curbing Predatory Home Mortgage Lending: A Joint Report*, 18-25 (June, 2000).

<sup>12</sup> *Id.* at 21-22.

Critics of subprime lending see much of it as overpriced and offered on "unfavorable" terms.<sup>13</sup> They also see the hardship cases that have been featured in legislative hearings as only the tip of the iceberg. And they believe that regulation of the type they propose will have predominantly beneficial effects. That is, they maintain that regulation will force credit to be available at lower interest rates and on more favorable terms. It will prevent, or at least significantly reduce the incidence of, fraudulent or abusive lending practices. Where regulation does reduce credit availability, only "predatory loans" will be cut out of the market.<sup>14</sup>

Lenders see a quite different picture. They argue that subprime lending provides a significant benefit by expanding mortgage credit opportunities to underserved borrowers, many of whom are minorities and recent immigrants.<sup>15</sup> They see the hardship cases which have been brought to public attention as infrequent occurrences, usually the result of fraudulent practice by specific sales personnel. Moreover, familiar with the competition for borrowers they experience day-to-day, they see most subprime mortgage loan rates and terms as market-driven either by the borrower's creditworthiness and legitimate creditor efforts to manage risk, or by the borrower's needs -- either for an affordable monthly payment, lower interest rates, or flexible repayment terms.

More significantly for the long term, lenders see the regulation the critics have proposed as both ineffective and counterproductive. First, they question whether the proposed regulation will significantly combat the actual conduct which causes the hardship cases the critics have

---

<sup>13</sup> Kenneth Temkin, Jenifer Johnson and Diane Levy, Subprime Markets, *The Role of GSEs and Risk-Based Pricing* (March, 2002)(paper prepared for U.S. Department of Housing and Urban Development Office of Policy Development and Research) 19-20.

<sup>14</sup> See, for example, website of Center for Responsible Lending Reform ([www.responsiblelending.org](http://www.responsiblelending.org)) and its discussion of the impact of anti-predatory lending legislation in North Carolina.

<sup>15</sup> Indeed, a Federal Reserve study found that subprime lending increased the number of mortgage loans to low-income and minority borrowers. Glenn B. Canner and Wayne Passmore, "The Role of Specialized Lenders in Extending Mortgages to Lower Income and Minority Borrowers," *Federal Reserve Bulletin*, vol. 85 (November 1999), pp. 709-723.

emphasized. Second, they contend that the regulation will seriously curtail credit availability to lower income and minority borrowers, in conflict with the goal of making credit as widely available as possible. Lenders urge that the real hardships that some subprime borrowers have experienced are best prevented by case-by-case deceptive practices enforcement. Several recently announced settlements with major subprime lenders suggest that at least some government leaders are aggressively pursuing such enforcement, with considerable effect.<sup>16</sup>

In short, the critics of subprime lending see a significant failure in the marketplace, characterized by excessive prices, unfair terms and "predatory" practices, and requiring drastic intervention through legislation which they see as having only beneficial effects. Proponents of subprime lending see a much narrower set of problems occurring in the context of a legitimate, efficient marketplace that otherwise provides significant benefits to most borrowers at an appropriate price, with significant curtailment of those benefits and/or increase in prices occurring if the critics' regulatory proposals are adopted.

The resulting public policy debate -- fueled by such legislative tactics as calling much of subprime lending "predatory" -- has increasingly lost sight of the fact that there is little disagreement over ultimate goals. Most critics and most suppliers of subprime loans agree that credit should be available to as many borrowers as possible.<sup>17</sup> Likewise, many agree that it

---

<sup>16</sup> Enforcement actions under the Fair Housing Act: *Hargraves v. Capitol City Mortgage Corp* (D.D.C. Civ No. 98-1021)(complaint); *United States v. Delta Funding Corp* (E.D. N.Y. CV 00 1872)(settlement agreement). Enforcement action under the Federal Trade Commission Act: *FTC v. Associates First Capital Corp.* (N.D. Ga. Civ. No. 1:01-CV 00606 JTC)(settled for \$215 million payment to consumers in September, 2002); *FTC v. First Alliance Mortgage Co.* (C.D. Cal. Civ. No. SACV 00-964)(settled for \$60 million in payments to consumers in March, 2002); *United States and State of Illinois v. Mercantile Mortgage Co., Inc.* (N.D. Ill.)(settled July, 2002); *FTC and State of Illinois v. OSI Financial Services Inc.* (N.D. Ill. Civ. No. 02 C-5078). State Attorney General Task Force enforcement actions: *State Attorney Generals v. Household Finance* (not filed; settlement announced October 11, 2002)(\$484 million to be paid to consumers). *State of Wisconsin Department of Justice, States Reach Settlement with Household Finance Corporation; Mortgage Lender Agrees to Pay \$484 Million in Consumer Refunds* (October 11, 2002) (<http://www.doj.state.wi.us/news/nr101102.asp>).

<sup>17</sup> See, for example, Testimony of Ellen Seidman, Director, Office of Thrift Supervision before the Committee on Banking and Financial Services, U.S. House of Representatives (May 24, 2000)(<http://www.ots.treas.gov/docs/87077.html>).

should be priced by the marketplace to reflect actual risk of the borrowers. Major terms and conditions of the credit should be understood by the borrower, and should provide flexibility so that the credit product can be configured to provide the mixture of price and repayment terms that best suits the borrower's desires and needs. There is also complete agreement that abusive and fraudulent practices should be effectively combated, although there is disagreement over what conduct should be viewed as "abusive" and "fraudulent".

The real disagreement is over the facts: how well the subprime market is working and the impact of some of the regulatory efforts recently implemented. The wide disparity in perception reflects a basic reality about subprime lending. Although lending to borrowers who do not qualify for "prime" credit has a long history in this country, subprime *mortgage* lending in its present form is only a decade old, and little careful empirical work has been done to identify its benefits and costs.<sup>18</sup>

This article takes a step toward filling the empirical void. It presents new evidence about how the subprime mortgage market is working using a unique database that has not heretofore been available. These new data strongly suggest that legislative "reform" of the type advocated by the critics of subprime mortgage lending will reduce availability of "good" subprime credit to higher risk borrowers without stopping in a significant way the abuse and fraud the critics decry. In many cases, these borrowers may also have low incomes and may also be minorities, the very groups about whom proponents of reform are most concerned. In contrast, a regulatory approach that focuses on increased enforcement of deceptive practices rules will have significantly less negative impact on credit availability than would restrictive, market-wide limits

---

<sup>18</sup> "Despite the recent growth in the subprime mortgage market, little is known about subprime borrowers, their default experience, or subprime lenders' underwriting practices". Lawrence L. Thompson, Foreword to Kenneth Temkin, Jenifer Johnson and Diane Levy, *Subprime Markets, The Role of GSEs and Risk-Based Pricing* (U.S. Department of Housing and Urban Development, Office of Policy Development and Research, March, 2002), at iii.

on loan terms and pricing. It will also be more effective at stopping episodic fraud and abuse than the broad changes in regulation of loan pricing and terms that the critics have proposed.

In Section II below we begin by reviewing the types of reform proposals have been widely advanced in state and local jurisdictions across the country in order to gauge the nature and extent of the impact they could have on the mortgage market. Section III examines the mortgage lending databases available for empirical research on subprime lending, including a unique new database (the AFSA Subprime Database, described in detail below). Section IV presents a profile of subprime borrowers and subprime loans, using data from both the AFSA Subprime Database and the Federal Reserve Board Surveys of Consumer Finances. Section V examines subprime loan pricing and performance to identify any apparent market failure that would justify drastic regulatory intervention of the type proposed. Section VI examines evidence from North Carolina where reforms were passed in 1999 to determine the impact of such laws on the availability of mortgage credit, particularly for lower income and minority borrowers. The paper concludes with a discussion of the policy implications of this new empirical evidence.

## **II. The "Reform" Proposals**

*Existing Regulatory Options* As of the mid-1990s, there were four existing models for legislative action to respond to abusive and deceptive mortgage lending practices. First, legislation could effectively ban high cost loans by imposing relatively low rate ceilings and limits on points and fees. Of course, economic analysis has shown that rate ceilings restrict the

supply of credit, which would conflict with the general policy in favor of making credit available to lower income and minority borrowers.<sup>19</sup>

Second, for nearly one hundred years, licensing of lenders coupled with relatively moderate restrictions on prices, terms and practices had been the preferred way to regulate lenders that were not depository institutions and which predominantly lent to lower and moderate income borrowers. Licensing lenders has traditionally been a function of the states, and most states have licensing and regulatory schemes covering mortgage lending.<sup>20</sup>

Deceptive practices laws provide a third regulatory tool, since abusive lending typically arises from fraud, misrepresentation and abuse. Deceptive practices laws include both section 5 of the Federal Trade Commission Act,<sup>21</sup> which proscribes unfair and deceptive practices, as well as state deceptive practices laws enforced by Attorney Generals and private causes of action.<sup>22</sup>

A fourth approach was introduced by the federal Home Ownership and Equity Protection Act of 1994 ("HOEPA").<sup>23</sup> HOEPA established a regulatory scheme, filled out by Federal Reserve Board regulations, which imposes special Truth in Lending Act disclosures and restrictions on contract terms of "high-cost" mortgage loans that are priced over a certain "threshold".<sup>24</sup> The substance of the disclosures and restrictions are set by the Federal Reserve Board pursuant to regulation.<sup>25</sup> In effect, this fourth regulatory approach deems "high-cost" loans as more likely to be associated with abusive tactics and contract features than other loans,

---

<sup>19</sup> See, for example, the report of the National Commission on Consumer Finance, *Consumer Credit in the United States*, (Washington: U.S. Government Printing Office, 1972), Chapter 7.

<sup>20</sup> According to the National Association of Mortgage Brokers, only 4 states do not require a company originating a mortgage loan to have a license. National Association of Mortgage Brokers, *Model States Statute Initiative*, 15 (June, 2002).

<sup>21</sup> 15 U.S.C. §45.

<sup>22</sup> For a general survey of these laws, see National Consumer Law Center, *Unfair and Deceptive Acts and Practices*, Appendix A (5th ed. 2002).

<sup>23</sup> 15 U.S.C. §1601 ff.

<sup>24</sup> *Id.*; 12 C.F.R. § 226.32(a).

<sup>25</sup> 12 C.F.R. § 226.31 - .34.

and so deserving of tighter restrictions than would be the case for lower-priced loans.<sup>26</sup>

Currently, a high cost loan subject to regulation under HOEPA must exceed one of two independently operating credit cost thresholds. The threshold is exceeded (1) if the annual percentage rate of a subprime mortgage loan at consummation exceeds by more than 8 percentage points for a first lien mortgage and 10 percentage points for a second lien the yield on U.S. Treasury securities of comparable maturity as of the 15th day of the month prior to the one in which the loan is originated; or (2) if the points and fees charged on the loan exceed 8% of the amount financed or \$400, whichever is greater.<sup>27</sup>

**Activist Groups Push a Modified, Tougher HOEPA-style Approach** Claiming that HOEPA was too weak to address the widespread incidence of abusive lending, activist groups (most notably the Association of Community Organizations for Reform Now, “ACORN,” and the American Association of Retired Persons, “AARP”) have urged that states and localities adopt significantly more stringent restrictions on pricing, terms and practices in subprime mortgage lending.<sup>28</sup> They have mounted strong legislative initiatives at the local, state and

---

<sup>26</sup> In developing recent amendments to these regulations, at least one Federal Reserve Board member has expressed concern about the impact on credit availability of too stringent regulation and the resulting need to strike a balance between restrictive regulation and availability of credit. Edward M. Gramlich, the Federal Reserve Governor who directed the 2000-2001 revision of the HOEPA regulations has stated that "The [amendments to the HOEPA regulation adopted in 2001] are a measured response that balances various concerns, so as not to impede the growth of the legitimate subprime mortgage market...Regulatory changes alone cannot solve the problems associated with predatory lending." Remarks at the 25<sup>th</sup> anniversary of the Neighborhood Reinvestment Corporation and the NeighborWorks System, Washington, DC, August 18, 2003.

<sup>27</sup> 12 C.F.R. § 226.32(a).

<sup>28</sup> See ACORN, *Predatory Lending: ACORN's Campaign Against Predatory Lending* (downloaded January 7, 2003 from <http://www.acorn.org/acorn10/predatorylending/campaign.htm> (copy in author's files); Mike Calhoun, Margot Saunders, Elizabeth Renuart, Mark Benson & Sharon Hermanson, *Home Loan Protection Act: A Model State Statute* (November 2001)(found on September 2, 2002 at <http://research.aarp.org/ppi>)(hereafter, "AARP Proposal). Other groups have had less frontal involvement, such as the National Fair Housing Alliance, which has published a study of Texas subprime lending and discrimination, and NAACP which sponsored a speech at the 2002 National Convention on predatory lending. See National Fair Housing Alliance, *Study: Race and Ethnicity Play Key Factor in Sale of High-Cost Refinance Loans in Texas; Blacks and Hispanics Targeted by High-Cost Lenders*; Texas'

national levels, with some success.<sup>29</sup> These legislative initiatives propose to regulate much or all of subprime mortgage lending stringently, with each initiative following a common regulatory

---

Midsize Cities Top List. (found January 7, 2003 at

[http://www.nationalfairhousing.org/html/archives/texzs\\_study.htm](http://www.nationalfairhousing.org/html/archives/texzs_study.htm)); Mike Snyder & Andrew Guy Jr., *Predatory Lending Tactics Mushrooming*, *Houston Chronicle*, July 12, 2002 (report of speech by Paul D. Young, counsel for plaintiffs in a New York class action claiming 'predatory lending' at NAACP National Convention)

<sup>29</sup> Sixteen states adopted statutes or regulation increasing the regulation of subprime lending in the three years ending in September, 2003. The legislation takes two directions. Three states passed tighter mortgage broker and banker licensing regulation. N.C. SB 904, Sess. Law 2001-393 (enacted August 23, 2001; effective July 1, 2002); Okla H.B. 2009 (enacted August 5, 2002); Conn. S.B. 231, Pub. Act 02-111 (enacted June \_\_, 2002). Fourteen states adopted substantive regulation of lending practices. This regulation ranges from the extremely stringent as adopted in the District of Columbia, Georgia, Illinois, New York and North Carolina to significant regulatory changes that are fairly moderate, as passed in California, Connecticut, Florida, Maryland, Michigan, Ohio and Pennsylvania, to minor legislative changes such as those passed in Virginia and Minnesota. Colo. HB 1259 (effective July 1, 2003); Conn. :HB 6131, Pub. Act 01-34 (enacted June 7, 2002; effective October 1, 2002); Calif. AB 489 (enacted October 10, 2001; effective June 1, 2002); District of Columbia L 14-132 (enacted 3-6-2002); Florida SB 2262 (enacted October 2, 2002); Ga. HB 1361 (effective October 1, 2002); 38 Ill. Reg. §345.10 to 345.150 (adopted April 17, 2001; effective May 17, 2001); MD HB 649 (enacted May 16, 2002); Michigan HB 6121, Pub. Act No. 660 of 2002 (enacted December 23, 2002); Minn. SF 2988 (enacted April 17, 2002; effective January 1, 2003); N.Y. HB 11856 (enacted October 3, 2002; effective April 1, 2003); N.C.G.S. §24-1.1E (effective July 1, 2000); Ohio HB 386 (enacted February 22, 2002; effective May 24, 2002); Pa. SB 377 (enacted June 25, 2001); Va. HB 2787 (enacted March 22, 2001). Since September of 2003, two states have additionally adopted stringent regulation. Home Loan Protection Act, New Mexico Senate Bill 449 (effective January 1, 2004); N.J.S.A. § 46:10B-1 ff. (effective November 28, 2003). As the result of an initiative strongly supported by ACORN, certain cities have adopted ordinances some of which closely follow the model of the AARP Proposal (discussed in greater detail below). There are two approaches used in these ordinances. The first, typified by an ordinance adopted by Chicago, defines certain loans over a rate and points and fees threshold as a special category, and then forbids the City from contracting with any company that makes such loans. Municipal Code of Chicago §§ 2-32-440, 2-32-455 (August 20, 2000). The other approach, either standing alone or in combination with the first, is to adopt regulatory provisions more or less similar to those in the AARP Proposal. Cities in Pennsylvania, California and Ohio have taken this approach. Philadelphia, Pennsylvania, Bill No. 000715-A (enacted April 19, 2001), Oakland, California, Ordinances 12361, 12362 (enacted July 24, 2001); Los Angeles, California, Ordinance 01-1476 (enacted December 18, 2002); Toledo, Ohio, Ordinance 291-02 (enacted November 6, 2002); Cleveland, Ohio, Ordinance No. 737-02 (enacted February 14, 2002); Dayton, Ohio, Ordinance No. 29990-01 (enacted July 11, 2001); DeKalb County, Georgia, Code of DeKalb County, Georgia, ch 2, art. III, §2-130 ff. (enacted June, 26, 2001); and City of Atlanta, Georgia, Code of Ordinances of the City of Atlanta, §§2-324, 2-965, 2-1213, 2-1623, 58-100 (enacted September 5, 2001). The effectiveness of the ordinances in Philadelphia, Oakland and Dayton were stayed by agreement between the parties pending resolution of the legal issues. [ ] The Philadelphia ordinance was subsequently preempted specifically by state statute, Pa. SB 377 (enacted June 25, 2001), as were the Ohio ordinances, Ohio HB 386 (enacted February 22, 2002; effective May 24, 2002). However, in Ohio, the preemption was attacked as unconstitutional. A trial court dealing with the Cleveland ordinance agreed that the preemption was unconstitutional, and that case is on appeal. In California, a state statute was adopted after the Oakland ordinance was adopted, but was silent about preemption. A trial court resolving a challenge to the Oakland ordinance on the basis that it was beyond local authority power ruled in favor of the ordinance. *American Financial Services Association v. City of Oakland*, Case No. 2001 027338 (Calif. Superior Court, Alameda County (February F. 2002)(Notice of Appeal). The decision was affirmed by the intermediate appellate court, *American Financial Services Association v. City of Oakland*, Case No. A100258 and A097784 (Calif. Court of Appeal, 1st Div, October 24, 2003), and leave to appeal to the California Supreme Court was granted December 24, 2003. The Atlanta and DeKalb County ordinances were enjoined from enforcement on the ground that regulation of mortgage lending is a state function and local governments do not have the power to regulate it. See *American Financial Services Association v. Dekalb County*, Civ. Action No. 01-8038-9 (Superior Court, Dekalb County November 2, 2001); *AFSA v Atlanta*, Civ. Action No. 44824 (Superior Court, Atlanta County, October 30, 2002). In any event,

pattern that was initially established by HOEPA.<sup>30</sup> First, as with HOEPA, "high cost loans" are defined by reference to either a threshold annual percentage rate, or a level of points and fees charged on the loan. Such loans priced "above the threshold" are then subject to special regulatory provisions. These regulations sharply restrict contractual terms to which the parties can agree as well as penalize credit-granting decisions that are not relatively conservative. Sometimes there are provisions that restrict the pricing and terms even of prime mortgages. Enforcement often relies upon new and ambiguous liability rules, reinforced by new private causes of action which can be enforced in class actions.<sup>31</sup>

**The AARP Model** The most prominent of the various "model" bills is that promoted by the American Association of Retired Persons ("AARP") with support from the National Consumer Law Center and ACORN. This approach has strongly influenced legislative enactments or regulations adopted in a number of states, including Georgia, New Mexico, New Jersey and North Carolina,<sup>32</sup> and continues to be a guide for advocates of stringent regulation as they

---

the subsequent Georgia state legislation specifically preempted local government efforts to regulate mortgage lending. Ga. HB 1361 (effective October 1, 2002). The Los Angeles ordinance has been stayed by agreement pending the decision in the City of Oakland case. The effectiveness of the Toledo ordinance has been challenged, and the matter is pending in the Ohio courts.

<sup>30</sup> "Model" regulation has been proposed by AARP and the National Consumer Law Center, and these proposals have clearly been the model for many of the more aggressive legislative proposals. See AARP Proposal (co-authored by National Consumer Law Center staff). The American Financial Services Association, an association of over 350 consumer credit grantors, also proposed a model regulatory statute. American Financial Services Association, State Fair Lending Act (2001). That National Association of Mortgage Brokers has proposed a model licensing act which focuses on better education and stronger regulation of mortgage bankers and brokers. National Association of Mortgage Brokers, Model State Statute Initiative (2002).

<sup>31</sup> It has been suggested that the overall effect of the critics' proposals, which are significantly more restrictive than the federal HOEPA rules, is to impose a "stealth" rate ceiling on subprime mortgage lending. See testimony of Columbia University finance professor Charles W. Calomiris, "What to Do and What Not to Do about 'Predatory Lending,'" Testimony before the U.S. Senate Banking Committee, July 26, 2001.

Available at [www.aei.org/news/filter.economic.newsID.17103/news\\_detail.asp](http://www.aei.org/news/filter.economic.newsID.17103/news_detail.asp) (September 22, 2003).

<sup>32</sup> GS § 7-6A-1ff (effective October 1, 2002, amended restricting scope and removing liability for assignees, effective March 7, 2003); Home Loan Protection Act, New Mexico Senate Bill 449 (effective January 1, 2004); N.J.S.A. § 46:10B-1 ff. (effective November 28, 2003); N.C.G.S. §. 24-1.1E, 24-10/2(b)(effective in part November 1, 1999, effective in part July 1, 2000).

prepare bills for introduction in state and local legislative bodies.<sup>33</sup> The approach incorporates the basic structure of HOEPA, but varies from it in significant detail.

A detailed table in the Appendix compares the significant features of current HOEPA and the AARP proposal. Part A of the table first looks at the regulation's coverage and scope. Surprisingly for a proposal nominally aimed at high priced loans, the AARP proposal would impose extensive new regulation on prime loans. Part B looks at these restrictions on prime loans -- in terms of the Proposal's structure, loans that are "below the threshold". Part C of the Table then looks at the regulation imposed on loans "above the threshold" -- the "high cost" loans presumed to carry a higher likelihood of abusive practices. Finally, Part D compares HOEPA's and the AARP Proposal's enforcement provisions. Enforcement is important because many lenders have complained that the sweeping and sometimes vague liability rules incorporated in the AARP Proposal combined with very strong sanctions for violations, including assignee liability and punitive damages and attorneys' fees, seriously impairs their ability to raise capital in the secondary market -- capital they need in order to make loans.

There are several important differences between HOEPA and the AARP proposal. First, the AARP proposal regulates far more mortgage loans than the HOEPA proposal. As already discussed, HOEPA covers only mortgage loans that exceed either an annual percentage rate or a

---

<sup>33</sup> A number of cities and counties have also experimented with adopting local ordinances which contain provisions closely derived from the AARP Proposal. These have been attacked as beyond the constitutional power of municipalities and other subdivisions of several states, although a definitive outcome of these claims in the state courts has not yet occurred. Decisions of lower and intermediate courts range from those finding preemption and those that do not. Compare *The Mayor of the City of New York v. The Council of the City of New York*, 2004 WL 235043 (N.Y. Supp. January 26, 2004)(preemption found) and *The City of Dayton, Ohio v. The State of Ohio*, Montgomery County Ohio Court of Common Pleas, Case No. 02-CV-3441 (August 27, 2003)(preemption found) with *American Financial Services Association v. City of Oakland*, Case No. A100258 and A097784 (Calif. Court of Appeal, 1st Div, October 24, 2003)(preemption not found)(appeal to California Supreme Court granted December 24, 2003).

points and fees threshold; it also exempts purchase money loans and open end loans.<sup>34</sup> For first mortgages, the annual percentage rate threshold is 8 percentage points over U.S. Treasury securities of comparable maturity; for subordinate loans it is 10 percentage points over comparable Treasuries. The HOEPA points and fees threshold is 8 points or \$400, *whichever is greater*.

In contrast, the AARP proposal imposes significant new regulation on *any purchase money or non-purchase money closed end or open end mortgage loan* -- prime or subprime -- regardless of a threshold, and it imposes a more stringent level of regulation on loans over the high cost threshold.<sup>35</sup> Moreover, it lowers the annual percentage rate threshold (relative to HOEPA) down to 6 percentage points over an index for first mortgages and 8 percentage points for subordinate mortgages, and uses 5-year Treasury securities as the index. HOEPA uses Treasuries with *comparable maturities* to the loan as an index. In the last few years, 5-year Treasuries have carried rates significantly lower than the longer maturity Treasuries comparable to the common 15-year or longer maturity of many subprime mortgage loans. This change in index further lowers the threshold relative to HOEPA. The points and fees threshold used by the AARP proposal is also significantly lower than the HOEPA threshold. It categorizes as over the threshold any loan for less than \$30,000 that charges, in effect, more than \$900 in points and fees<sup>36</sup> and any loan over \$30,000 if it charges more than 3 points. It also defines what is counted

---

<sup>34</sup> HOEPA exempts any purchase money loan, as well as open end loans and reverse mortgage transactions. 12 C.F.R. § 226.32(a).

<sup>35</sup> See Appendix A, Table 1, Part A.

<sup>36</sup> The threshold for loans under \$30,000 is 6% or \$900, whichever is the *lesser*. The use of the "lesser" of the two factors (HOEPA uses the "greater" of a dollar amount or percentage of the loan amount) means that in all loans for an amount over \$15,000, the \$900 figure will control. Six percent of \$15,000 is \$900. Up to 2 "bona fide" discount points are excluded from the transaction. A "bona fide discount point" is in fact stringently defined, so as to exclude any point charged except for interest rate buydown, and must be "recouped", apparently in interest savings, within the first 4 years of the loan.

as points and fees much more expansively than under HOEPA, broadening coverage even further.

Moreover, apparently small differences in wording between the AARP proposal and HOEPA turn out to have potentially large effects. Although the AARP proposal exempts from "points and fees" up to "two (2) bona fide discount points",<sup>37</sup> the definition of what is a bona fide discount point restricts this category to very limited application and actually turns it into what is, in effect, a price ceiling. The proposal requires that an exempt discount point must be only for the purpose of lowering the interest rate on the loan below a "benchmark" rate (a term which is not defined, introducing considerable ambiguity), and the resulting interest savings must lower the monthly payment by enough so that the borrower will, over the first 4 years of the loan, recover the points paid. If the common prime mortgage rule-of-thumb for an interest rate buydown is used (i.e., one point paid at closing will reduce the interest rate charged for the loan by one quarter percent or 25 basis points), the requirement to recoup the discount points within 4 years will never be met. In effect, the interest rate must be reduced by at least 35 basis points for one point paid at closing in order to qualify as a "bona fide discount point" under the AARP proposal.<sup>38</sup>

The effect of this provision is to regulate prices for credit, in this case, the price for a rate reduction (commonly known as an interest rate buydown) by imposing heavier regulation on lenders who do not offer a better-than-current-market-rate for such buydowns.<sup>39</sup> Thus under the AARP proposal, any loan that charges more than 3 points in "points and fees" -- which can

---

<sup>37</sup> AARP Proposal, §2(b).

<sup>38</sup> For example, in a loan with a principal amount of \$30,000 with a "benchmark rate" of 10%, the monthly payment will be \$322.38. A 25 basis point reduction in interest rate will reduce the payment to \$317.81, or a monthly payment savings of \$4.57, equaling a total payment reduction of \$219.49 over 48 months or 4 years. That will be insufficient to cover the \$300 or one point paid to obtain the payment savings. A 35 basis point reduction will reduce the monthly payment to \$315.99, for a savings over 4 years of \$306.87, or enough to cover the \$300 or one point paid for the reduction.

<sup>39</sup> See note \_\_\_ *infra* and accompanying text.

frequently occur even with a prime, conventional mortgage priced at current market rates if there are significant closing costs -- or that charges 3 points plus 1 point for a quarter percent rate buydown, will exceed the threshold and be subject to the higher level of regulation reserved for "high cost loans". It is easy to see how this sort of regulation begins to operate as a rate ceiling for any lender trying to avoid the expense and exposure to liability of making what the AARP proposal designates "high cost loans".

A second major point of difference between HOEPA and the AARP proposal is the stringency of the regulation imposed. The HOEPA regulation of loans over the HOEPA threshold is extensive, but it pales in comparison with the AARP proposal. Review of the table in the Appendix quickly makes clear that on virtually every point, the AARP proposal is far more restrictive, but two examples illustrate. One of the most controversial provisions of the AARP proposal is the requirement that refinancing borrowers receive a "reasonable, tangible net benefit to the borrower", as determined by the trier of fact, whether judge or jury, in later litigation.<sup>40</sup> There is a presumption that a refinancing loan is *not* beneficial if the primary benefit is a lower interest rate on the new loan under which it would take more than four years to recoup the cost of the fees and points.

Lenders have argued that provisions like these relying on vague or convoluted standards of liability leave them subject to expensive litigation of unsure outcome if they try to foreclose on a refinanced loan. The borrower can claim that the loan did not produce a net benefit on virtually any ground, and with the wisdom of hindsight (after all, the borrower has been unable to repay), a jury or other trier of fact may well agree. Consequently, it could be argued that this provision essentially makes reliance on the real estate security of the loan problematic in

---

<sup>40</sup> AARP Proposal § 3(b). The provision calls the practices it prohibits "flipping", but the name appears to add nothing to the substance of the provision. It is apparently used to gain advantage in lobbying the proposal.

assessing the risk the loan presents, since the ability to foreclose will be severely restricted. The fact that the AARP proposal imposes a cure period and significant restrictions on foreclosure procedures as well only reinforces this argument.<sup>41</sup> *The provision applies to prime as well as subprime loans.* But even if it applied only to subprime loans over the threshold, lenders argue it would still be of significant concern, since it would make this category of loan, recognized to carry greater credit risk than prime loans, even more risky if the real estate security could not be realized upon reliably.

A less complicated example involves balloon loans. Balloon loans are regulated by both HOEPA and the AARP proposal. HOEPA forbids balloon loans unless the loan maturity is longer than 5 years, and it also exempts all bridge loans. The AARP proposal does not exempt bridge loans and flatly forbids all balloon payments in any loan.<sup>42</sup>

A ban on balloon payments may sometimes put a borrower at a disadvantage. Depending on capital market conditions, it is not uncommon for a lender to obtain cheaper capital to fund mortgage loans if the loans are for a shorter period of time. Sometimes underwriting standards can be somewhat more relaxed, as well, if the period of time for which the investor is at risk is shortened, say, to five years. However, few borrowers are prepared to make a monthly mortgage payment large enough to pay the loan off in a five-year time period. The balloon loan is a device used to capture this pricing or underwriting advantage and still meet borrower needs, in this case for a reasonable monthly payment. In a balloon loan of this type, the loan payments are set up as for a longer maturity loan so they can be affordable, but the loan is payable in full in a shorter period to satisfy investor constraints. For example, a borrower may be offered a loan for five years with payments set to amortize the loan over 20 years. There is nothing sinister in this

---

<sup>41</sup> See Appendix A, Table 1.

<sup>42</sup> AARP Proposal §4(c).

arrangement as long as the borrower understands that in five years, the loan will have to be refinanced either with this lender or another, or paid off in full, and that the cost of a refinancing at that point may reduce the financial benefits the loan otherwise provides.<sup>43</sup> Nevertheless, the AARP proposal forbids balloon payments on all loans.

Over and above the substantive provisions, HOEPA and the AARP proposal vary significantly with regard to how they are enforced and how third party purchasers of loans are treated. Once again, a review of the table in the Appendix will provide a fuller picture, but certain points are worth stressing.

First, virtually any violation of any provision of the AARP proposal results in exposure to liability provisions that are extremely friendly to class actions and under which large damages are recoverable against the lender, including punitive damages and attorneys' fees. For example, for an unintentional violation, all interest the loan would have earned had it been carried to maturity, plus 10% of the original principal is recoverable by the borrower.<sup>44</sup> For intentional violations, no matter how minor, the whole loan becomes void.<sup>45</sup> Under HOEPA, there is liability for violations under the standard provisions for Truth in Lending, and also enhanced liability for any "material" violation.<sup>46</sup> Class action liability is possible, but overall both the exposure to class action liability and to damages is very much less under HOEPA than under the AARP provisions.<sup>47</sup>

Second, third parties are subjected to a much larger range of liability under the AARP proposal than under HOEPA. The AARP Proposal makes virtually any assignee subject to the

---

<sup>43</sup> Sometimes refinancing will provide a financial benefit, either because interest rates have decreased by the time refinancing is necessary or the borrower's credit history or repayment ability have improved.

<sup>44</sup> AARP Proposal §7.

<sup>45</sup> Id.

<sup>46</sup> 15 U.S.C. §1640.

<sup>47</sup> Compare 15 U.S.C. §§1640, 1641, 1639(j) with AARP Proposal §7.

borrower's ability to assert any violation as an offset to the liability on any prime or subprime mortgage loan, and for manufactured home or home improvement loans, the assignee becomes affirmatively liable for anything the original seller would have been liable for.<sup>48</sup> Moreover, if the loan is over the AARP threshold, the assignee takes subject to any affirmative claims the borrower can make against the original creditor or broker.<sup>49</sup> In contrast, under Truth in Lending, assignee liability is quite restricted. For HOEPA loans, assignees are liable to defenses based on liability for HOEPA violations, but not affirmatively liable.<sup>50</sup>

The overall pattern that emerges is clear. The AARP proposal imposes very significant restrictive regulation on all mortgage lending, whether prime or subprime. Those restrictions go far beyond what present regulation imposes.<sup>51</sup> Since the AARP proposal covers prime as well as subprime loans, it by definition regulates far more loans than anyone has seriously suggested may involve abusive practices or terms. Furthermore, it sharply lowers the thresholds and then very stringently regulates subprime loans over those thresholds, far more stringently than current regulation. Yet, so far, persuasive empirical evidence has not been presented that many or most subprime loans involve the types of abuse at which the AARP proposal is supposedly aimed.

Some have suggested that stringent regulation of subprime loans over a threshold combined with sweeping liability provisions operates in effect as a rate ceiling, discouraging all but the most determined (some would say foolhardy) lender from making loans over the threshold. One major rating agency for subprime loan securitizations has reported, after

---

<sup>48</sup> AARP Proposal §6.

<sup>49</sup> AARP Proposal §6(b).

<sup>50</sup> 15 U.S.C. §1640(d)(1), (e).

<sup>51</sup> For example, the North Carolina provisions apply only to closed end loans and then most of the provisions apply only to loans that are over the HOEPA threshold, which is incorporated by reference. N.C.G.S. §24-1.1E (effective July 1, 2000). Georgia applies to both closed end and open end loans, but also uses the HOEPA thresholds, not the much lower thresholds the AARP Proposal adopts. Georgia did adopt a very expansive definition of "points and fees" which probably increases coverage significantly over HOEPA. HB 1361 (The Georgia Fair Lending Act) (effective October 1, 2002).

surveying a large sample of subprime lenders, that few if any of them made loans over the HOEPA thresholds.<sup>52</sup> The AARP thresholds are significantly lower, and the regulation and liability exposures are much larger than under HOEPA, fueling speculation that the effect of legislation modeled on the AARP proposal will be equivalent to a low rate ceiling on subprime mortgage loans, with the well known side effects of decreasing credit availability. When Georgia enacted legislation closely derived from the AARP Proposal, the major rating agencies refused to rate bonds containing Georgia prime or subprime loans. The effect was reportedly sharp curtailment of the subprime and prime markets, until the legislature revised the enactment to significantly narrow the scope of the legislation and remove the provision making assignees liable.<sup>53</sup>

Since the AARP Proposal would so significantly change the regulation of mortgage lending, and particularly subprime lending, the obvious questions are does serious marketplace dysfunction justify such significant intervention and what effect will all these changes have on the market for subprime loans and the subprime borrowers who use that market? The next section explores the problems that arise when we try to answer these questions empirically.

---

<sup>52</sup> Mortgage Bankers Association, *In the News, Fitch Ratings Comments on Recent Predatory Lending Legislation*, (January 2, 2003) ([www.mbaa.org/briefs/03/0102b.html](http://www.mbaa.org/briefs/03/0102b.html))(quoting from Fitch Ratings, December 24, 2002). We have found, using the AFSA database (described below), that in Georgia, Massachusetts and North Carolina, three states that adopted regulation derived from the AARP Proposal or a precursor, that subprime lending over the threshold virtually stopped. The North Carolina results are reported in text accompanying note \_\_\_\_, *infra*. See Center for Statistical Research, Inc., *The Impact on Massachusetts Subprime Borrowers and the Massachusetts Economy of Proposed Subprime Lending "Reforms"* (March, 2004).

<sup>53</sup> Georgia Senate Bill 53 (effective March 7, 2003).

### III. The Information Shortfall: A Short Primer on the Available Subprime Databases

A Department of Housing and Urban Development annual survey of subprime lending reports that approximately 868,000 subprime purchase money and refinance mortgage loans were made in 2000 in the United States.<sup>54</sup> In that same year, a joint Department of Housing and Urban Development and U. S. Treasury Department study on subprime lending cited a widely followed mortgage industry publication that reported the dollar amount of subprime lending in 1999 was \$160 billion.<sup>55</sup> Dividing one into another produces the result that the average subprime loan was \$184,000, a surprisingly large *average* loan amount for a market that some argue is "targeted" at the poor, the elderly, and minorities with little economic resources.<sup>56</sup> This loan amount contrasts sharply with the \$62,000 average amount of a subprime loan as reported by the Office of Thrift Supervision in 2000 based on their analysis of a large and proprietary industry

---

<sup>54</sup> The origination number was derived from Home Mortgage Disclosure Act data provided by the Department of Housing and Urban Development as part of the 2000 Subprime List, available at [www.huduser.org/datasets/manu/subprime\\_2001\\_distributed.xls](http://www.huduser.org/datasets/manu/subprime_2001_distributed.xls). For discussion of the representativeness of Home Mortgage Disclosure Act data when used to examine subprime mortgage lending, see discussion accompanying note     , *supra*.

<sup>55</sup> U.S. Department of Housing and Urban Development and U.S. Department of the Treasury, 17-18 *Curbing Predatory Home Mortgage Lending: A Joint Report* 29 (June, 2000)(Table 3.1).

<sup>56</sup> The text compares reported dollar loan volume to reported number of loans in successive years. Loan volume tended to decrease from 1999 to 2000 based on reported HUD statistics for refinance loans. If the number of subprime loan originations in 2000 was about the same or slightly smaller than 1999, the average loan amount would increase or stay the same if 2000 originations were compared to 2000 total dollar amount originated. Randall M. Scheessele, "Black and White Disparities in Subprime Mortgage Refinance Lending," Table B.2 (Office of Policy Development and Research, Department of Housing and Urban Development 2002); Email from Randall M. Scheessele to Andrew Platt, July 10, 2002 (attached document entitled "sub\_2001\_distributed.doc")(source for updated 2000 figure for refinance subprime loans). Results are no less confusing using HUD data exclusively: the average loan amount was \$166,000 for 2001 subprime mortgage lending. The number of subprime loans made in 2001 was provided by the Office of Policy Development and Research at HUD. Email from Randall M. Scheessele, Department of Housing and Urban Development, Office of Policy Development and Research. Total subprime volume amounts are reported in Randall M. Scheessele, Black and White Disparities in Subprime Mortgage Refinance Lending, figure 1 (Office of Policy Development and Research, Department of Housing and Urban Development 2002).

subprime mortgage database (Loan Performance System, formerly known as Mortgage Information Corporation).<sup>57</sup>

In fact, there is no reason to believe that any of these statistics is correct – the 868,000 figure for the number of subprime mortgage loans, the \$160 billion figure for subprime loan volume, or the \$184,000 average loan amount. The fundamental obstacle to doing empirical work on subprime mortgage lending is that there is no comprehensive database of subprime loans. No central collection point captures all subprime mortgage lending activity. Researchers therefore use databases that capture information on some subgroup of subprime loans. There are three main databases.

**HMDA Data** By far the most common data used in various studies of subprime mortgage activity are derived from reports by financial institutions to the government in compliance with the Home Mortgage Disclosure Act (HMDA).<sup>58</sup> HMDA requires that all financial institutions -- essentially depository institutions and bank holding company subsidiaries -- and *some* for-profit mortgage companies report certain information about their residential mortgage lending, whether prime or subprime, to the Federal government. The resulting data are annually compiled and made publicly available.<sup>59</sup>

---

<sup>57</sup> F. Phillips-Patrick, E. Hirschhorn, J. Jones, and J. LaRocca, *What About Subprime Mortgages?* 4 Mortgage Market Trends, Issue 1, at 7 (Office of Thrift Supervision 2000).

<sup>58</sup> 12 U.S.C. §2801 ff. Pursuant to the Act, interpretive regulations have been issued, known as Regulation C. 12 C.F.R. §203.1 ff. Under Regulation C, information is collected only on applications for loans secured by a residential structure, which includes condominiums and cooperatives and mobile or manufactured homes, if the loans are for a home purchase or home improvement purpose. As a matter of administrative interpretation, a refinance loan is treated as falling within the home purchase requirement. The information that must be provided is listed in 12 C.F.R. §203, and includes (1) the date of the loan application, (2) the purpose of the loan, (3) the owner-occupied status of the property, (4) the amount applied for or the amount actually loaned if the loan was actually made, (5) whether the loan was approved or denied and the date of denial or closing, (6) location of the residential property by MSA, state, county and census tract, (7) the race or national origin of the applicant, (8) the gross annual income relied upon for the purposes of the application, and (8) the type of entity, if any, that purchased the loan if the purchase occurs within 1 year of loan closing. The required report format provides for somewhat more information, including whether the loan is a purchase money or refinance, and whether the security property is a manufactured or mobile home.

<sup>59</sup> HMDA website. [www.ffiec.gov/hmda](http://www.ffiec.gov/hmda)

HMDA mandates collection of mortgage application activity data in order to help public officials evaluate how well financial institutions are meeting the housing needs of their communities. Since 1989, covered institutions have been required to report the disposition of each mortgage loan application (both accepted and rejected) as well as the race, sex and income of applicants and borrowers. These data have been used by regulators to identify potentially discriminatory lending patterns. Coverage of mortgage lending institutions has expanded several times over the past decade, so that for calendar year 2003 there were approximately 41 million loan records reported by over 8,000 financial institutions.<sup>60</sup>

However, when used as a source of information about *subprime* mortgage lending activity, the HMDA database has a number of significant difficulties that sharply limit its accuracy and usefulness. Most importantly, the HMDA database does not provide information on loan pricing, many of the loan characteristics, or the risk characteristics of the borrower other than the borrower's income. Of course, since the HMDA loan data capture only application information, there is no information about the borrower's actual repayment (or repayment failure) history on a specific loan. Thus, price and risk, the two factors that define whether a loan is subprime, are not reported. As a result, HMDA data cannot provide accurate information about what loans are subprime nor about whether subprime borrowers are paying more than their risk level warrants.

A product of the civil rights revolution of the 1960s and 70s, HMDA was designed to provide information about whether mortgage loans were available to borrowers based on the geographical location of the property and the borrower's income and race. But, the HMDA loan data are not designed to provide information on subprime mortgage lending as distinct from prime lending, and do not do so.

---

<sup>60</sup> Statistics as reported on HMDA website, [www.ffiec.gov/hmda/history.htm](http://www.ffiec.gov/hmda/history.htm).

Nonetheless, faced with a lack of data about the rapidly growing subprime lending sector, the Clinton Administration's Department of Housing and Urban Development (HUD) tried to re-categorize raw HMDA data so that it could separate subprime from prime loans in order to empirically examine various allegations regarding subprime lending patterns. HUD has made public a number of studies using the methodology.<sup>61</sup> The methodology has likewise been adopted by a number of studies publicized by advocacy groups, which argue for tighter regulation of subprime lending, and a number of academic studies as well.<sup>62</sup> Most of the studies focus on subprime mortgage use by minorities, lower income borrowers, and the elderly. Studies relying on HMDA data dominate the literature presenting empirical information on subprime mortgage lending.

---

<sup>61</sup> Randall M. Scheessele, *Black and White Disparities in Subprime Mortgage Refinance Lending* (Office of Policy Development and Research, Department of Housing and Urban Development 2002); U.S. Department of Housing and Urban Development, *Unequal Burden: Income and Racial Disparities in Subprime Lending in America* (April, 2000).

<sup>62</sup> Abt Associates Inc., "Analyzing Trends in Subprime Originations and Foreclosures: A Case Study of the Atlanta Metro Area" (February, 2000); Abt Associates Inc., *Analyzing Trends in Subprime Originations and Foreclosures: A Case Study of the Boston Metro Area* (February, 2000); ACORN, *The Great Divide 2002: An Analysis of Racial and Economic Disparities in Home Purchase Mortgage Lending Nationally and in Sixty-Eight Metropolitan Areas* (Oct. 1, 2002); Calvin Bradford, *Risk or Race? Racial Disparities and the Subprime Refinance Market* (May, 2002)(prepared for and published by the Center for Community Change, available at [www.communitychange.org](http://www.communitychange.org)); Harold Bunce, Debbie Gruenstein, Christopher Herbert and Randall Scheessele, *Subprime Foreclosures: The Smoking Gun of Predatory Lending?* (undated)(available at [www.HUDuser.org/publications/pdf/brd/12bunce.pdf](http://www.HUDuser.org/publications/pdf/brd/12bunce.pdf)) (uses HUD subprime list of lenders to determine which loans in a database of foreclosed loans derive from subprime loans); California Reinvestment Committee, "Predatory Lenders Feed on the Poor, Seniors and People of Color" (November 29, 2001)(press release); Consumers Union, *Minority Subprime Borrowers* (October 2002)(Texas)(found November 12, 2002 at <http://www.consumersunion.org/pdf/au-minority-rpt.pdf>); Keith Ernst, John Farris & Eric Stein, "North Carolina's Subprime Home Loan Market After Predatory Lending Reform," 4, 11 (obtained on August 15, 2002 from [ww.responsiblelending.org](http://ww.responsiblelending.org).); Daniel Immergluck, "Stark Differences: The Explosion of the Subprime Industry and Racial Hypersegmentation in Home Equity Lending" (2000)(Woodstock Institute Paper); Daniel Immergluck and Marti Wiles, "Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development" (1999)(The Woodstock Institute); NTIC, "Preying on Neighborhoods: Subprime Mortgage Lenders and Chicagoland Foreclosures" (May, 2000); Quericia, Roberto G., Michael A. Stegman, and Walter R. Davis, *The Impact of North Carolina's Anti-Predatory Lending Law: A Descriptive Assessment* (June 25, 2003)(available at [www.kenan-flagler.unc.edu/KI/commCapitalism](http://www.kenan-flagler.unc.edu/KI/commCapitalism)); Keith D. Harvey & Peter J. Nigro, "Do Predatory Lending Laws Influence Mortgage Lending? An Analysis of the North Carolina Predatory Lending Law," *Journal of Real Estate Finance and Economics*, 2004; Keith D. Harvey and Peter J. Nigro, "How Do Predatory Lending Laws Influence Mortgage Lending in Urban Areas? A Tale of Two Cities," March, 2003

Unfortunately, this heavy reliance on HMDA data may well give a distorted view of what is going on. This is because the method HUD developed to modify HMDA data to identify subprime loans was only a rough approximation and changed year by year.<sup>63</sup> Because HMDA does not contain information on loan price or borrower risk, there is no way directly to distinguish prime from subprime loans using HMDA. HUD developed a "guesstimate" method of specifying the loans to be treated as subprime. Since HMDA data provide the name of the lender, HUD developed a list from non-HMDA sources which it claims identifies those lenders that make "predominantly" subprime loans. The list is based on HUD staff inquiries of companies as to whether they were "primarily" subprime lenders, and by asking consumer advocates whether a company was "primarily" a subprime lender.<sup>64</sup> HUD's current articulated standard for identifying a subprime lender is whether 50% or more of its loans are subprime in the estimation of the lender, but even that "standard" has varied over the years as HUD has revised it.<sup>65</sup>

A second and far more serious flaw in the HMDA subprime database arises from HUD's initial segregation of HMDA-reporting *lenders* into prime and subprime categories. Under HUD's approach, once a lender is identified as "subprime" or "prime", *all* of its loans are treated

---

<sup>63</sup> The joint Department of Housing and Urban Development and Treasury study of subprime lending specifically acknowledged these difficulties and suggested that HMDA data reporting be changed to correct these deficiencies. U.S. Department of Housing and Urban Development and U.S. Department of the Treasury, 100-104 *Curbing Predatory Home Mortgage Lending: A Joint Report* (June, 2000). Despite the methodological problems with the HMDA data when used to analyze the subprime market, most authors who use the HMDA database to analyze subprime lending do so without much, if any, qualification of their results.

<sup>64</sup> HUD's method of identifying a "subprime lender" has changed over the years, and HUD has just recently updated its subprime lender list retroactive to prior years. In a statement HUD now provides with its current list of "subprime lenders", HUD points out some of the difficulties with its method of designating a lender as "subprime". "A large number of lenders told us that they offer subprime or manufactured home loans but these loans do not constitute a large percentage of their overall conventional mortgage originations. Most lenders identified themselves as primarily a manufactured home, subprime, or prime lender. In cases where lenders offered both prime and subprime or manufactured home loans, we identified lenders as subprime or manufactured home lenders if they reported that at least 50 percent of their conventional originations were subprime or manufactured home loans." Email from Randall M. Scheessele to George J. Wallace November 25, 2002 (attached document entitled "sub\_2002\_distributed.doc).

<sup>65</sup> *Id.*

as in that category, even though, as HUD recognizes, many of a lender's loans may be in the other category. The result is that a number of subprime loans made by "predominantly" prime lenders (including some very large institutions) are not counted as subprime loans at all, while a number of prime loans made by "predominantly" subprime lenders *are* counted as subprime loans. The degree of the inaccuracy is unknown, but is potentially quite large. Many lenders that are not on the HUD subprime list likely make a significant number of mortgage loans on terms that are directly comparable to those made by lenders on the subprime list. The HMDA subprime database built off the HUD subprime lender list does not capture any of these subprime loans, and the reverse is also true. Conseco's treatment in the HUD subprime list is an example of an inaccuracy that HUD itself has pointed out. Although Conseco was a HMDA reporter until its liquidation, its loans were not included in HUD's subprime lending totals because Conseco was also a large manufactured home lender, and all of its loans were arbitrarily placed in the manufactured home category.<sup>66</sup> HUD could not determine which of Conseco's loans were regular mortgage loans rather than manufactured home loans.<sup>67</sup>

As a result of this type of flaw, no one really knows how many of the loans HUD designates as subprime in fact are subprime. Many of the studies of subprime lending using HMDA data compare the number of "subprime" loans made in neighborhoods with high concentrations of lower income, minority or elderly borrowers to the number of such loans in other communities, in order to test where subprime lending is more prevalent. However, the failure of the HMDA data to accurately identify which loans are subprime and which are prime makes the results of these studies suspect.

---

<sup>66</sup> Id. HUD notes that it excludes any loans that are noted as being sold to one of the Government Sponsored Entities ("GSEs"); i.e., GNMA, FNMA or FHLMC.

<sup>67</sup> Id.

Third, a number of subprime lenders are not included in HUD's subprime list because they do not report under HMDA. HMDA only requires reports from depository institutions, or lenders whose mortgage originations in any one year are more than 10% of their preceding calendar year loan origination volume.<sup>68</sup> A number of mortgage lenders that make subprime loans are excluded from reporting under this standard. For example, until the 2001 HUD subprime list released earlier this year, mortgage loans of Household Finance Corporation ("HFC"), a very large subprime mortgage originator, were not included as subprime because HFC was not required to report under HMDA until that year.<sup>69</sup>

Given all these difficulties with the database, any statistical analyses of *subprime* lending activity derived from the HMDA subprime database cannot be relied upon with confidence.<sup>70</sup> We do not know the extent of the inaccuracy, but it is possibly quite significant. Caution suggests that policy not be formulated based on conclusions drawn from analysis of HMDA subprime data, unless those results can be confirmed using independently derived data.

Some of these failings will be addressed by HMDA data covering 2004 originations, which will be first available to the public in Spring of 2005. The Federal Reserve Board in 2002 revised its regulations implementing HMDA to expand its scope and content, and those changes eventually became effective for reports concerning any originations after January 1, 2004.<sup>71</sup> Under the changes, in 2004 most prime and subprime lenders will be required to report under HMDA, and they will provide interest rate and loan amount information, as well as revised

---

<sup>68</sup> 12 C.F.R. § 203.2(d)(2).

<sup>69</sup> Email from Randall M. Scheessele to George J. Wallace November 25, 2002 (attached document entitled "sub\_2002\_distributed.doc). After a major acquisition, HFC became a HMDA reporting company.

<sup>70</sup> The listing of difficulties with the HUD/HMDA database is not intended to be exhaustive. For example, unless special steps are taken, loans listed in HMDA data may significantly overcount the number of actual loans made, since HMDA reporters who originate the loan in a calendar year must report, as must a reporter that purchases the same loan that year.

<sup>71</sup> 12 C.F.R. §203.1 ff. (as amended February 5, 2002, 67 Fed. Reg. 7222 ff. (February 15, 2002), effective date of amendments extended to January 1, 2004, Board of Governors of Federal Reserve System, Regulation C, Docket No. R-1001 (May 2, 2002)).

racial, ethnic origin and sex information. However, even the revised data will not provide loan performance information or critical information about the past credit history of borrowers, their asset holdings or other characteristics of the loan that affect loan risk.

Given the failings in the currently available HMDA subprime databases, it is troubling that most studies of subprime lending over the past 5 years have relied on the HUD/HMDA database. The most common types of studies are those that claim to find evidence of targeting by subprime lenders based on the borrower's minority status, income or age. For example, several studies using the HMDA subprime database have concluded that minority or elderly borrowers receive subprime loans significantly more frequently than some comparison group, usually comparable non-minority or non-elderly borrowers.<sup>72</sup> Yet, this sort of research design is compromised by the fundamental flaws in the HMDA subprime database.

If one looks closely at these studies, what they show is that certain lenders that are on the HUD subprime lender list tend to have a bigger market share in minority and lower income concentrated neighborhoods than lenders not on the HUD subprime lender list. Since HMDA subprime data has not in the past provided the loan interest rate (price) or any measure of risk, it is not possible to use the data to draw conclusions about how many borrowers in fact obtained subprime loans, or whether borrowers who obtained them could have qualified for prime credit, or whether the prices for the credit they did obtain were appropriately related to the risk they presented.

Nevertheless, some studies based on HMDA data claim significant findings. For example, HUD's analysis, using 2000 HMDA data, suggests "[s]ubprime refinance lending has

---

<sup>72</sup> See, for example, Calvin Bradford, *Risk or Race? Racial Disparities and the Subprime Refinance Market* (May, 2002)(prepared for and published by the Center for Community Change)(found on September 9, 2002 at [www.communitychange.org](http://www.communitychange.org)); California Reinvestment Committee, *Predatory Lenders Feed on the Poor, Seniors and People of Color* (November 29, 2001)(press release).

been *disproportionately* concentrated in neighborhoods where home equity is most likely to be a borrower's principal asset."<sup>73</sup> Critics of subprime lending and advocacy groups have gone farther. They claim that studies based on HMDA data provide evidence that "subprime lending" is definitely targeted on minorities, the elderly and lower income borrowers. However, when their basic data are examined, it turns out that the source is the HMDA *subprime* database, and no matter how one tries, that database will not yield information which supports their conclusions, given the flaws in the underlying data.<sup>74</sup>

Simply put, even if a loan is identified as a "subprime loan" using HUD/HMDA data, it does not follow that the borrower in fact got a high interest rate loan. The reverse is also true. It is quite possible that when a borrower in a lower income neighborhood borrows from a lender HUD treats as "prime", that "prime" lender in fact is offering a subprime loan product. HMDA data do not permit any inference to be drawn as to the interest rate, points and fees or terms borrowers actually receive. HUD denominated "subprime lenders" may make prime loans, and HUD denominated "prime lenders" may make subprime loans -- in fact, we know they do. The lesson to be learned is that unless the shortcomings of the existing HMDA subprime database are

---

<sup>73</sup> Randall M. Scheessele, *Black and White Disparities in Subprime Mortgage Refinance Lending 5* (Office of Policy Development and Research, Department of Housing and Urban Development 2002)(emphasis supplied).

<sup>74</sup> We note here that even if the observation about subprime loan concentration was valid, a perfectly innocuous explanation for the relatively higher frequency of lenders on the subprime list making loans in lower income communities can be hypothesized. Some lenders may have specialized in marketing to poorer borrowers, or to borrowers who are not entirely comfortable dealing with mainstream lenders. Such specialization is not surprising and has been a feature of consumer lending since its development as a widespread phenomenon early in the 20th century. See David H. Rogers, *Consumer Banking in New York*, (New York: Columbia University Press, 1974); Thomas A. Durkin, "A High Rate Market for Consumer Loans: The Small Small Loan Industry in Texas," National Commission on Consumer Finances, *Technical Studies*, Vol. 2 (Washington, U.S. Government Printing Office, 1975). For evidence of preferences for small loan (finance) companies in spite of risk characteristics that would allow bank borrowing, see Gregory E. Boczar, "Competition Between Banks and Finance Companies: A Cross Section Study of Personal Loan Debtors," *Journal of Finance*, 33 (March 1978), pp. 245-258. It has been common knowledge that some borrowers are put off by the formalized and depersonalized approach that many mainstream lenders now use, and that some lenders offer a more personalized approach to overcome that resistance, with positive effect. In any event, it is not at all surprising that these studies found that some lenders were relatively more likely to loan to lower income borrowers and to particular ethnic groups. Nor is it surprising that lenders who are better at marketing to lower income and minority borrowers offer a significant portfolio of subprime loan products, since low income often signals financial vulnerability, past credit problems, higher than average debt, and weaker real estate values.

recognized and acknowledged, researchers can easily reach -- and have reached -- unsubstantiated conclusions, misleading those who would rely upon the "findings" of such studies to formulate policy.

*Alternatives to HMDA Data*

Two other databases with information at the individual loan level have been used by some researchers, the Loan Performance System (formerly Mortgage Information Corporation) subprime database, and the American Financial Services Association subprime mortgage database. Both of these databases were assembled with the cooperation of participating companies that agreed to supply loan-level data on a confidential basis. Loan-level observations from participating companies were pooled to form a database for benchmarking and analysis. Both databases contain several million loans originated over a period of several years.

*Loan Performance System Database:* The Loan Performance System ("LPS") database collects information on prime, Alternative A and subprime (B and C graded) loans. For these purposes, we focus on the B and C loans in the database, since these are generally considered subprime, while Alternative A loans are near prime and far less controversial. The number of loans in the LPS database has grown over the years. It is now reported to cover 3.5 to 3.9 million B & C loans, compiling information from approximately 20 loan securitizers over several years of originations but predominantly 1998 and thereafter.<sup>75</sup> The loan level information in the database includes loan amount, interest rate, borrower FICO score, appraised value of the security property, borrower income and loan quality as well as information on delinquency and foreclosure. There is no information on race, ethnicity, sex or age. Loans are

---

<sup>75</sup> We report the number of B&C loans only rather than Alt A and B&C because the B&C loans are widely recognized as subprime. Alt A, while not prime, are on the edge of prime status and are much less controversial than subprime loans. LPS figures are based on LPS' February, March and September, 2003 Distributions of data. The LPS database classifies loans as B&C based on lender reporting. There may therefore be differences in the determination from one lender to another. The size of the LPS database is growing. As of the end of 1999, The Mortgage Information Corporation subprime database was reported to contain 1.8 million loans with an aggregate face value of \$112 million. F. Phillips-Patrick, E. Hirschhorn, J. Jones, and J. LaRocca, *What About Subprime Mortgages?* 4 Mortgage Market Trends, Issue 1, 5-6 (Office of Thrift Supervision 2000).

located by state of origin and Zipcode. In 2000, the database contained 90% first and 10% second mortgages, while in 2003, the breakdown was 80% first and 20% second mortgages.<sup>76</sup> 40% of the LPS B&C loans were purchase money loans (as opposed to refinancings) in 2003. The average loan size in 2000 was \$78,000, and by 2002 B & C average loan size climbed to approximately \$122,500.<sup>77</sup>

The LPS database is proprietary and its various analytical products are widely purchased within the industry to develop and improve marketing and management decisions. It covers a large number of loans and captures a wide range of information about loan terms, borrower characteristics and loan performance, which makes it initially attractive for social policy research. However, for some kinds of social policy research, particularly that which seeks to track changes in number or loan characteristics over time, the database has limitations. As has been pointed out, the database tracks loans that are *securitized*, not loans that are *originated*. Unless securitized loans have a direct relation to the number of loans originated, the numbers of loans reflected in the database may be the result of lender decisions on how they will fund loans rather than how many loans were actually originated.<sup>78</sup> The number and characteristics of securitized loans tells us only how many of the loans lenders originated they decided to fund through securitization, and the criteria the securitization process imposed. Depending on market conditions in the capital market and individual company balance sheet objectives, it may be

---

<sup>76</sup> The size of the LPS database varies year-by-year and month-by-month as new securitized pools are added and loans are paid off or foreclosed. The Office of Thrift Supervision research staff examined the LPS database in 2000. Fred Phillips-Patrick, Eric Hirschhorn, Jonathan Jones, and John LaRocca, *What About Subprime Mortgages?* (Research and Analysis, Office of Thrift Supervision June 2000). The 2003 LPS information is from the March, June and September 2003 distributions. There are slight differences in numbers of loans reported depending on distribution.

<sup>77</sup> F. Phillips-Patrick, E. Hirschhorn, J. Jones, and J. LaRocca, *What About Subprime Mortgages?* 4 Mortgage Market Trends, Issue 1, 7 (Office of Thrift Supervision 2000)(reports 2000 average loan size). The 2002 information is based on the February, March and September 2003 distributions from LPS.

<sup>78</sup> Litan, Robert E., *North Carolina's Anti-Predatory Lending Law: Still A Problem Despite New Study*, AEI-Brookings Joint Center For Regulatory Studies, Regulatory Analysis 03-9, 8 (September, 2003)(citing data from *Inside MBS&ABS*).

advantageous at any one time to securitize all, some, or none of the loans a company originates. As an alternative to securitization, lenders can instead fund loans using their own funds (funding against portfolio) or sell entire loan pools privately, and they will not appear in the LPS database. This potential difference between the actual number and characteristics of loans lenders are originating and the number and characteristics of loans that are securitized makes it problematic to use the LPS database to examine trends in originations. This defect, however, does not affect the usefulness of LPS data for many other purposes. The LPS database has a wealth of information that describes how the loans performed and the types of borrowers that obtained them.

*American Financial Services Association Subprime Database:* Still another view of subprime mortgage activity can be gleaned from the American Financial Services Association (AFSA) subprime mortgage database. In the summer of 2000, the American Financial Services Association (AFSA) commissioned PriceWaterhouseCoopers (PWC) to collect loan-level data on subprime mortgages from nine AFSA member companies.<sup>79</sup> Originally, the dataset began with loans originated from July 1, 1995 to June 30, 2000. Recently this database was updated to March 31, 2002 and contains information from 10 companies (the "2002.1 database").<sup>80</sup> The loans in the resulting dataset reflect all of the loans originated by the subprime division of each reporting company between July 1, 1995 and March 31, 2002 and are loans secured by residential real estate (either first or second lien). Data include both closed-end loans and open-end home equity lines of credit. Sixty-six percent of loans resulted from the companies' own

---

<sup>79</sup> Eight companies provided the data in the AFSA 2003.2 database. To obtain accurate origination data, data is updated by requesting reporting companies to provide a completely new database going back to July 1, 1995 each time.

<sup>80</sup> The database continues to be updated. Starting in the second quarter of 2003, quarterly collection of data was instituted. For the purposes of this article, however, we have used the database as it was updated to March 30, 2002, since that was the latest database available when the principal research reported in this article was done.

retail originations. The remaining 34% were purchased from other companies and mortgage brokers.

The 2002.1 database principally used for this article includes information on over 2.9 million subprime loans nationally. Most loans are refinance loans. Only 6.7% of closed end loans were purchase money loans. Individual loan records provide the annual percentage rate (APR), the borrower's FICO risk score at the time of application, loan amount, property Zip code, whether the loan is a first or subordinate lien, information on delinquency, foreclosure and write off, prepayment and other information. The average loan amount is \$58,370. Loans originated by reporting companies average \$58,225, while purchased loans average \$58,525. Slightly more than half of the loans originated in 2000 were first liens, and slightly less than half were subordinate, compared to the 90% first, 10% second distribution reported in 2000 for the LPS sample.<sup>81</sup>

**Summary.** The HMDA, LPS and AFSA databases each provide a different snapshot of subprime lending activity. Although they overlap significantly in the loans they capture, each covers loans the other does not reach. For example, we estimate that no more than one quarter of the loans in the LPS database, if that much, are also included in the HUD/HMDA subprime database.<sup>82</sup> We also estimate that approximately 40% of the loans in the AFSA database are also in the HUD/HMDA subprime database, while 60% are not.<sup>83</sup> The LPS and AFSA databases

---

<sup>81</sup> F. Phillips-Patrick, E. Hirschhorn, J. Jones, and J. LaRocca, *What About Subprime Mortgages?* 4 Mortgage Market Trends, Issue 1, 8 (Office of Thrift Supervision 2000).

<sup>82</sup> There is some uncertainty inherent in determining whether the loans that securitizers report to LPS are HMDA reportable and, if so, whether they are captured in the HUD/HMDA subprime list. This is because of several factors, including the fact that a number of reporters to LPS buy loans for securitization. These lenders may purchase from an entity that provides HMDA reports, and that entity could be on the HUD/HMDA list. However, by the time the loan is securitized, the security is issued in the name of the securitizer, an entity not on the HUD/HMDA list. For the purposes of this analysis, we used the January '04 LPS distribution and the 2002 HUD/HMDA list of subprime lenders. All of this further highlights the problem of using company name to identify a subprime loan.

<sup>83</sup> The percentage of loans in the AFSA database that are also reflected in the HUD/HMDA database varies by year. Only approximately 20% of the loans included in the AFSA Q2 2003 database originated in 2000 would be captured

have a partial overlap as well. Taking 2002 as an example, about 37% of the loans originated in that year in the LPS database are also in the AFSA database for that year, while 63% of the AFSA database loans are not found in the LPS information.

Second, with respect to refinance loans, the three databases each contain about the same number of loans. For the years 2000-2002, the HUD/HMDA database contained approximately 2.2 million refinance loans, the LPS database had approximately 1.6 million refinance loans, and the AFSA database had 2.15 million refinance loans.<sup>84</sup> The HUD/HMDA database, however, also contained just under 1 million purchase money loans, about 31% of the total number of HUD/HMDA loans in that period; the LPS database about 405,000 purchase money loans, about 40% of all LPS loans reported for that period; while the AFSA database had about 5% purchase money loans.

Third, the HUD/HMDA, LPS and AFSA databases may each capture a somewhat different type of subprime loan. In general, the AFSA database has fewer first lien loans, smaller loan sizes, and much fewer purchase money loans than the LPS database. It appears to provide a fairly broad picture of the higher risk, higher priced subprime loan market. The AFSA database has a high proportion of second or subordinate mortgage loans. About 40% of the loans in the AFSA database are first liens, and about 60% are subordinate, compared to the 90% first, 10%

---

in the HMDA subprime database based on the HUD 2000 subprime list. This would be true for previous years as well. Because of changes in the list affecting the 2001 data and thereafter, we estimate that about 30% more of the loans in the AFSA database that were originated in 2001 would also be in the HMDA 2001 subprime database. HUD revises its list of "subprime lenders" each year, and in 2001 added Household and Chase/Advanta.

<sup>84</sup> For these purposes, we used the January 2004 LPS distribution to determine the size of the LPS loan pool, the AFSA database updated to the second quarter of 2003 so as to provide accurate reporting for calendar 2002, and the HUD/HMDA subprime loan summary prepared by HUD, for each of the years involved. For the data presented in much of this study, we used the AFSA database updated to the end of the first quarter of 2002, a database which had information from most of the lenders reporting in the database updated to the second quarter of 2003, but with some differences. One large lender provided its data to the 2003 update that was not included in the 2002 update, while three small lenders no longer existed in 2003 as a result of mergers, acquisitions and liquidations. If we compare the relative size of the HUD/HMDA, LPS and AFSA databases using the AFSA database updated to the first quarter of 2002, and compare them based only on 2000-2001 loan volume reported, the HUD/HMDA database provides information on 1.44 million refinance loans, the LPS database provides information on 693,982 refinance loans, and the AFSA database provides information on 1.17 million refinance loans.

second distribution reported in 2000 and approximately 80% first and 20% second distribution reported in 2003 to be in the Loan Performance Systems database.<sup>85</sup> We do not have comparable information about lien status from the HUD/HMDA database, since it did not capture that information during the time period under consideration.

Consistent with a higher risk, higher cost market, the AFSA database loans tend to be smaller than LPS loans. The average loan size of LPS loans is somewhat higher than for AFSA database loans. For example, 2002 B & C originations reported by LPS have an average loan size of approximately \$122,500, while the AFSA database average loan size is approximately \$78,500. In fact, following overall mortgage market trends, the average size of loans has been increasing in the last few years in both the LPS and AFSA databases, although much more rapidly in the LPS databases. For example, in 2000, LPS average loan size nationally was approximately \$78,000 and AFSA database average loan size was \$53,000. Of course, there is no comparable information for HUD/HMDA loans, since the necessary information was not collected during this period.

Of the three databases, the HUD/HMDA database is most problematic. We have already reviewed several issues which raise doubts about how well it reflects subprime lending activity in general. Even more importantly, unless research is focused primarily on the number of loans made to racial and income categories, the database simply lacks relevant information. During the period tracked in this article, it lacked information that would permit close examination of the assets, borrowing patterns, credit-worthiness, interest rate and risk of subprime lending, all relevant to questions raised by critics of subprime lending. The one advantage of the

---

<sup>85</sup> The size of the LPS database varies year-by-year and month-by-month as new securitized pools are added and loans are paid off or foreclosed. The Office of Thrift Supervision research staff examined the LPS database in 2000. Fred Phillips-Patrick, Eric Hirschhorn, Jonathan Jones, and John LaRocca, *What About Subprime Mortgages?* (Research and Analysis, Office of Thrift Supervision June 2000). The LPS information is from the March, June and September 2003 distributions. There are slight differences in numbers of loans reported depending on distribution.

HUD/HMDA data is that it provides information on the application process, which the other two databases do not.

On the whole, the LPS and AFSA databases appear to provide much more useful data than HUD/HMDA for examining the policy issues related to subprime lending. In addition, both the LPS and the AFSA databases provide price, risk and delinquency information, making them more useful than the HMDA subprime database for examining the economics of subprime lending, the degree to which pricing correlates with loan risk, and the responses of lenders to various regulatory efforts to curb abusive lending practices.<sup>86</sup>

As between the AFSA and LPS databases, the AFSA database provides more relevant information to some policy issues. For example, it provides interest rate, point and APR information, while the LPS database provides only the interest rate on the loan.<sup>87</sup> The AFSA database captures the age of the borrower, while the LPS database does not. On the other hand, preliminary investigation of the LPS database suggests that its measures of delinquency and default may be highly sophisticated, and it does provide paper ratings may enable the researcher to identify B and C loans. However, it has widely recognized uncertainties when used to

---

<sup>86</sup> Two features of the AFSA database limit its usefulness for some analyses. First, because a number of participating AFSA companies are not subject to HMDA reporting, the database does not capture information on the borrower's race. This limitation is ameliorated to some degree by the presence of the Zipcode of the property. Segmentation of the sample by zip code supports, for example, some analysis of lending patterns in geographic areas with very high concentrations of minorities or lower income households. The second limitation is that the sample is dominated by a small number of large companies (10 lenders held nearly 3 million loans), compared with 170 – 200 lenders on the HUD subprime list, depending on year. Consequently, although the sample encompasses a sizeable portion of all subprime loans, it reflects the activities of only a small number of lenders. However, it is also true that about 40% of the AFSA sample is comprised of “purchased” loans that were originated by smaller companies or mortgage brokers. Smaller mortgage loan originators sell most of their loans shortly after origination to free up scarce working capital. An important outlet for their subprime mortgages are the larger companies that can raise the necessary funding most cheaply directly from the capital markets, either through securitization or through the bond market based on their own credit. The 1.1 million purchased loans in the AFSA database probably represent a significant amount of the smaller company originations, significantly expanding the range of companies originating the loans captured in the database.

<sup>87</sup> Nominally it also provides information on points, but we have found a high incidence of missing information in this data category.

examine trends in loan origination or borrower characteristics over time, as we have already discussed.

The utility of a database like the AFSA database that contains loan-level pricing information (including the APR) is illustrated by its ability to estimate loan-coverage differences between HOEPA and the AARP proposal discussed in Section II. For example, it is initially relevant in considering proposed legislation such as that presented by the AARP Proposal to know how many more loans it will regulate compared to present law. The AFSA database provides an answer to this question. Considering only closed-end loans, we compared the HOEPA and AARP "threshold" tests for classifying loans as high cost using the loans in the AFSA database originated from July 1, 1995 to the first quarter of 2002.<sup>88</sup> In essence, we calculate the percentage of loans made during the period that would have been classified as "high cost" loans under the HOEPA rules that existed at the time, and under the proposed AARP model legislation had it been in effect. The results indicate that the proportion of first mortgages subject to more stringent regulation would increase about four times, from 18.9% to 77.7%. The proportion of second mortgages subject to more stringent regulation would more than double, from 38.4% to 81.4%.<sup>89</sup> Because neither the HUD/HMDA nor the LPS database captures either

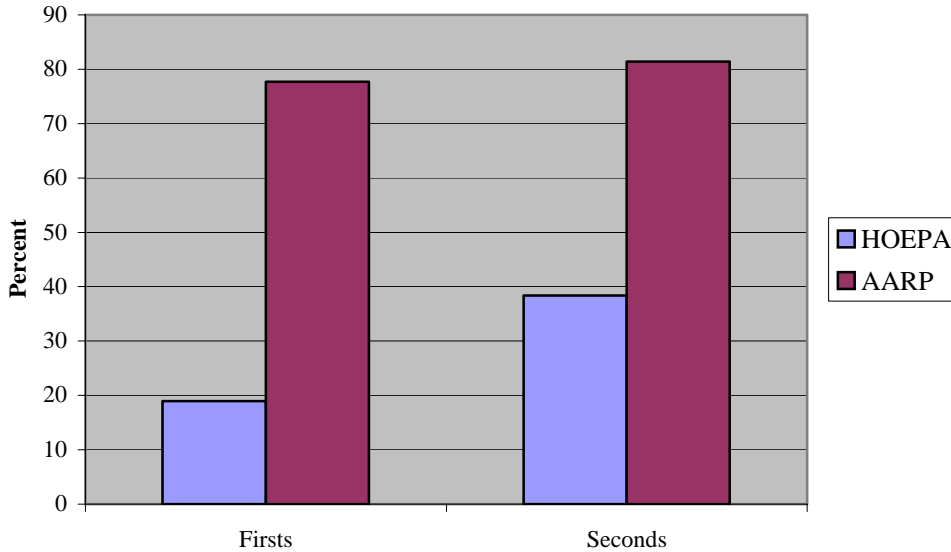
---

<sup>88</sup> The AARP Proposal applies the threshold to the interest rate on the loan, not the annual percentage rate. The AFSA database captures both the annual percentage rate and the interest rate on the loan. The projection of coverage of the AARP Proposal was done using the interest rate; the HOEPA coverage using the annual percentage rate.

<sup>89</sup> It is important to remember that this chart *understates* the difference in coverage between HOEPA and the AARP Proposal. The AARP Proposal in fact regulates all mortgage loans, not just loans over the threshold, in sharp contrast with HOEPA which only restricts loans over a threshold. The chart focuses only on the difference in the percentage of loans that are over the threshold under HOEPA and the AARP threshold. Moreover, the AARP proposal counts considerably more of the fees and charges a borrower pays toward the threshold than HOEPA, resulting in more loans exceeding the AARP threshold than the HOEPA threshold. This difference is not captured because the AFSA database does not provide enough information on the composition of fees to model that distinction.

APR or much point and fee information, neither is suited to this task.

**Chart 1: Subprime Loans Classified as High Cost,  
A Comparison of Revised HOEPA to the AARP Proposal**



Because of its flexibility and focus on the higher risk, higher priced subprime mortgage loan, and particularly the refinance loan, we utilize the AFSA database in the following sections to search for evidence of any apparent market failure that would justify the aggressive regulatory intervention that has been proposed by the critics of subprime lending. Section IV constructs a profile of subprime borrowers and loans. Section V examines the relationship between the pricing and subsequent performance subprime loans to identify any evidence of consistent overpricing. Section VI examines the experience of North Carolina where legislation more restrictive than HOEPA was passed in 1999. The North Carolina experience foreshadows the likely impact of even more stringent regulation like the AARP proposals on the availability of mortgage credit, particularly for lower income and minority borrowers.

## IV. Characteristics of Subprime Borrowers

Because data on subprime mortgage lending are limited, many of the perceptions of subprime mortgage markets and customers are based on anecdotal evidence. Often the anecdotes become known because they involve exceptional cases of deception or abusive practices against financially unsophisticated borrowers. Hence, the generality of such anecdotal evidence is doubtful. In contrast, the AFSA database offers detailed information on nearly three million subprime borrowers and their loans originated from 1995 to 2002. Although perhaps not representative of the *entire* subprime market, the AFSA database contains information on loans that comprise a large part of that market, and particularly the most controversial part of that market, the refinance sector.

### *Income and Age of Subprime Borrowers*

The AFSA database provides information on the income and age of subprime mortgage borrowers, which can be compared with population statistics on mortgage borrowers from the Federal Reserve Board's 2001 Survey of Consumer Finances.<sup>90</sup> The results of this comparison, summarized in Table 1 below, show that nearly all subprime borrowers are in moderate income and relatively young age groups, in which mortgage borrowing is generally prevalent. This finding contrasts sharply with much of the anecdotal evidence, which creates the perception that subprime borrowers are poor or old.

At the outset of any discussion of subprime mortgage borrowers, it is important to emphasize the obvious point, that subprime mortgage borrowers are homeowners. What

---

<sup>90</sup> Ana M. Aizcorbe, Arthur B. Kennickell, and Kevin B. Moore, *Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances*, Federal Reserve Bulletin 1-32 (January 2003)(hereafter, "Ana M. Aizcorbe, Arthur B. Kennickell, and Kevin B. Moore, *Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances*").

discussions of subprime lending often overlook is that the economic circumstances of homeowners differ significantly from those of the general population. First, relatively few homeowners have low income. A bit more than 20% of U.S. homeowners had incomes less than \$25,000 in 2001, compared to nearly one-third of all U.S. households overall (see Table 1). Homeowners are predominately moderate and higher income consumers.

Since only a small percentage of homeowners have low incomes, it is not surprising that relatively few subprime mortgage borrowers have low incomes. Only 2.9% of subprime first mortgage borrowers taking out mortgages between 1997 and 2001 had incomes below \$15,000, and only 15.7% had incomes below \$25,000 (Table 1, column 5). During the same period, even smaller proportions of borrowers obtaining subprime second mortgages (5.5%) had incomes below \$25,000.

Subprime mortgage borrowers are predominately from moderate income households. Forty-eight percent of subprime first mortgage borrowers between 1997 and 2001 had incomes between \$25,000 and \$49,999 (compared to 23.7% of first mortgage borrowers overall), and another 23.1% had incomes between \$50,000 and \$79,999 (compared to 24.1% for all first mortgage borrowers). Among borrowers who obtained subprime second mortgages during the same period, 37% had incomes between \$25,000 and \$49,999 (compared to 25.2% of second mortgage borrowers overall), and another 30.7% had incomes between \$50,000 and \$79,999 (compared to 21.8% overall).

These data belie the common belief that subprime mortgage borrowers are predominantly poor or that subprime mortgage lenders “target” the poor. To be sure, some subprime borrowers have low incomes, but the percentage of low-income borrowers in the subprime market is not

much greater than in the mortgage market overall. Subprime mortgages are primarily a middle-class product.

Relatively few subprime mortgage borrowers are old. Ten percent of subprime first mortgage borrowers and 5.6% of subprime second mortgage borrowers taking out loans between 1997 and 2001 were 65 years of age or older. These percentages are not much different than the proportion of all borrowers taking out new first and second mortgages of any kind during the same period and who were 65 years of age or older (6.4% and 5.2% , respectively).

Indeed, nearly all recent subprime borrowers were young or middle-aged. A large percentage (38.0%) of subprime first mortgage borrowers between 1997 and 2001 were less than 45 years of age. About 52% of both subprime second mortgage borrowers during the same period were less than 45 years of age.

To summarize, these data do not support claims that lenders across the subprime mortgage market “target” the elderly. Like mortgage borrowers generally, some subprime borrower are old. However, as we would expect, subprime mortgage lending is heavily concentrated in age groups in which life-cycle considerations create a high demand for credit. About 71% of subprime first mortgage borrowers and over 80% of subprime second mortgage borrowers between 1997 and 2001 were under the age of 55.

**Table 1. Income and Age of Household Heads, Homeowners, and Mortgage Borrowers, 2001**  
(Percent)

	All households	Home-owners	Has first mortgage	Obtained first mortgage 1997-2001	Obtained subprime first mortgage 1997-2001	Has second mortgage	Obtained second mortgage 1997-2001	Obtained subprime second mortgage 1997-2001
<b>Income</b>								
Less than \$15,000	16.7	9.6	3.6	3.7	2.9	3.1	2.6	0.9
\$15,000-24,999	14.8	12.2	7.7	8.1	12.8	2.2	2.6	4.6
\$25,000-34,999	13.2	11.2	8.4	8.6	18.2	9.7	9.5	11.2
\$35,000-49,999	14.5	14.7	15.7	15.1	29.5	14.4	15.7	25.9
\$50,000-74,999	17.5	21.0	24.3	24.1	23.1	22.1	21.8	30.7
\$75,000 or more	23.3	31.3	40.3	40.4	13.5	48.5	47.8	26.7
All	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
<b>Age</b>								
Less than 25	5.6	1.2	1.6	2.5	0.6	0.0	0.0	1.1
25-34	17.1	12.2	17.3	23.6	10.7	16.9	18.0	17.5
35-44	22.3	22.3	30.8	32.9	26.7	33.1	34.3	33.3
45-54	20.6	23.4	27.8	24.3	32.8	33.1	34.3	29.3
55-64	13.2	16.2	13.7	10.3	18.9	11.0	8.2	13.2
65-74	10.7	13.1	6.9	5.2	8.1	5.8	5.2	4.5
75 or older	10.3	11.6	1.9	1.2	2.2	0.0	0.0	1.1
All	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Sources: Federal Reserve Board, 2001 Survey of Consumer Finances; American Financial Services Association Subprime Mortgage Database.

### **Home Value of Subprime Borrowers**

The home is the largest asset in most households' portfolios.<sup>91</sup> Thus, evidence of the wealth of subprime borrowers is provided by the distribution of their house values. Again, we use distributions for home owners and mortgage debtors from the 2001 Survey of Consumer Finances as a benchmark, and the results are presented in Table 2, below.

Subprime borrowers' homes were not disproportionately among the lowest valued homes. Subprime first mortgage borrowers' homes were about as likely to have a value less than \$50,000 as homes generally, but subprime second mortgage borrowers' homes were much less likely to have a value less than \$50,000 (Table 2). The values of the majority of subprime borrowers' homes, on both first and second mortgages, were between \$50,000 and \$149,999. The majority of all first mortgages and a little more than a third of all second mortgages are also

<sup>91</sup> The median house value of homeowners in 2001 was \$122,000. This amount was 71.1% of these homeowners' median net worth. See Ana M. Aizcorbe, Arthur B. Kennickell, and Kevin B. Moore, *Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances* at 7, 19.

on homes in this range of house values. Thus, most subprime borrowers do not appear to be much richer or much poorer than most mortgage borrowers.

However, subprime mortgage borrowers do borrow more heavily against their houses than mortgage borrowers generally, as shown in Table 3. Only about a fifth of subprime first mortgage borrowers from 1997 to 2001 had loan-to-house value percentages of 70% or less, compared to about half of all first mortgage borrowers during this period (Table 3). Sixteen percent of subprime first mortgage borrowers had “high” loan-to-house value mortgages (loan was 100% or more of house value), which was about twice the frequency of such mortgages among all first mortgages obtained during the 1997-2001 period.

**Table 2. Home Value of Homeowners and Mortgage Borrowers, 2001**  
(Percent)

<i>House value</i>	Home- owners	Has first mortgage	Obtained first mortgage 1997-2001	Obtained subprime first mortgage 1997-2001	Has second mortgage	Obtained second mortgage 1997-2001	Obtained subprime second mortgage 1997-2001
Less than \$50,000	12.3	6.2	5.4	11.3	3.5	3.3	4.5
\$50,000-74,999	12.4	11.6	12.2	21.9	6.9	6.7	9.5
\$75,000-99,999	14.8	14.5	14.5	20.4	10.3	9.4	15.9
\$100,000-149,999	20.1	22.8	21.6	24.1	20.8	20.3	28.3
\$150,000-199,999	12.7	14.2	12.3	11.7	15.2	13.7	17.1
\$200,000-249,999	7.3	8.1	9.4	5.5	11.5	11.8	9.1
\$250,000-349,999	9.2	9.7	9.0	4.3	16.3	18.5	9.2
\$350,000 or more	11.3	13.0	15.6	0.8	15.5	16.4	6.3
All	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Sources: Federal Reserve Board, 2001 Survey of Consumer Finances; American Financial Services Association, Subprime Mortgage Database.

**Table 3. Loan-to-House Value Percentage**  
(Percent)

<i>Loan to house value</i>	Has first mortgage	Obtained first mortgage 1997-2001	Obtained subprime first mortgage 1997-2001
70.0% or less	59.0	49.1	20.8
70.1-80.0%	16.1	19.7	27.5
80.1-90.0%	11.4	13.4	26.0
90.1-99.9%	7.6	10.6	9.9
100.0% or more	5.9	7.3	15.9
	100.0	100.0	100.0

Sources: Federal Reserve Board, 2001 Survey of Consumer Finances; American Financial Services Association, Subprime Mortgage Database.

### **Financial Sophistication of Subprime Borrowers**

We do not have direct evidence on the financial sophistication of subprime mortgage borrowers. However, homeowners in the income groups from which the majority of subprime borrowers are drawn generally have experience with credit. Survey evidence shows that the majority of homeowners with incomes between \$15,000 and \$49,999 had closed-end consumer debt, as shown in Table 4. More than half had bank-type credit cards. Of those having credit cards, the majority revolve credit card balances at least some of the time. Virtually all reported annual percentage rates on frequently used bank cards that suggest that they were aware of the cost of bank card credit.<sup>92</sup> Most consumers in this group also reported that they generally shopped before obtaining credit.<sup>93</sup>

It seems likely that subprime borrowers would have similar credit experience. Indeed one might expect that most subprime mortgage borrowers would have previous credit experience since large percentage have impaired credit histories. However, through misfortune (such as unemployment, illness, or divorce), preference for greater leverage, or simply poor financial management they end up as subprime rather than prime borrowers.

---

<sup>92</sup> Because actual annual percentage rates cannot be verified, researchers using survey methods devised a concept of “awareness zones” to measure knowledge of APRs. If a respondent reports an APR within a range that is deemed as reasonable on the basis of a survey of current market rates, the respondent is characterized as aware. If the respondent reports an answer outside the range or answers “do not know,” he is characterized as unaware. The broad definition used in 2000 allowed for the possibility that the respondent reported a teaser rate. For further discussion, see Thomas A. Durkin, *Credit Cards: Use and Consumer Attitudes, 1970-2000*, Federal Reserve Bulletin, 630-631 (September 2000).

<sup>93</sup> Homeowners in these income groups also have financial assets. Nearly all have a savings account, and a third have an IRA, Keogh, or 401K account.

**Table 4. Financial Characteristics of Recent Mortgage Borrower Income and Age Groups that Disproportionately Use Subprime Credit (Percent)**

	<i>Income</i>			<i>Age</i>		
	\$15,000 -24,999	\$25,000 -34,999	\$35,000 -49,999	35-44	45-54	55-64
<i>Other Credit Use</i>						
Has bank cards	62.1	85.4	83.7	89.2	92.5	80
Hardly ever pays bank card balance in full	32.5	38.2	44.2	29.6	21.5	31.4
Has closed-end consumer instalment debt	50.6	59.4	59.5	62	51.3	51.2
Obtained closed-end consumer instalment credit in last 12 month	15.2	5.8	38.3	18.3	26.2	30.7
<i>Use of credit info.</i>						
Aware of bank card APR						
Broad definition	99.9	95.8	89	94.7	96.2	94
Narrow definition	99.9	95.8	89	90.9	90.5	90.1
<i>Amount of credit shopping</i>						
Little	28.8	25.1	15.2	12.4	12	25.2
Moderate	39.5	37.4	41.1	38.1	42.2	39.2
Large amount	31.7	37.5	43.7	49.5	45.8	35.6
<i>Financial assets</i>						
Has IRA, 401K, Keogh	31.5	49.8	57.2	74.1	75	62.1
Owns stock directly	7.1	18.4	13.5	29.1	29.2	37.8
Has mutual fund	5.3	11.3	15	23.5	29.6	20
Has savings account	88.8	96.6	97.5	98.7	98.5	99

Sources: Federal Reserve Board, 2001 Survey of Consumer Finances; American Financial Services Association, Subprime Mortgage Database; University of Michigan Survey Research Center, January 2000 Survey of Consumer Attitudes.

## **Summary**

Anecdotal evidence creates an impression that subprime lending is concentrated among the poor and the aged. Examination of characteristics of subprime borrowers in the AFSA database, which covers a large part of the subprime mortgage market, suggests that the anecdotal evidence is misleading. The subprime borrowers in the AFSA database are largely young or middle aged and have moderate incomes. The majority of subprime borrowers have moderately valued homes, but they borrow more heavily against their homes than mortgage borrowers generally.

## V. How Closely is Subprime Mortgage Pricing Correlated with Risk?

At the core of the debate over abusive mortgage lending practices and subprime lending is the allegation that many subprime mortgage borrowers are overcharged for their loans. For example, Federal HOEPA regulations use loan pricing as the signal of *possible* abusive behavior that triggers additional restrictions on loans and lenders. Of course, not all subprime loans are abusive, a distinction that Federal Reserve Board officials have made repeatedly.

Community activists have apparently interpreted the observed higher incidence of subprime vs. prime mortgage lending in minority neighborhoods as a signal that these borrowers are being *systematically* overcharged. One recent study on subprime lending patterns in 331 metropolitan areas using HUD/HMDA data, found “widespread” racial disparities in subprime lending across the nation, regardless of income.<sup>94</sup> Specifically, a higher proportion of African American homeowners had subprime mortgage loans in a given geographic area than did white homeowners, regardless of income. The title of a 2000 HUD report, “Unequal Burden: Income and Racial Disparities in Subprime Lending,” also appears to suggest that race and income are responsible for some groups getting less favorable loan pricing than others.<sup>95</sup> Organizations such as ACORN explicitly link abusive lending with the act of targeting higher cost loans at certain categories of borrowers, many of whom would qualify for credit on better terms.<sup>96</sup>

Ironically, the positive aspects of the growth in subprime lending (i.e., increased availability of purchase-money and mortgage refinance loans to minorities and lower-income households) are increasingly overshadowed by the suggestion that, because these higher-priced loans are used more often by vulnerable or protected classes of borrowers, these groups are being

---

<sup>94</sup> Calvin Bradford, *Risk or Race? Racial Disparities and the Subprime Refinance Market*, A Report for the Center for Community Change, Calvin Bradford and Associates, (May 2002).

<sup>95</sup> U.S. Department of Housing and Urban Development, *Unequal Burden in Atlanta: Income and Racial Disparities in Subprime Lending*, (2000).

<sup>96</sup> ACORN. *Separate and Unequal: Predatory Lending in America*, 2 (November 2002).

abused. And, even though the many studies that have observed higher incidence of subprime lending in minority and lower-income neighborhoods seldom offer additional evidence that these borrowers' loans are unfairly priced, the suggestion that they might be has been enough to drive legislative action to curb abusive lending at the state and local level.

### **Prior Studies of Pricing and Risk**

In essence, the critics of geographic lending patterns in the subprime mortgage market allege that price is not sufficiently correlated with risk. In making this claim, the critics often cite a report released in 2000 by research staff at Freddie Mac. The report analyzed the mortgage experience of borrowers who received prime or subprime loans in 1996-1997, and concluded that, "risk is the key element in explaining whether loans are originated as prime or subprime, but we find that borrower's demographic characteristics, knowledge, and financial sophistication also play a statistically and practically significant role in determining whether they end up with subprime mortgages."<sup>97</sup> The report goes on to note that "when comparing interest rates across the [prime vs. subprime] market segments, the higher rates charged by subprime lenders cannot fully be explained as a function solely of the additional risks they bear."<sup>98</sup> By the authors' calculations, subprime borrowers in 1996-1997 received an interest rate on their loans that was

---

<sup>97</sup> Howard Lax, Michael Manti, Paul Raca and Peter Zorn, *Subprime Lending: An Investigation of Economic Efficiency* (unpublished paper, revised version, December 21, 2000)(hereafter, "Lax, Manti, Raca and Zorn, *Subprime Lending: An Investigation of Economic Efficiency*").

<sup>98</sup> Lax, Manti, Raca and Zorn, *Subprime Lending: An Investigation of Economic Efficiency*, at 2. Both Freddie Mac and Fannie Mae have for some time considered entering the subprime market, and have done so at various points in time. Eventually, however, they have withdrawn as the risks -- political and economic -- become apparent. Since both agencies enjoy what amounts to a federal guarantee of their investment securities, they benefit from lower costs of funds than private lenders. Because they are potential competitors of current subprime lenders, their claims that subprime markets could work better may have been influenced to some degree by a desire to obtain political approval to become more active in the subprime market. The authors note that, subsequent to when their sample was drawn in 1997: "... increasing price competition in the subprime sector is likely changing this, enhanced by the recently more aggressive entry of prime market participants. We see a promise, therefore, that future subprime borrowers will benefit from better service and lower rates and fees." p. 20.

about 100 basis points over and above what risk factors alone would have dictated, relative to their counterparts who received prime mortgage loans.<sup>99</sup>

No one likes a creditor that overcharges, particularly when the people being overcharged are vulnerable. Still, although critics of subprime lending have often cited the Freddie Mac report to justify their proposed reforms, its results are not particularly compelling as a rationale for legislative intervention to curb overpricing. The authors admit several limitations on their results. First, they examine only the default risk associated with the borrower in determining the role that risk plays in the pricing of the loan. The calculations do not consider prepayment risk, which has been shown to be substantially higher for subprime borrowers, and which often increases what must be paid in interest to the investor in order to obtain funding for the loans.<sup>100</sup> Nor do they consider higher servicing costs associated with greater incidence of minor delinquencies on subprime mortgages than prime mortgages.

The authors also acknowledge that a borrower's education, knowledge of mortgage alternatives, lack of shopping for the best rates, and willingness to respond to an offer of "guaranteed" loan approval were also important determinants of whether they ended up with a prime or subprime loan. A subprime lender is unlikely to turn away a qualified applicant because the applicant might qualify for a prime loan from another lender. Perhaps even more importantly, the study describes borrowers and loans at a time when the subprime market was rapidly growing and evolving. A recent assessment of both the Freddie Mac analysis and the evolution of the subprime market by economists at the Office of the Comptroller of the Currency ("OCC Paper") concludes that the higher pricing of subprime mortgages that was unexplained by

---

<sup>99</sup> Lax, Manti, Raca and Zorn, *Subprime Lending: An Investigation of Economic Efficiency*, at 18.

<sup>100</sup> Amy Crews Cutts and Robert Van Order, *On the Economics of Subprime Lending* (March 2003)(Appendix Figure 1).

risk factors may actually be attributable to demand having outstripped the supply for subprime mortgage credit in recent years.<sup>101</sup>

In contrast to the Freddie Mac study, a later examination of the issue by the Office of Thrift Supervision research staff also concludes that subprime loan pricing is consistently related to borrower risk. The study used the proprietary database collected by Loan Performance Systems (discussed in Section III) that provided performance information for approximately 1.8 million subprime loans up to the end of 1999. Using the information available in that database, the price of subprime loans was correlated with the delinquency and default experience. Looking at pricing, delinquency rates, and the risk level at which the lender classified the loan using an A-, B, C, and D scoring system, the study concluded that "most of the evidence from the [Loan Performance System] subprime database is broadly consistent with a well-functioning market. Coupon rates, for example, increase steadily as grade and credit scores decline."<sup>102</sup>

The OCC Paper also looked at the available empirical evidence on the correlation of price and risk from a number of sources and concluded that there is no convincing case that subprime mortgage pricing is excessive, or that the market suffers from competitive failure.<sup>103</sup> Reexamining the correlation between pricing and delinquency rates, it concludes that pricing and delinquency experience appear to be closely correlated.<sup>104</sup>

To these findings we now add evidence from the AFSA database. The following discussion and charts focus on the relationship between borrower risk and the loan price (APR), as well as the relationship between the loan price and subsequent loan payment performance. In

---

<sup>101</sup> U.S. Comptroller of the Currency, *Economic Issues in Predatory Lending*, 15-17.

<sup>102</sup> Fred Phillips-Patrick, Eric Hirschhorn, Jonathan Jones, and John LaRocca, *What About Subprime Mortgages?*, 12 (Research and Analysis, Office of Thrift Supervision June, 2000). The study did find that 16% of A- rated mortgages had FICO scores over 680, leading the study to observe that "we cannot determine whether overpricing exists [in the loans with 680 score or higher], but the data certainly raise the issue." *Id.* at 10.

<sup>103</sup> U.S. Comptroller of the Currency, *Economic Issues in Predatory Lending*, 13-17.

<sup>104</sup> *Id.* at 8-10. The OCC Paper used updated data from Loan Performance System (formerly Mortgage Information Corporation) for this aspect of the study.

an efficient, smoothly functioning market, competitive pressures increase the likelihood that consumers can find a loan at the lowest price for which they qualify. Thus, the price for loans rises with measured borrower risk and will be positively correlated with measures of delinquency and foreclosure as loans seasons over time. The AFSA database offers another opportunity to see if this describes the subprime mortgage market in recent years.

### **New Evidence on Loan Price, Borrower Risk, and Payment Performance**

This analysis correlates the prices charged for subprime first mortgage loans in the AFSA database with borrower FICO scores and the delinquency and default experience on those loans.<sup>105</sup> Because mortgage interest rates vary over time with the overall cost of funds, unrelated to underlying borrower risk, the risk “premium” component of the loan price is a relevant focus for the analysis. In the following analysis the risk premium for each loan was calculated as the difference between the loan APR and the yield on U.S. Treasuries of comparable maturity as of date of loan origination.<sup>106</sup> Loans were grouped into pricing categories based on that difference.

---

<sup>105</sup> Although we focus here on delinquency and default costs, we of course recognize that lending involves other risks and costs that must be carefully managed if a lender is to be successful. It is important to note that subprime loans are not just prime loans with a higher price and somewhat more risk. They have a different cost structure. In part this is because subprime loans have higher delinquency and default experience than prime loans. Delinquency increases servicing costs; default losses obviously also raise the cost of providing the loan. Subprime loans also prepay at a different rate than prime loans. They prepay both when mortgage rates fall (like prime loans) but also when a borrower's credit risk profile improves. Prepayment risk raises cost of funds for subprime loans relative to prime loans. Consequently, prepayment risk is an important factor in determining the price investors will pay to purchase subprime loans. Our focus in this section is primarily on delinquency and foreclosure costs because the costs and consequent effect on credit prices associated with the special prepayment risk of subprime loans have not raised the policy issues that price and delinquency and default risks have. Perhaps prepayment risk should raise policy issues. Most of the state-level abusive lending laws proliferating around the country sharply ban prepayment penalties on covered loans. If lenders cannot charge borrowers who prepay, they must distribute the cost of prepayment over all borrowers in the form of higher APR or higher fees. But then borrowers who do not intend to prepay end up subsidizing borrowers who do. For additional discussion see Fred Phillips-Patrick, Eric Hirschhorn, Jonathan Jones, and John LaRocca, *What About Subprime Mortgages?*

<sup>106</sup> This is essentially the method adopted by the Federal Reserve Board for the reporting of interest rates under the revised HMDA reporting regulations effective January 1, 2004. 12 C.F.R. Appendix A to Part 203, Part G.

The risk “premium” on loans should be positively correlated to measures of borrower risk if the subprime market is operating efficiently.

One measure of risk is the FICO risk score. The FICO risk score is derived from a statistical model that uses information on credit use from credit bureau files to predict the likelihood that a consumer will have a serious delinquency, bankruptcy, or other major derogatory event in the next two years. The predictions are the basis for constructing the FICO risk score, which ranks consumers from highest risk (low score) to lowest risk (high score).<sup>107</sup>

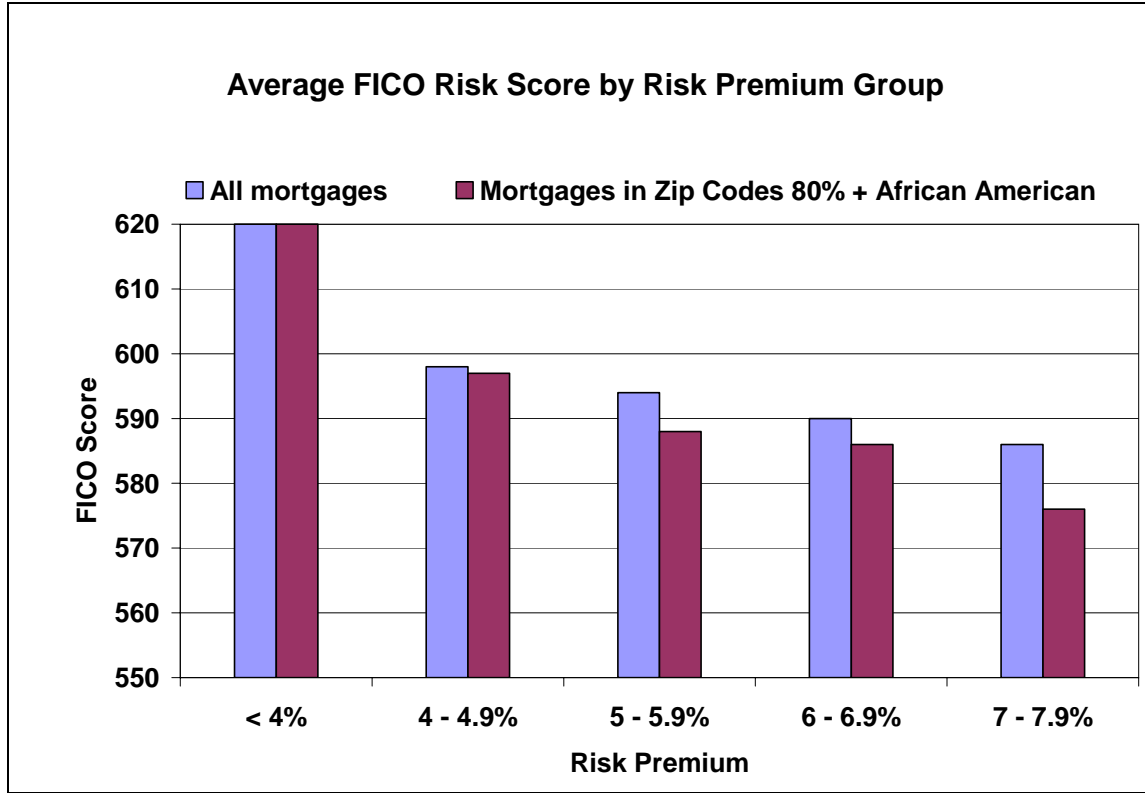
Chart 2 displays the relationship between the FICO risk score and risk premiums for over 900,000 subprime first mortgages originated nationwide between July, 1995 and March 2002. The average FICO risk score falls (indicating increasing risk) from 620 in the lowest risk premium group to 585 in the highest risk premium group. That is, higher risk borrowers (as indicated by their lower FICO scores) received, on average, mortgages with higher risk premiums, a relationship that is consistent with risk-based pricing in a well functioning mortgage market.

Chart 2 also provides some insight into loan pricing in minority neighborhoods. Recall that one limitation of the AFSA database is that it does not contain loan-level information about the borrower’s race. However, it does contain the ZIP code of the collateral property securing each loan. We can, therefore, examine the relationship between risk and risk premiums in ZIP-code areas dominated by minority residents. Chart 2 displays the relationship between FICO risk score and loan risk premiums on approximately 50,000 first mortgage loans that were made in ZIP-code areas in which 80% or more households are black. The relationship between subprime borrower risk and loan pricing in predominantly black neighborhoods is strikingly similar to that for all subprime loans nationwide.

---

<sup>107</sup> See [www.myfico.com](http://www.myfico.com) for discussion of the FICO risk score.

Chart 2



Next, we examine the relationship between loan pricing and subsequent loan performance. The AFSA database reports the performance and current status of all loans as of March 31, 2002, providing nearly seven years payment experience on the oldest loans in the database. The relationship between the loan pricing premium and subsequent loan payment performance provides insight into whether, over a period of years, the subprime mortgage lenders in this study were accurately pricing the loans they made relative to delinquency and foreclosure risk, as should be the case in an efficient marketplace.<sup>108</sup> Weak or no correlation

<sup>108</sup> There is perhaps a need for an additional word of caution. People unfamiliar with lending often find the function of loan underwriting confusing. An underwriting decision places a particular loan applicant in a class of borrowers with a similar probability of serious delinquency or default over the life of the loan. Loans are then priced based on that classification. Even if underwriting predicts that a borrower has a relatively high level of risk, most of the borrowers in that class will still pay the loan on time and without difficulty. This leads to some suggesting that the borrowers who did repay "should" have been placed in a better risk class and paid less for their mortgage. Wasn't the underwriting wrong since the borrower in fact repaid? This approach based on hindsight misses what underwriting really is: A prediction of what level of risk the borrower has of the occurrence of very low levels of

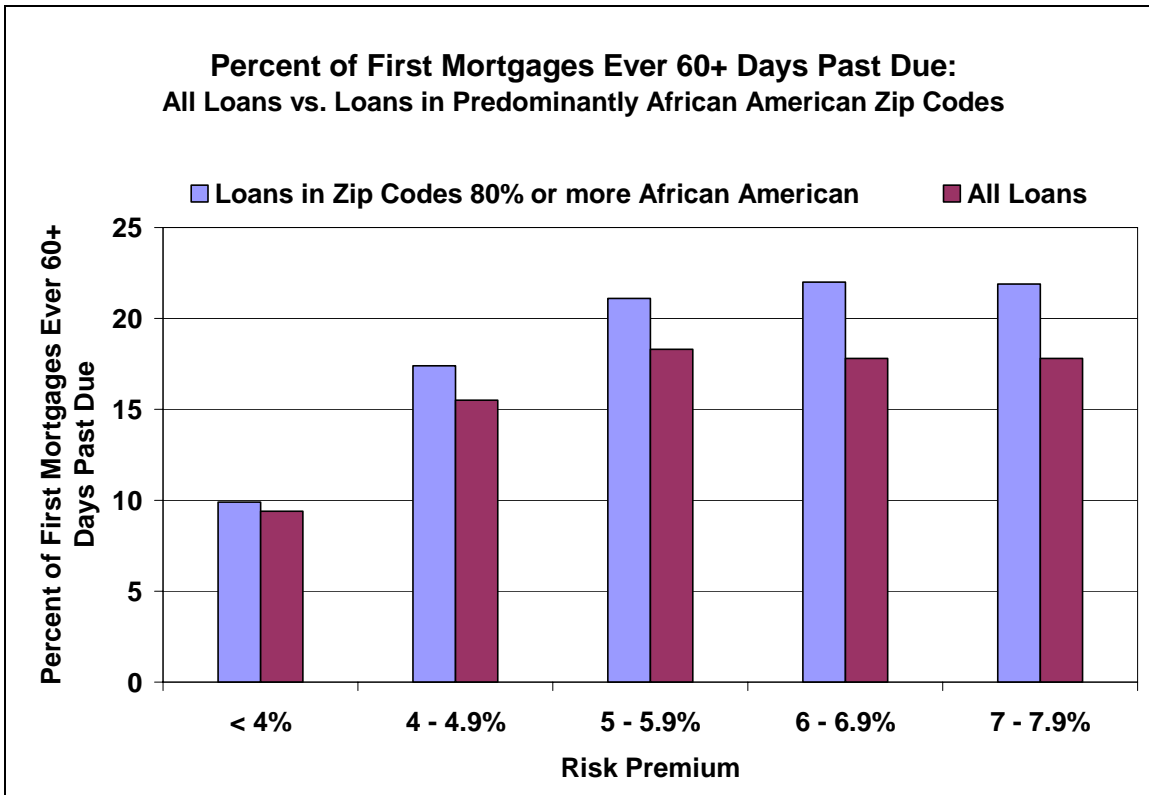
between the risk premium and subsequent performance is essentially the allegation of industry critics who claim that lenders often exploit vulnerable borrowers by opportunistically charging higher rates, regardless of the borrower's risk.

Chart 3 displays the percent of first mortgages ever 60 days or more delinquent over the life of the loan, for each risk premium category. Delinquencies of 60 or more days are a widely recognized indicator of serious delinquency within the industry and a proxy for escalated servicing costs. Indeed, some of these loans resulted in foreclosures. The chart illustrates that the incidence of repayment difficulty across all loans rises with the loan risk premium. Moreover, even subprime borrowers with relatively low risk premiums experienced significant incidence of serious delinquency (9.3% of all such borrowers) sometime during the first few years of their loan.

---

adverse events that nonetheless sharply increase lending costs. An analogy to automobile liability insurance is appropriate: the insurer may predict that a particular driver has a high risk of major accident, and place the borrower in a high-premium group. If the driver avoids serious accident, it does not follow that the insurer's decision was wrong. As is the case with insurance pricing, as a matter of social policy there is widespread agreement that borrowers should pay for credit based on their actual level of risk. Otherwise, in a market characterized by the same price for all borrowers, low risk borrowers would pay too much, and end up subsidizing higher-risk borrowers, who pay too little. The result would be unfair as well as create adverse incentives for loan repayment (and accident avoidance).

Chart 3



The chart also demonstrates that the same general pattern holds for loans in predominantly black ZIP-code areas. That is, in black neighborhoods there is a higher incidence of serious delinquency on loans with higher risk premiums, a sign of rational loan pricing. Interestingly, within a given pricing category, the incidence of serious delinquency on loans in predominantly black neighborhoods is somewhat higher than the average for all loans in the database. However, it is possible that the clustering and distribution of loans within what is admittedly a fairly broad (100 basis points) price category accounts for the observed difference between the two groups in the level of serious delinquency. It is also possible that the incidence of less serious delinquencies differs. In any case, without more precise measures of the associated collection costs/losses (e.g., number of times and length of time delinquent; whether a foreclosure action was started; whether foreclosure was completed), no statement can be made about whether the difference in delinquency levels *within* a price category is meaningful.

### **Performance of Subprime High-FICO and Low-Premium Loans**

Despite the evidence that higher risk premiums are closely correlated with risk, the extension of credit by subprime lenders to borrowers with FICO risk scores that are above or near levels required to qualify for prime loans raises the question: Could these borrowers have qualified for prime credit? To address this question, we compared the performance of high-FICO risk score mortgages with that on all conventional mortgages, as reported in the Mortgage Bankers Association's (MBA) National Delinquency survey. For these purposes, conventional mortgages are essentially prime loans.

Table 5 presents the results for first mortgages.<sup>109</sup> As one would expect, high-FICO subprime mortgages were less likely to be 60+ days past due or in foreclosure than subprime mortgages overall in the first quarter of 2002. However, high-FICO subprime mortgages were far more likely to be 60+ days past due or in foreclosure than the conventional mortgages in the MBA survey. It is also notable that about one in ten high-FICO subprime mortgages were 60+ days past due at some point during the life of the loan. Clearly even for this relatively low-risk subprime group, repayment problems are common and much more frequent than for prime borrowers.

---

<sup>109</sup> Inclusion of second mortgages would not substantially alter the results shown in Table 5.

**Table 5**  
**Performance of High-FICO First Mortgages, Subprime Mortgages, and All Mortgages**  
 (Percent of loans)

	<u>AFSA subprime mortgages</u>			MBA, all mortgages
	FICO score 640 or greater	FICO score 680 or greater	All	
<u>Open mortgages, Q1 2002</u>				
60+ days past due	4.7	4.1	7.5	0.7
In foreclosure	2.8	2.2	5.1	0.8
<u>All mortgages</u>				
Ever 60+ days past due	11.2	10.1	15.8	n.a.

n.a. Not available

Sources: American Financial Services Association and Mortgage Bankers Association (MBA).

Another category of borrowers that may raise concern are those whose loans are priced at or close to prime rates. Exactly what rates are prime rates is difficult to say. Some claim that prime is no more than two percentage points over Treasury rates, while others view anything up to four percentage points as prime. Nonetheless, it is likely that some subprime borrowers may actually receive prime pricing from subprime lenders. The question arises whether these borrowers, which chart 3 shows to have the lowest delinquency rate, should be viewed as prime borrowers.

Table 6 presents performance of subprime first mortgages priced two and four percentage points above comparable Treasury rates. The performance of these subprime borrowers is substantially poorer than that of prime borrowers. Despite receiving loans that are priced near prime, the performance of these borrowers suggests that they are not prime borrowers.

**Table 6**  
**Performance of Low Premium First Mortgages, Subprime Mortgages, and All Mortgages**  
 (Percent of loans)

	<u>AFSA subprime mortgages</u>			MBA, all mortgages
	Premium 4% or less	Premium 2% or less	All	
<u>Open mortgages, Q1 2002</u>				
60+ days past due	4.8	2.2	7.5	0.7
In foreclosure	5.2	3.0	5.1	0.8
<u>All mortgages</u>				
Ever 60+ days past due	9.4	5.5	15.8	n.a.

n.a. Not available

Sources: American Financial Services Association and Mortgage Bankers Association (MBA).

### Summary

Although critics of subprime lending have argued that many subprime mortgages are priced "too high", and that significant numbers of subprime borrowers are really "prime" borrowers, this study finds that subprime mortgage prices correlate closely with delinquency and foreclosure experience as we would expect in an efficient marketplace. Mortgages with relatively lower prices have, on average, a significantly lower delinquency and foreclosure experience than higher priced mortgages. There is no evidence in the AFSA database that lower-risk borrowers (as measured by FICO score at the time of application) are *routinely* paying more than borrowers who present significantly greater risk, as has been alleged by critics of subprime lending. In other words, an evaluation of the pricing vs. performance of this large sample of subprime loans does not reveal sort of market malfunction that critics have alleged to justify legislative intervention to protect borrowers.

Moreover, when we look deeper and examine only high FICO borrowers (borrowers with "prime" or "near-prime" FICO scores), again prices and actual delinquency and foreclosure experience closely track. When a high FICO borrower is charged at the upper end of the range

for subprime loans, that borrower is generally part of a group of borrowers with a high incidence of delinquency and default. This evidence reinforces the point that the riskiness of a loan is determined by more than just the borrower's initial FICO score. Matters such as the value of the property, the extent of the borrower's equity, overall debt load, job and income stability and so on all play a role in the actual likelihood of the borrower repaying without difficulty.

In other words, when the actual performance of subprime loans is considered, all of the evidence is consistent with an efficiently operating market for subprime loans. When high priced loans are looked at closely, they turn out to be priced that way for a reason: Delinquency and default is indeed high. When the performance of subprime loans is compared with that of prime loans, even in the most favorably priced category of subprime loans, higher delinquency and foreclosure experience with subprime loans is obvious.

We conclude that the available evidence strongly suggests that the subprime market is working as a competitive market should. To be sure, some people are charged more for loans than others, but all the evidence indicates that they have a higher risk of delinquency and foreclosure than borrowers who receive lower prices. We found no evidence of any group of borrowers whose loans are priced higher than justified by the delinquency and default experience of the group.

## **VI. Abusive Lending Laws: The Impact on Credit Availability of HOEPA-Style Regulation of Subprime Mortgage Pricing, Terms and Procedures**

The central fact limiting what regulation derived from the AARP Proposal can accomplish with regard to subprime lending is that restrictions on pricing and loan terms can significantly reduce the amount of credit available to borrowers.<sup>110</sup> We refer to this type of regulation as "HOEPA-style" since it relies on price thresholds to impose the most stringent regulatory provisions, originally a regulatory innovation introduced by HOEPA. Ironically, when limits keyed to price cause lenders to retreat to less risky loans, the impact is greatest on the very borrowers such laws are intended to protect, namely, financially vulnerable borrowers with limited or impaired credit histories, lower incomes, relatively high debt ratios and few assets. If the goal of regulation is to benefit financially vulnerable borrowers and if availability of mortgage credit is considered an important benefit, it is clear that this type of regulation has a significant downside.

All HOEPA-style regulations undoubtedly constrain mortgage lenders to some degree, including the regulatory provisions of HOEPA itself. The amount by which a particular law raises the cost and risk of making so-called "high-cost" loans will determine how much it curtails lending to higher risk borrowers.<sup>111</sup> Laws like those derived from the AARP Proposal that are significantly tougher than HOEPA can be expected to generate an observable decline in credit availability, especially if they also cover a larger proportion of the loan population than HOEPA.

---

<sup>110</sup> See National Commission on Consumer Finance, *Consumer Credit in the United States* (Washington: US Government Printing Office, 1972); Daniel J. Villegas, *An Analysis of the Impact of Interest Rate Ceilings*, 37 *Journal of Finance* (September, 1982); Christopher C. Demuth, *The Case Against Credit Card Interest Regulation*, 3 *Yale Journal on Regulation*, 201 (1986); Thomas A. Durkin, *An Economic Perspective on Interest Rate Limitations*, 9 *Georgia State University Law Review*, 821 (1993).

<sup>111</sup> The tradeoff between the restrictiveness of consumer protections and the availability of mortgage loans has been explicitly noted by Federal Reserve Board staff in commentary related to the Fed's proposed new HOEPA APR and fee triggers which became effective October 1, 2002. See Thomas A. Durkin and Glenn B. Canner, *Memorandum to the Board of Governors, Federal Reserve System, Regulatory Analysis of Proposed Revisions to Regulation Z Concerning Predatory Lending Practices*, (December 6, 2000).

As abusive lending laws proliferate across the United States, they provide an opportunity for measuring this tradeoff between tighter restrictions and credit availability.

Recent events provide reasons to worry that broad expansion of HOEPA-style regulations could reduce the flow of credit to subprime borrowers. In the spring of 2000, Freddie Mac announced that it would not purchase any mortgage loan that triggers HOEPA disclosures and protections.<sup>112</sup> Fannie Mae has adopted a similar policy. Both actions sharply reduce the liquidity of HOEPA loans by truncating the demand for such loans in the secondary market. This raises the cost to a lending institution of making such loans and would likely reduce a lender's appetite for extending higher cost loans to higher risk borrowers. The Fannie and Freddie ban on purchase of HOEPA loans became more worrisome for market liquidity when the Federal Reserve Board's new (lower) HOEPA trigger rules became effective on October 1, 2002.<sup>113</sup> Estimates based on an earlier version of the AFSA database indicate that by lowering the APR trigger for classifying a loan as "high-cost" under HOEPA by 200 basis points, the Fed's new rules expanded coverage of subprime first mortgages nationally from about 10% to nearly 40% of all such loans.<sup>114</sup>

We also know that state-level abusive lending laws can trigger swift and sharp reactions from the secondary mortgage markets. The most notorious example of unintended curtailment of mortgage credit in the wake of a abusive lending law occurred when Georgia passed its abusive lending law, effective October 1, 2002. The Georgia Fair Lending Act (GFLA) contained an "assignee liability" provision, which, combined with vague phrasing of other sections of the law, opened parties throughout the mortgage-market chain (for example, originators, brokers,

---

<sup>112</sup> See David A. Andrukonis, *Freddie Mac Defends Purchase of Subprime Mortgages*, *American Banker*, April 6, 2000(editorial by Chief Credit Officer, Freddie Mac).

<sup>113</sup> 12 C.F.R. §226.32, .34(as amended, 66 Fed. Reg. 65618 (December 20, 2001)(effective October 1, 2002)).

<sup>114</sup> Michael E. Staten and Gregory Elliehausen, *The Impact of the Federal Reserve Board's Proposed Revisions to HOEPA*, (2001)(unpublished paper).

underwriters, holders of asset-backed securities) to liability for GFLA violations.<sup>115</sup> Rating agencies such as Standard and Poor declared that as of February 1, 2003 they would no longer rate mortgage-backed securities that included loans covered by the GFLA.<sup>116</sup> As the number of subprime lenders declaring they would no longer do business in the state mushroomed, the Georgia legislature moved quickly to rescind the assignee liability provisions.<sup>117</sup> The incident provided a vivid reminder that the supply of credit can be directly and sharply affected by regulatory activity, no matter how well intended.

Even without troublesome assignee liability provisions, experience demonstrates that HOEPA-style anti-abusive lending laws at the state level based on the AARP Proposal can diminish the supply of credit. North Carolina was the first jurisdiction to enact HOEPA-style anti-abusive lending legislation (without assignee liability) that was substantially tougher than the prevailing federal HOEPA regulation. Its provisions were derived from a common precursor to the AARP Proposal. In July 1999 the North Carolina General Assembly passed a law that imposed new restrictions on all closed-end home mortgage loans, and created a new category of high-cost mortgages subject to additional restrictions.<sup>118</sup> Under the new law a mortgage loan was considered high-cost if any one of three criteria were met:

- The APR exceeded the federal HOEPA APR trigger for a high cost loan.
- Points and fees exceeded 5% of loan amount if loan > \$20,000, or exceeded the lesser of 8% of loan amount or \$1,000 if loan < \$20,000.
- Prepayment penalty imposed more than 30 months after closing or exceeded 2% of amount prepaid..

---

<sup>115</sup> 7 GSA §6A-1 ff.

<sup>116</sup> Jennifer Ablan, *Georgia Law Sparks Mortgage Crisis*, Barron's MW12 (January 27, 2003). Freddie Mac also declared it would not purchase loans designated as "high-cost" under the GFLA, regardless of whether they were classified as high-cost under HOEPA. See Erick Bergquist, *Georgia Predator Law Drives Out Some Lenders*, *American Banker* 12 (October 1, 2002).

<sup>117</sup> Senate Bill 53 (effective March 7, 2003), codified at 7 GSA §6A-1 ff.

<sup>118</sup> N.C.G.S. §24-1.1E (effective July 1, 2000); §24-10.2(c)(prepayment and anti-flipping provisions effective October 1, 1999).

The restrictions on mortgage lending included the following:

*Effective October 1, 1999*

- No prepayment penalties on first mortgages of \$150,000 or less (all loans).
- No refinancing of an existing loan without reasonable, tangible benefit to the borrower (all loans).

*Effective July 1, 2000*

- No financing of single-premium credit insurance (all loans).
- On “high-cost” loans:
  - No financing of fees.
  - No call provision.
  - No balloon payment.
  - No increased interest rate as a consequence of default.
  - No points or fees can be charged if a high-cost loan is used to refinance another high-cost loan.
  - Confirm borrower received home-ownership counseling regarding the advisability and terms of the loan prior to closing.

The enforcement provisions were similar to those in the AARP Proposal examined above, except there was no provision explicitly imposing liability under the statute on assignees. However, proponents of laws like the AARP Proposal claim that other North Carolina law imposes liability on assignees.<sup>119</sup>

Relative to the federal HOEPA regulation, the North Carolina law imposed even tighter restrictions on high cost loans and boosted the percentage of loans that would be so classified. For example, on first mortgages made by companies in the AFSA subprime database during the first 6 months of 1999, the new North Carolina statute (had it already been implemented) would have considered 20% of them “high-cost” loans, vs. less than 1% under the prevailing HOEPA regulations.<sup>120</sup> Consequently, it is likely that new regulations that covered all mortgage loans, the tighter restrictions on “high-cost” loans, the expansion of the definition of a “high-cost” loan (relative to HOEPA), and broad enforcement provisions providing for punitive civil liability in

---

<sup>119</sup> See ACORN, *Predatory Lending: Comparison of Laws* (chart available on March 20, 2004 at [www.acorn.org/acorn10/predatorylending/comparison.htm](http://www.acorn.org/acorn10/predatorylending/comparison.htm))

<sup>120</sup> Since North Carolina adopted the HOEPA APR threshold, this effect occurred because of the expansion of the Points and Fees threshold relative to HOEPA.

the case of violation, would all combine to increase the cost and risk of making mortgage loans in North Carolina, relative to other states. Because tighter regulation was triggered by the loan price, lenders' costs would rise most on loans to higher-risk borrowers in the market, those consumers who would be eligible for mortgage loans only at higher APRs or fees. Theoretical economic analysis predicts that lenders would respond to higher costs by reducing the supply of mortgage credit, especially to higher-risk borrowers. Other factors held constant, we would expect to see a decline in subprime mortgage originations.<sup>121</sup> Thus, North Carolina's experience offers a valuable opportunity to examine the tradeoff between more stringent regulation and credit availability.

### **The Evidence of the Impact of the North Carolina Law**

Four studies of the law's impact on credit availability in North Carolina have been released (one in preliminary form). All found significant contraction of credit availability. This effect holds regardless of the database used to examine the impact of the legislation. One study uses the AFSA subprime mortgage database, two use the HMDA subprime database, and the fourth study uses the LPS database. Although all four studies have found evidence of contraction in loan originations attributable to the law, they differ sharply in their interpretation of the decline.

---

<sup>121</sup> This prediction assumes that demand is unchanged. If the new law increases consumer demand for subprime mortgage loans, the price will be higher, but the number of originations may be more or less than before. If demand falls, originations will fall, but the price may be higher or lower than before. The direction of any effect of the law on demand is uncertain. The law has provisions that may increase demand (such as a prohibition of prepayment penalties on all mortgages less than \$150,000 and the prohibition of increases in the interest rate in the event of default on high-cost loans) and provisions that may decrease demand (such as the restriction limiting refinancing on all loans and the prohibition on financing points and fees on high cost loans). It is possible that the net effect on demand is negative because the law has many features restricting consumers' choices or making the process more cumbersome.

One study was conducted by economists Keith Harvey (Boise State University) and Peter Nigro (Office of the Comptroller of the Currency) using HMDA data.<sup>122</sup> Looking at subprime loan originations from 1998 through 2000 in North Carolina and four comparison states in the southeastern United States (South Carolina, Georgia, Tennessee and Virginia), the authors found that the North Carolina law reduced the overall level of subprime mortgage activity in that state, although it did not appear to reduce the number of subprime lenders. More specifically, the authors found the decline in North Carolina originations was due to a large decline in applications rather than to an increase in denial rates, “suggesting that subprime lenders in North Carolina may have been less aggressive in marketing loans during the post-enactment period.”<sup>123</sup> Minority and low-income borrowers were less likely to get loans after passage of the law. The authors acknowledge that the limitations of the HMDA data “do not allow us to discern how much of this reduction in lending was predatory in nature.”<sup>124</sup>

Another study by Elliehausen and Staten using the AFSA database produced similar results.<sup>125</sup> Using multivariate statistical methods to analyze loans made from 1997 through June 30, 2000, the authors concluded that first mortgage originations per county in North Carolina fell 14% following passage of the North Carolina law, relative to county-level originations in South Carolina, Tennessee and Virginia. The impact on lower income borrowers was even greater:

---

<sup>122</sup> Keith D. Harvey and Peter J. Nigro, *Do Predatory Lending Laws Influence Mortgage Lending? An Analysis of the North Carolina Predatory Lending Law*, forthcoming in *The Journal of Real Estate Finance and Economics*. (hereafter "Harvey and Nigro, *Do Predatory Lending Laws Influence Mortgage Lending?*"), December 2004. Harvey and Nigro use HMDA once again to document similar effects in Philadelphia and Chicago following passage of HOEPA-style municipal ordinances that imposed tougher restrictions on high cost loans. See Keith D. Harvey and Peter J. Nigro, *How Do Predatory Lending Laws Influence Mortgage Lending in Urban Areas? A Tale of Two Cities*, unpublished manuscript, March 2003.

<sup>123</sup> Harvey and Nigro, *Do Predatory Lending Laws Influence Mortgage Lending?* 16.

<sup>124</sup> Harvey and Nigro, *Do Predatory Lending Laws Influence Mortgage Lending?* 17.

<sup>125</sup> Gregory Elliehausen and Michael E. Staten, *Regulation of Subprime Mortgage Products: An Analysis of North Carolina's Predatory Lending Law*, forthcoming in the *Journal of Real Estate Finance and Economics* (hereafter "Elliehausen and Staten, *Regulation of Subprime Mortgage Products*"), December 2004.

the magnitude of the decline in the number of first mortgages to borrowers with incomes less than \$50,000 was equal to 27% of the quarterly county originations before the law.<sup>126</sup>

Both of these studies examined the period immediately after enactment of the North Carolina legislation, raising the possibility that the observed decline in originations was transitional and may not have been sustained as the North Carolina market matured under the new statute.<sup>127</sup> In particular, the AFSA database used in Elliehausen and Staten (2004) initially contained loan originations of the participating companies only through June 30, 2000, the date when the phased-in provisions of the North Carolina statute were fully implemented. As already discussed, the AFSA database was extended to include all subprime loan originations of 9 companies for the entire period from July 1, 1995 to March 31, 2002.<sup>128</sup> Subsequent analysis of the AFSA database has confirmed that credit contraction continued to occur some two years after enactment, generating a persistent reduction in loan availability in North Carolina relative to surrounding states.

Like the original database, the extended database provided information on first and second closed-end subprime mortgage originations in North Carolina and three adjacent states, South Carolina, Virginia and Tennessee (the "comparison states").<sup>129</sup> Chart 4 displays an extended view of mortgage originations in North Carolina, relative to the comparison states. For each quarter in the observation period, the chart displays the year-over-year percentage change in

---

<sup>126</sup> Elliehausen and Staten, *Regulation of Subprime Mortgage Products*, 15. Because 95% of the first mortgage loans in the AFSA database are refinance loans, these results apply almost exclusively to the availability of refinance loans, as opposed to purchase-money loans for home buyers.

<sup>127</sup> Recall that the North Carolina legislation became law during the summer of 1999 and its first regulatory provision went into effect October 1, 1999. The effective date for the rest of the new regulatory provisions was July 1, 2000.

<sup>128</sup> The AFSA database excludes any loans with an original loan amount over the conforming amount for 2002, \$310,000. In addition, care was taken to inspect the data for any significant merger and acquisition activity that could artificially inflate the observed originations during post-law time period. Ten companies reported data for the full period, but one company expanded its portfolio through significant mergers and acquisitions during the period. This company's data was excluded from the analysis described below. The remaining nine companies reporting data had no such activity.

<sup>129</sup> The North Carolina legislation only applies to closed end loans. N.C.G.S. §24-1.1E (effective July 1, 2000).

loans to lower income borrowers, who were found in the earlier study to have been affected by the law. Keep in mind that the phased-in implementation of the North Carolina law began in the fourth quarter of 1999 and was completed on July 1, 2000.

**Chart 4**

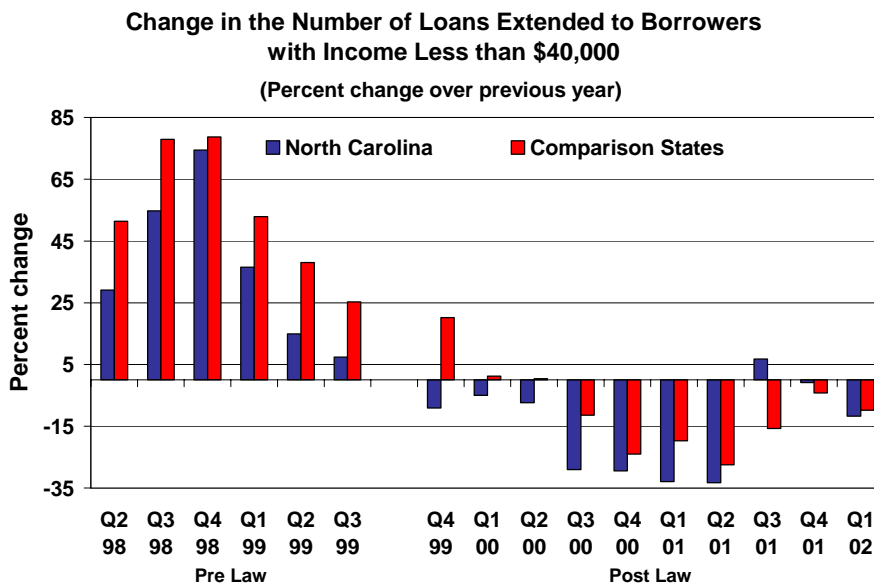


Chart 4 reveals that year-over-year origination activity declined in North Carolina beginning in the fourth quarter of 1999, (the start of the phase in period), both in absolute terms and relative to the comparison states. Originations continued to fall both in absolute terms and relative to the comparison states for the subsequent 21 months (through June 2001). By the third quarter of 2001, after this prolonged period of steeper declines, the total number of subprime mortgages originated per quarter in North Carolina relative to the comparison states was nearly 20% lower than where it had been two years earlier, prior to passage of the law.<sup>130</sup>

<sup>130</sup> The reduction translates into approximately 620 mortgage loans per quarter that were not made to North Carolina borrowers compared to the third quarter of 1999. At an average loan amount of \$48,550 (the approximate average loan amount for loans in the AFSA database originated by reporting companies), this cumulates to

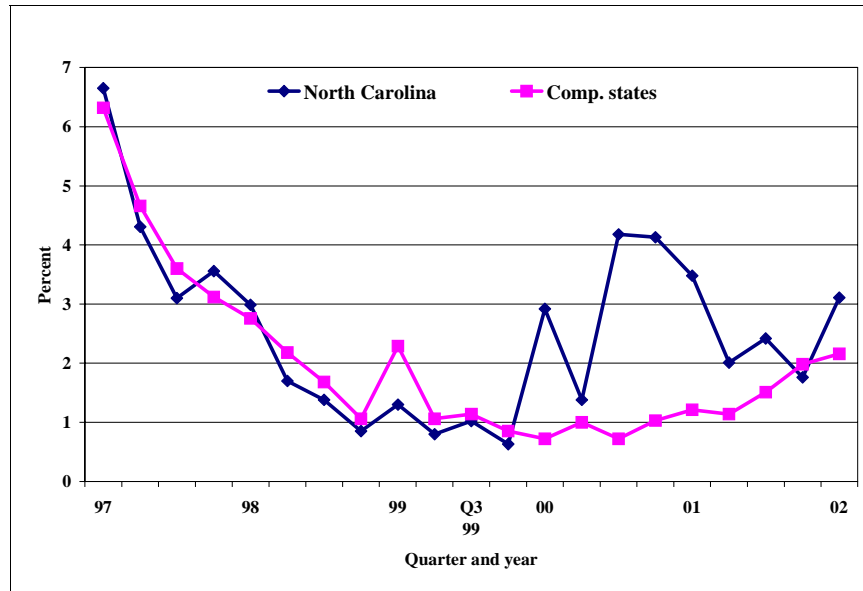
Of course, the post-enactment period was marked by general economic turmoil, beginning with the sharp drop in the equity markets in early 2000 (the dot.com bust), followed by sharp drops in consumer confidence by the fourth quarter of 2000 and a recession in late 2000 early 2001. These events would surely dampen both consumer demand for loans and lender willingness to make them in all states. The significant feature of the chart is that the downturn in originations in North Carolina precedes the economic downturn, and the reduction in North Carolina is steeper than in the comparison states. All of this confirms and extends the basic results of the multivariate analysis in the Harvey and Nigro and the Elliehausen and Staten studies.

The expanded AFSA database also allowed the testing of an additional hypothesis. Some observers have speculated that because the North Carolina law only covered closed-end mortgages, lenders may have steered subprime borrowers into open- end loans to circumvent the regulation. The updated AFSA database includes open-end loans made by all participating companies between 1995 and March 2002. The data indicate that creditors did not offset the decline in closed-end extensions with open-end credit. The percentage of total extensions that were open-end did increase in 2000, as seen in Chart 5. But, even after the increase, from 0.6% in the fourth quarter of 1999 to a peak of 4.2% in the third quarter of 2000, open-end loans remained a small percentage of the total. An examination of year-to-year changes in the number of originations in North Carolina in Chart 6 shows that changes in open-end credit were indeed a negligible part of the total change. Changes in open-end credit were simply too small to have served as an end-run around the statute.

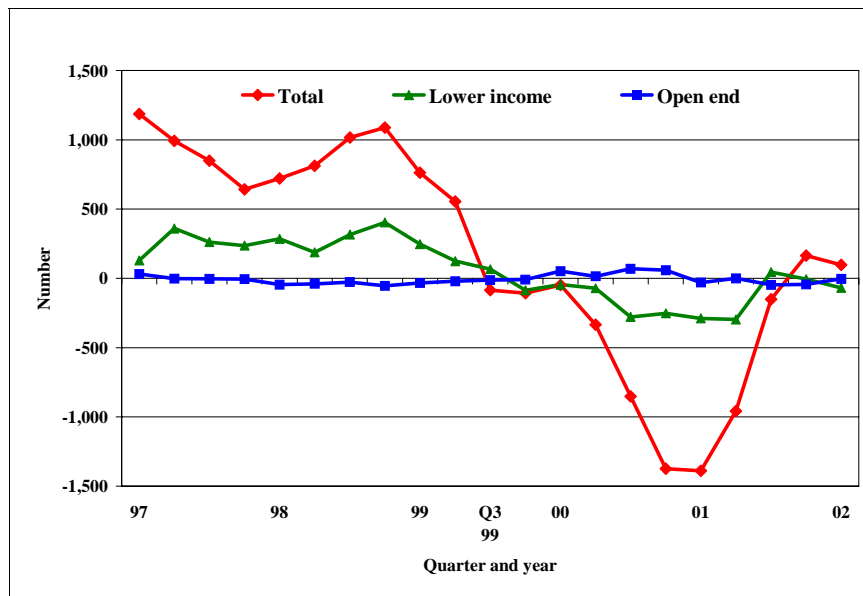
---

approximately \$30,000,000 per quarter not made available in mortgage credit to North Carolina residents, or roughly \$120 million per year.

**Chart 5**  
**Open-End Loans as Percent of Total Loans,**  
**North Carolina and Comparison Group States, Q1 1997-Q1 2002**



**Chart 6**  
**Change in the Number of Loans in North Carolina, Q1 1997-Q1 2002**  
**(Change over previous year)**



Two other studies using HMDA and LPS data, respectively, found similar patterns in loan originations, but interpreted the evidence quite differently. In 2002 a North Carolina-based

nonprofit advocacy group, the Center for Responsible Lending (CRL), released a study claiming to show that North Carolina's 1999 anti-abusive lending law saved consumers \$100 million on home mortgages originated during 2000.<sup>131</sup> The authors evaluated HMDA data from 1998-2000 (the same period analyzed by Harvey and Nigro) but concluded that subprime mortgage lending continued to thrive in North Carolina after passage of the statute.<sup>132</sup> Both the North Carolina governor and attorney general hailed the study and opined that if other states followed North Carolina's lead in clamping down on abusive lending practices, consumers could save billions of dollars nationwide.

A careful review of the report reveals quite a different story. The authors present statistical evidence on originations that shows a decline in both total subprime originations and originations per capita for North Carolina, relative to comparison states, consistent with the findings of Harvey and Nigro using the same database. The authors acknowledge the decline, but simply asserted that all of the foregone loans were "predatory".<sup>133</sup>

This same conclusion is repeated in a fourth study of the North Carolina law conducted by researchers at the Center for Community Capitalism at the University of North Carolina.<sup>134</sup>

---

<sup>131</sup> Keith Ernst, John Farris, and Eric Stein, *North Carolina's Subprime Home Loan Market After Predatory Lending Reform* (August 13, 2002)(unpublished paper by the Center for Responsible Lending, Durham, North Carolina).

<sup>132</sup> *Id.*

<sup>133</sup> Savings to borrowers were calculated in terms of single premium credit insurance premiums not paid (because the statute banned the sale of the product), avoidance of payment of refinance fees for those foregone loans that would have provided the borrower no net tangible benefit, savings attributable to limits imposed by the statute on "excessive" fees, and the savings from the ban on prepayment penalties for loans under \$150,000. None of the data used to support the calculations of savings from banned contractual features derives from the HMDA data. More troubling from a methodological standpoint, the authors repeatedly rely on the (unstated) assertion that a ban or limitation placed on a particular contractual feature triggers no additional cost or loss of benefit to the borrower. Consequently, there is little or no scientific justification for the author's calculations. In the end, the estimates of consumer savings, like the statement that all foregone loans would have been abusive, are merely assertions unsupported by empirical analysis.

<sup>134</sup> Roberto G. Quercia, Michael A. Stegman and Walter R. Davis, *The Impact of North Carolina's Anti-predatory Lending Law: A Descriptive Assessment* (June 2003)(unpublished paper by Center for Community Capitalism, University of North Carolina at Chapel Hill)(hereafter "Quercia, Stegman and Davis, *The Impact of North Carolina's Anti-predatory Lending Law*"). The study acknowledges support from the Self Help Credit Union, an entity associated with both Center for Responsible Lending and some of the authors of the third study.

At a press conference in July 2003, researchers Roberto G. Quercia, Michael A. Stegman and Walter Davis released a “preliminary” report on a study that used LPS data (3.3 million subprime loans covering 1998-2002). The authors found that subprime originations declined more in 1999-2000 in North Carolina than in surrounding states. The declines applied to refinance loans; purchase-money loan originations in their sample actually rose in North Carolina, as well as in surrounding states. After 2000, refinance loans grew nationally and in some surrounding states but not in North Carolina.

The authors note that the reduction in originations is consistent with the findings of prior studies. What is significant about their findings, they claim, is the “large decline in subprime refinance originations with abusive or predatory terms.”<sup>135</sup> However, as supporting evidence they cite sharp declines in refinance loans with characteristics that were explicitly limited by the statute.<sup>136</sup> A decline in the incidence of a proscribed term is neither surprising nor evidence that the characteristic (or loan) was abusive. Nor does it provide any evidence that all of the loans not made in North Carolina as a result of the law would have contained abusive terms. Nevertheless, like CRL before them, the North Carolina authors interpret the findings as evidence that the subprime market behaved essentially as the law intended and that “there was a reduction in predatory loans but no change in the cost of subprime credit or reduction in access to credit for high-risk borrowers.”

Notwithstanding the different interpretations of results, the emerging consensus from empirical analysis is that refinance loan originations did fall in North Carolina as a result of the

---

<sup>135</sup> Quercia, Stegman and Davis, *The Impact of North Carolina’s Anti-predatory Lending Law*, 1.

<sup>136</sup> For example, they find declines in North Carolina in (1) loans with prepayment penalties imposed three or more years after origination (loans with such penalties were increasing during this period in surrounding states) and (2) loans with balloon payments (although Tennessee and South Carolina experienced declines of similar magnitude). But the North Carolina statute prohibited prepayment penalties on all loans up to \$150,000, and prohibited balloon payments on any loan designated as “high-cost” under the statute.

state's abusive lending law. The question is whether the bulk of the foregone loans were abusive and consequently undesirable from a public policy viewpoint. Alternatively, could some or even most of the decline have resulted from lenders raising credit standards for applications that come through the door, or shifting the criteria they use in their marketing programs so as to target fewer higher-risk borrowers?

As mentioned, Harvey and Nigro found that denial rates on applications in North Carolina were unchanged following passage of the law, but the volume of applications was down significantly.<sup>137</sup> They speculate that subprime lenders may have been less aggressive in marketing loans during the post-enactment period. Indeed, to the extent that much of a lender's subprime business is generated through direct mail and telemarketing promotions, when a lender decides to shift its marketing emphasis to lower-risk borrower there would not be a surge in denials to signal the tightening of underwriting standards. Changed marketing emphasis would accomplish the desired change in borrower risk profile.

What do the risk distributions of subprime borrowers tell us about whether the decline in originations came at the expense of higher-risk consumers? In their preliminary report Quercia, Stegman, and Davis observed the counterintuitive result that loans to North Carolina borrowers with FICO scores below 580 actually *increased* by nearly one-third after the North Carolina statute was passed, as was the case in surrounding states (except Tennessee).<sup>138</sup> However, they concede that at least two attributes of the database may have contributed to the result. First, there was an improvement in data reporting in the LPS database that reduced the percentage of missing FICO scores on the individual loan records by more than 50% between 1998 and 2001.

---

<sup>137</sup> Harvey and Nigro, *Do Predatory Lending Laws Influence Mortgage Lending?*

<sup>138</sup> Quercia, Stegman and Davis, *The Impact of North Carolina's Anti-predatory Lending Law*, 17-18. This statistic applies to all North Carolina loans. They do not report the statistic for the subgroup of refinance loans.

Secondly, the estimated market share of subprime lending captured in the LPS database increased from 41% to 51% between 1998 and 2002.

Regardless of the improvement in quality of data collection, it is quite possible (even likely) that a significant portion of this gain resulted from merger and acquisition activity (as opposed to faster growth by the same set of reporting companies).<sup>139</sup> Adding companies not previously reporting will bias results toward increases. There is no indication that the authors took steps to segregate the additional volume generated by acquired portfolios and/or new reporting companies from the volume of loans generated by companies throughout the entire period. Without such a correction, the subprime origination totals are biased upward as time goes on because of the addition of new companies. Moreover, the acquisition of a large, higher-risk portfolio by one of the reporting companies in the post-enactment period could easily account for the upward shift in the incidence of higher risk consumers among subprime borrowers.

Another problem which calls in question the reliability of the study's findings comes from the nature of the LPS database itself when used to track the growth or contraction of loan originations over time. As observed in Section III, the LPS database tracks loans that are securitized, not loans that are originated. Unless securitized loans have a direct relation to the number of loans originated, they will provide a distorted picture of what is going on. The number of originations is what tells us about how available credit really is. The number of securitized loans tells us how many loans lenders decided to fund through capital markets. Other methods lenders can use to fund loans include using their own funds (funding against portfolio) or selling whole loan pools privately. They decide which method to use based on their financial resources and their perception of capital market conditions, usually seeking the lowest cost of

---

<sup>139</sup> It is also possible that the number of companies reporting to the LPS database increased.

funds. In any event, it is clear that securitizations do not necessarily reflect loan originations directly.

The disconnect between originations and securitizations was particularly strong during the period 1999 to 2002, the relevant period of study. During that time, securitized subprime loans increased almost 4 times as rapidly as did originations (by dollar amount).<sup>140</sup> This would call into question such findings as the increase in loan availability to borrowers with FICO scores below 580 and the increase in purchase money credit availability. As Robert E. Litan of the AEI Brookings Joint Center for Regulatory Studies has written about the use of the LPS database for this particular study, "[T]here is no way to draw legitimate inferences from sub-prime loan securitizations about the pattern of subprime mortgage originations. This is the case not only for subprime loans in general, but also for subprime loans with the abusive characteristics targeted by the North Carolina statute."

After controlling for mergers and acquisitions of participating companies, the AFSA database reveals quite different evidence on the risk distribution of subprime borrowers following enactment of the North Carolina law. Elliehausen and Staten report that the risk distribution of originated refinance loans in North Carolina shifted notably toward lower-risk borrowers (higher FICO scores) in the period after the North Carolina law began to be implemented.<sup>141</sup> Chart 7 presents some evidence of tightening in underwriting standards also occurring in surrounding states, but the effect is significantly larger in North Carolina. This shift is consistent with the economic prediction that higher-risk borrowers who would otherwise have received higher loan rates became more expensive for lenders to lend to and service after

---

<sup>140</sup> Litan, Robert E., *North Carolina's Anti-Predatory Lending Law: Still A Problem Despite New Study*, AEI-Brookings Joint Center For Regulatory Studies, Regulatory Analysis 03-9, 8 (September, 2003)(citing data from *Inside MBS&ABS*).

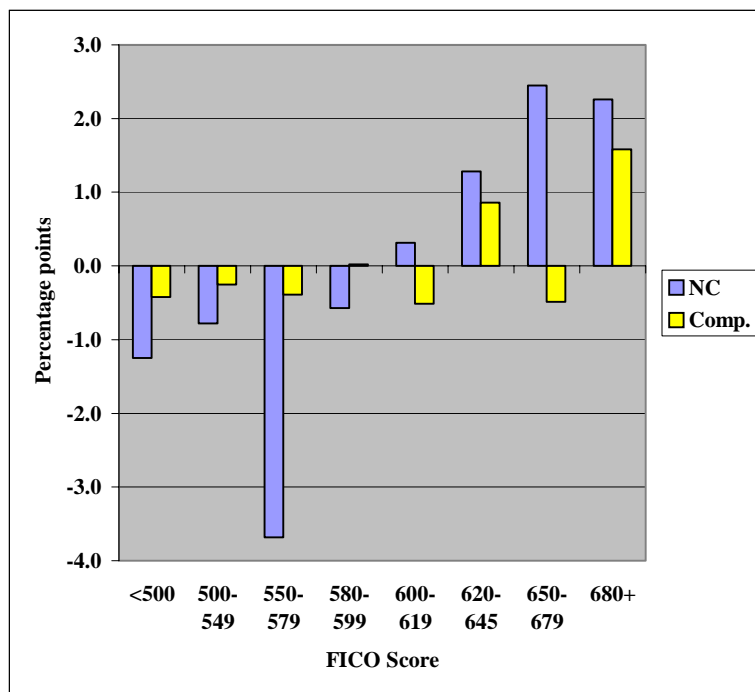
<sup>141</sup> "Regulation of Subprime Mortgage Products."

passage of the North Carolina law. Consequently, the extra regulation and litigation risk triggered by loan pricing above the thresholds set by the North Carolina law would discourage lenders from making such loans.

**Chart 7**

**Shift in Distribution of First Mortgage Originations  
In North Carolina vs. Comparison Group States**

(Change in percent of loans in each FICO score category after October 1, 1999)



For this argument to be empirically consistent, we should also observe a decline in higher-priced loans. Specifically, we should see a decline in loans priced above the North Carolina trigger levels. And, we do. The AFSA database can be used to calculate the proportion of actual loans that were classified as high-cost loans by the federal HOEPA regulations, as well as the proportions of loans that were classified as high-cost loans by the North Carolina statute (after implementation) and would have been classified as high-cost loans had the statute been

effective earlier.<sup>142</sup> Table 7 displays the results for North Carolina refinance first mortgage loans. In the last quarter prior to full implementation of the North Carolina statute (Second quarter 2000), 17.4% of subprime refinance first mortgages in North Carolina were priced such that they would have been considered high-cost loans had the law been fully implemented. In the very next quarter (Third quarter 2000), the first quarter after full implementation, the percentage of actual “high-cost” loans was only 3.9%. This fell further to 1.6% in the following period and remained between 1% and 2% of all North Carolina loans through March 2002.

**Table 7      Percent of Refinance First Mortgages Covered as High-Cost Loans under HOEPA and North Carolina’s Law**

<b>Quarter</b>	<b>HOEPA</b>	<b>North Carolina</b>
1999:1	0.9	20.4
1999:2	0.5	19.7
1999:3	1.1	16.7
1999:4	0.5	17.4
2000:1	0.5	15.8
2000:2	0.4	17.4
2000:3	0.4	3.9
2000:4	0.2	1.6
2001:1	0.2	1.5
2001:2	0.1	1.7
2001:3	0	1.7
2001:4	0	2.0
2002:1	0	1.4

The table gives empirical support to the argument that the North Carolina statute effectively functions as a “stealth” usury ceiling. That is, while the law does not formally ban the extension of mortgage credit at rates above the trigger values set by the statute, the package of regulations that accompany loans priced above the trigger imposes costs sufficient to

---

<sup>142</sup> North Carolina excludes "bona fide discount points" from consideration in calculating the Points and Fees threshold, but we do not have sufficient information to determine when points and fees that are reported are in fact "bona fide discount points". This inability to exactly duplicate the statutory result would, at most, result in the conclusion that a loan was over the threshold, when in fact it was not. Since we found that most loans made after enactment are under the threshold, this inability to completely identify covered loans is unimportant for this purpose.

discourage lenders from making such loans.<sup>143</sup> Donald Lampe, an attorney with considerable experience developing compliance programs in North Carolina, has noted that “Bank compliance lawyers in North Carolina concur that their clients have adopted a novel compliance strategy for the high-cost home loan law: avoidance.”<sup>144</sup> Whether a statute which has the virtual effect of a rate ceiling is nullified by the federal preemption of state laws which impose rate ceilings on first mortgage credit has yet to be raised in litigation, or decided.<sup>145</sup>

### **Was the Observed Decline a Decline in Abusive Lending?**

One additional piece of evidence casts further doubt on activist claims that North Carolina’s law reduced abusive lending. As was discussed in Section V, a central tenet in the activist push for legislative change is that subprime borrowers, especially vulnerable groups such as minorities and the elderly, are systematically overcharged. In other words, subprime loan pricing is not sufficiently related to underlying borrower risk. Presumably, a law that succeeded in driving out abusive behavior would alter the underlying pricing structure, restoring a more positive relationship between risk and the risk premium. Consequently, if the primary accomplishment of North Carolina’s law was the reduction of abusive lending, we should observe a stronger correlation between price and underlying borrower risk after implementation.

Chart 8 displays the mean risk premiums in North Carolina and comparison states by borrower FICO score category, before and after implementation of the North Carolina law.

---

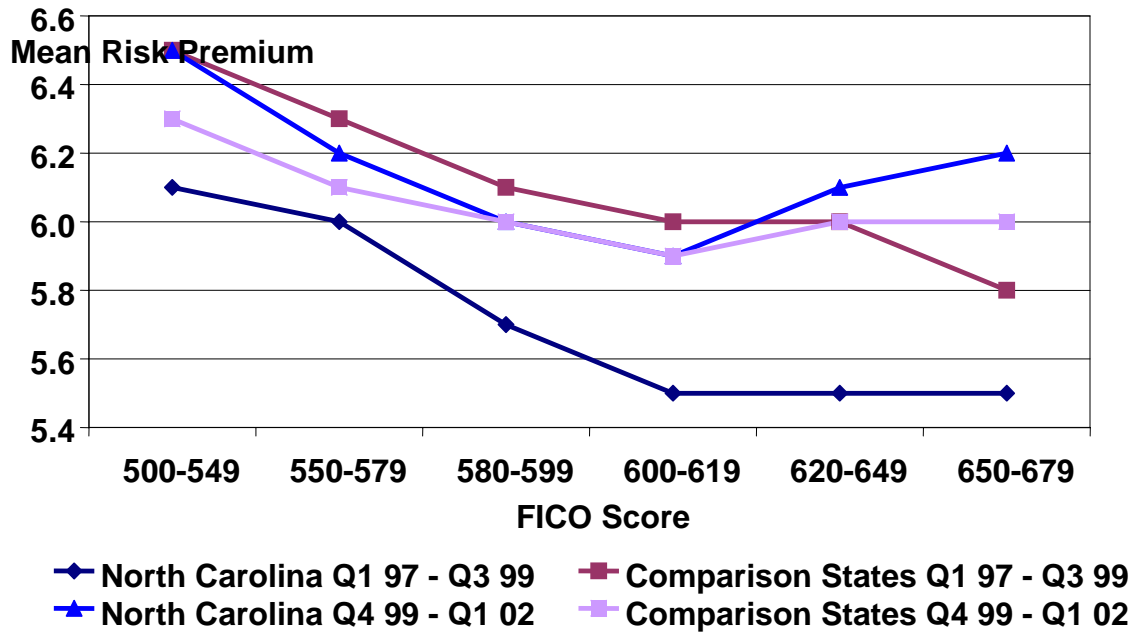
<sup>143</sup> See Testimony of Charles W. Calomiris, Hearings before the Committee on Banking, Housing and Urban Affairs, United States Senate, *Predatory Mortgage Lending: The Problem, Impact and Responses*, 107<sup>th</sup> Congress, 1st Session, (July 26, 2001). There is a notable difference between a usury ceiling and a stealth usury ceiling. A binding usury ceiling reduces both quantity sold and the price. A stealth usury ceiling may reduce quantity and increase price. See note \_\_\_ *supra*.

<sup>144</sup> Donald C. Lampe, *Trigger Happy: Enactment and Aftereffects of North Carolina’s Predatory Lending Law* (July 24, 2003) (paper presented at The Federalist Society, Predatory Lending Conference, Washington, DC).

<sup>145</sup> Title V of the Depository Institutions Deregulation and Monetary Control Act of 1980, P.L. 96-221 s 501, 94 Stat. 132 (1980), codified at 12 U.S.C. s 1735f-7 note.

Specifically, the pre-law period includes all originations in the respective states from January 1 1997 through September 30, 1999. The post-law period covers all originations from October 1, 1999 through March 31, 2002. A positive relationship between risk and risk premiums is evident in both the pre and post-law period in North Carolina, as well as in the comparison states. But, the striking feature of the chart is that in North Carolina, loan risk premiums generally rose after passage of the statute, even as they were falling in the comparison states. That is, loans to higher-risk borrowers in North Carolina, those who had FICO scores in the 500-580 range carried a higher premium in the post-law period than prior to the law's enactment. Precisely the reverse was true in the comparison states. The same effect is evident on loans to borrowers with FICO scores in the 620-680 range in North Carolina, relative to the comparison states. We conclude that not only is there no evidence that the North Carolina law increased the correlation between price and risk, there is clear evidence that the higher costs and risks imposed on lenders because of the law actually raised loan pricing to North Carolina borrowers, in absolute terms as well as compared to borrowers obtaining loans in other states. In other words, after the North Carolina law went into effect, there was less refinance mortgage credit available, and North Carolina borrowers paid more for what they were able to get than they did before enactment of the legislation. If the legislation was intended to lower credit prices, it failed miserably. And credit became less available, as well.

**Chart 8 Mean Risk Premiums  
in North Carolina and Comparison Group States**



**Summary**

HOEPA-style regulation of subprime lending, particularly that type of regulation that is similar to the AARP Proposal, clearly runs the risk of reducing the amount of credit available to borrowers. Four studies have documented the effect of North Carolina’s HOEPA-style law on credit availability in that state. All found significant contraction in subprime mortgage availability. The studies differ sharply in their interpretation of the decline. Two essentially assert that the decline was a decline in abusive lending. The others caution that any decline in abusive lending is likely at the expense of many legitimate loans. Evidence on risk and pricing in North Carolina is consistent with the latter interpretation. Based on a review of all these studies, analysts at the U.S. Office of Comptroller of the Currency reached the conclusion “There is a good deal of empirical evidence to suggest that anti-abusive lending statutes impede the flow

of mortgage credit, especially to low income and higher-risk borrowers, and any reductions in predatory abuses resulting from these measures in probably achieved at the expense of many legitimate loans.”<sup>146</sup>

Even more importantly, such legislation is likely to raise loan interest rates to borrowers relative to their respective risk classes. So, if you are a higher risk borrower in North Carolina today, you will pay more for your subprime mortgage credit relative to your risk class than you would have before the "protective" legislation became effective. The overall problem is that the unintended consequences of this type of legislation fall most heavily on the very borrowers the law was intended to help.

## **VII. The Implications for Reform**

In light of the facts that (1) subprime credit is predominantly used by middle income, young to middle aged borrowers with significant assets rather than by the old, the poor and the vulnerable, (2) stringent reform proposals can significantly reduce credit availability and increase the cost of credit to middle-income borrowers with credit difficulties, and (3) there is no evidence of any significant market failure in the subprime mortgage market, a cautious approach to "reform" proposals would seem appropriate. Those evaluating reform proposals should ask three critical questions: What benefits does the reform promise consumers? Will the reform actually deliver the promised benefits? Are the benefits worth the costs?

### **What benefits does the reform promise consumers?**

Critics of subprime mortgage lending commonly advocate reform packages like the one presented in the AARP Proposal. The lending industry tends to favor case-by-case enforcement

---

<sup>146</sup> U.S. Comptroller of the Currency, *Economic Issues in Predatory Lending*, 20.

focused upon specific instances of fraudulent and misleading behavior plus disclosure and education of borrowers. At one level, the two approaches have similar goals: the reduction of the opportunity for and occurrence of fraudulent and manipulative sales practices. But advocates of the AARP Proposal promise quite a bit more than a reduction of fraud and manipulation. They promise lower fees and interest rates, as well as the removal from the marketplace of credit contract terms like prepayment penalties, default and delinquency fees, and balloon payment terms. Implicitly, they promise as well that credit will continue to be available for those who "need" it.

**Will the reform proposal actually deliver the promised benefits?**

We are concerned that proposals like the one advanced by the AARP will fail to deliver the benefits they promise. Moreover they may cause changes in the marketplace that in the end strongly disfavor consumers.

The AARP proposal would impose extensive regulation on the terms and practices of *all* prime and subprime mortgage lending, as well as tightly regulate any mortgage over a threshold significantly lower than the HOEPA threshold. As a practical matter for many lenders, the regulation indirectly imposes a price ceiling on points that can be charged in prime mortgages. The points and fees threshold, which determines whether the mortgage is regulated only by the provisions that apply to all mortgage loans or instead by the more restrictive provisions applying to high cost mortgages, turns on whether the lender charges more than three points. For many lenders, this limits the points that can be charged in a prime loan, since, as we found to be the case in North Carolina, few lenders will choose to become regulated under the "high-cost" provisions. An exception allows two points to be charged if they are "bona fide discount points", but the exception is limited only to an interest rate buydown, and then requires that the lender

give the borrower at least a 35 basis point improvement in interest rate for each buydown point charged, in effect regulating the pricing of buydown points.

Moreover, this regulation, which applies to prime as well as subprime mortgages, closely regulates the lender's decision to extend credit in a refinancing transaction by permitting the borrower to defend against a mortgage foreclosure on the basis that the lender should not have lent to that borrower.<sup>147</sup> It also controls another significant matter, what the borrower can finance in the mortgage loan. Some consumers may very well not view this impediment to refinancing as a benefit.

For subprime loans over the threshold, the AARP Proposal leaves only miniscule discretion to the lender with respect to the decision whether to extend credit. In any foreclosure, or in a class action proceeding for damages, the lender's underwriting decisions on all over-threshold loans can be challenged based on whether the lender extended credit "without due regard for repayment ability".<sup>148</sup> If the loan is a refinance loan, a second attack can be mounted on whether the refinance provided a "reasonable, tangible net benefit to the borrower considering all of the circumstances".<sup>149</sup> A safe harbor applies only against the first ground of attack, and only if the borrower's credit worthiness would meet Veterans' Administration underwriting guidelines (which are themselves ambiguous). The practical effect is virtually to require that subprime lenders use the VA underwriting guidelines as a basis for loan extension, while still leaving the lender on a refinanced loan easily subject to attack on the ground the borrower did not get a "reasonable, tangible net benefit".

---

<sup>147</sup> AARP proposal §3(b).

<sup>148</sup> AARP proposal §4(i).

<sup>149</sup> AARP proposal §3(b).

In addition, the AARP proposal forbids or tightly regulates late fees, default interest, prepayment penalties, balloon mortgages, and arbitration in any loan over the threshold. Similar provisions are found in other "model" proposals critics have advanced.

What effect will regulation of this type have on the overall subprime market?

We find no evidence of systematic market failure or lack of competition in the subprime mortgage market. As shown in Section V, higher prices in the subprime market reflect higher risk than the prime market. The large number of firms offering subprime mortgages suggests that the market is reasonably competitive.<sup>150</sup> Imposing price and terms restrictions on a *competitive* market usually has effects that are not beneficial to consumers.

One likely effect indicated by the empirical evidence presented in Section VI is that credit becomes less available to consumers after imposition of stringent regulation. Another effect, also shown in Section VI, is that prices may increase. Given the complexity of the regulation contained in the AARP Proposal and legislative proposals derived from it, as well as the severe penalties imposed on violators, the regulation will certainly increase the costs and perceived risks of extending credit as companies establish detailed compliance and audit programs. Credit prices will likely increase when effective price ceilings do not prevent them from doing so. A third effect is less flexible terms, making product offerings, in this case loan terms and conditions, less convenient, affordable and budget-fitting than at present.

Yet another effect putting upward pressure on credit prices is likely to develop because of the peculiar structure of the AARP Proposal and its reliance on price thresholds to impose more stringent regulation on higher priced loans. Simply put, the mortgage credit marketplace likely to develop in response to legislation derived from the AARP Proposal is one of sharply

---

<sup>150</sup> For example, the 2002 HUD/HMDA subprime list of subprime mortgage lenders lists 201 companies reporting subprime mortgage loan originations or purchases in that year. The prevalence of mail, telephone, internet and public media advertising of subprime mortgage credit likewise suggests strong competition for customers.

segmented lender-specialists. Most companies will make only loans priced below the "high cost" threshold. Companies formerly making loans the regulation now defines as "high cost" may remove themselves from the market, unwilling to take the substantial litigation risks. A few companies may specialize in the special compliance forms, procedures and risk management, and the development of funding sources willing to provide risk capital to a highly regulated market exposed to major class action litigation risks. Few companies will be active in both the "not high cost" and "high cost" markets simultaneously, reducing the amount of competition in each market. Dropout of competitors increases the ability of those left to raise prices successfully as competition weakens.

The resulting picture of the subprime marketplace is clearly not of a market favorable to consumers. To be sure, some critics of subprime mortgage credit may think that consumers would be "better off" if they couldn't get subprime loans and so welcome any suggestion that subprime credit will be curtailed, but generally the society supports the wide availability of credit as long as it is competitively priced and the terms meet some basic social standard. The important point for policy consideration is that stringent regulation of the type proposed by the AARP Proposal will not deliver the lower prices that its advocates implicitly (and sometimes explicitly) promise.

Nor will borrowers benefit overall and in the long run by restricting loan terms. For example, although those borrowers likely to prepay loans may favor limits on prepayment penalties, if the costs associated with prepayment cause prices to rise for all borrowers, then those who are not likely to prepay will subsidize those who do. Restrictions on balloon payments provide another example of ambiguous "benefits". Liquidity constrained borrowers expecting higher income or lower expenses in a few years may prefer and actually be better off

having a loan with lower monthly payments now followed by a balloon. For the predominantly younger to middle-aged borrowers who use subprime credit, this management of their life-time earning and spending capability may be good financial planning. They borrow to help manage the costs of younger children and other heavy expenses of creating a home, and pay back at a later time when those burdens are less. If a balloon payment loan is not available, higher monthly payments on a fully amortizing loan may make borrowers in such situations more vulnerable to delinquency and default.<sup>151</sup>

Will legislative initiatives derived from the AARP Proposal at least stop most fraudulent practices and manipulation in the subprime market? There is some evidence that at least a few borrowers have been victims of misleading or sometimes high pressure salesmanship, or outright fraud. This evidence, while episodic, nonetheless raises grounds for concern. We know that the subprime market has only recently expanded greatly. An increase in the availability of mortgage and home equity credit to people who have heretofore had only restricted opportunities to borrow may put into the market consumers who are not particularly well prepared to understand the sometimes complex terms of a mortgage transaction. These new customers may be easily misled by the glib salesperson pushing a deal that increases his or her sales commission income at the expense of what is best for the consumer. Some witnesses testifying at legislative hearings certainly fit this mold.<sup>152</sup>

---

<sup>151</sup> Also, balloon mortgages often have lower rates than 15 or 30-year mortgages. The balloon mortgage allows the lender to assure investors willing to provide risk capital to the subprime market, that their money will not be tied up beyond a particular date.

<sup>152</sup> See, e.g., testimony of Mary Podelco, before the Committee on Banking, Housing and Urban Affairs, United States Senate (July 26, 2001)("Hearings on Predatory Mortgage Lending: The Problem, Impact and Responses")(elderly woman owning home without debt borrowed and then refinanced seven times in one year, increasing her debt from approximately \$12,000 to over \$65,000, and increasing her monthly payments to over her monthly income. She lost her home when income from her brother was lost when he died. She also indicated that a granddaughter who may have lived with her had income from SSI).

However, the AARP proposal is not well suited to getting at fraudulent practices. To be sure, it forbids or restricts balloon mortgages, prepayment fees, and other terms. But as discussed above and elsewhere, each of the items it restricts has valid uses that in many instances provide benefits to the consumer. Do restrictions on terms also eliminate the opportunity to mislead borrowers by letting them believe, for example, that a 7-year balloon mortgage is really a 15-year mortgage? Perhaps, to some extent. But even curtailing this opportunity for fraud is a benefit that is by no means clear, since it also prevents mortgage terms which may benefit other consumers.

We understand that the nature of the fraudulent and manipulative salesperson is to take whatever opportunities the customer presents and maximize them. If they cannot mislead the consumer one way, they will do so another. While prohibiting balloon payments may close off the opportunity to use a balloon mortgage as the means of enticing an unsophisticated borrower into a deal that looks good at the time but has risks later, the skilled con artist will simply work out another means of accomplishing the same goal. For example, he or she can sell the consumer instead on a mortgage with higher payments, assuring the borrower that these terms are affordable. Prohibition of a particular term certainly puts its benefits beyond reach of consumers, but probably does not decrease the incidence of fraud and manipulation. It simply manifests somewhere else.

We therefore conclude that the AARP approach is unlikely to deliver significant net benefits. It will almost certainly decrease credit availability, and it will probably raise credit prices to consumers of each particular risk class. It will reduce the flexibility in the marketplace to provide loan products to consumers that best meet their needs or best manage the risks of subprime lending.

The alternative approach of increased enforcement of deceptive and manipulative practices laws, along with clear and meaningful disclosures and consumer education, appears more likely to get at the fraudulent and manipulative conduct that has been of significant concern. Some recent highly publicized settlements with the Federal Trade Commission have highlighted how far reaching the deceptive practices laws can be in combating high pressure and manipulative sales practices, as well as actual fraud.<sup>153</sup> While it is possible to disagree with the specifics of these settlements, as a practical matter they demonstrate the effectiveness of the technique. Of course, there are budget constraints that enforcement agencies face, but from a policy perspective, applying the resources of federal and state government to increased enforcement is much more likely to produce positive results than applying those same resources to a restrictive regulatory scheme exemplified by the AARP Proposal.

**Are the benefits worth the cost?**

When the empirical evidence presented in this article is taken into consideration, we think it is clear that the combination of a lack of significant benefits and likelihood of very significant costs of the AARP Proposal approach require its rejection as a matter of social policy. There simply is no evidence of major market failure in the subprime market that would justify such a broad effort to restrict pricing and terms. Moreover, it is quite clear that the subprime market is not primarily a market for low income, aged or minority borrowers. Instead, young to middle aged, middle income borrowers predominate. Whatever hope some may have had that through legislative fiat significant benefits could be delivered at little or no cost to people with low incomes, racial minorities or the elderly, that hope proves to be entirely unjustified. Instead, enacting such regulation will result in significantly reduced credit availability and increased prices for credit, without any significant benefit.

---

<sup>153</sup> See note 16, *supra*.

That result is clearly not desirable. For over thirty years Congressional policy has been to remove barriers to making credit available to lower income and particularly minority borrowers. The 1968 Fair Housing Act provisions barring discrimination in the provision of credit services in connection with the purchase of a dwelling<sup>154</sup> were reinforced by the Equal Credit Opportunity Act specifically requiring lenders to provide credit without discrimination based on race, sex or national origin.<sup>155</sup> In 1977, Congress strongly encouraged financial institutions to lend to their surrounding communities, by enacting the Community Reinvestment Act, which in practice has become a tool to require banks and depository institutions to lend to minority and lower income communities.<sup>156</sup> Vigorous enforcement of these requirements during the 1990s resulted in several consent decrees against major lenders.<sup>157</sup>

Congressional intervention to promote credit availability has also included deregulation of state lending restrictions which restricted credit availability. In 1980, state law restrictions on what a lender could charge in mortgage interest rates on first mortgages were specifically preempted,<sup>158</sup> and in 1982, state law restrictions on any "alternative mortgage transaction" term were also preempted.<sup>159</sup> Cumulatively, this amounts to a longstanding national policy favoring availability of mortgage credit. What is now apparent is that efforts like the North Carolina legislation and the AARP Proposal, although intended to combat abusive lending, would in fact erode the wider availability of affordable mortgage credit to lower income and minority borrowers which it has been our national policy to promote.

---

<sup>154</sup> 42 U.S.C. §3604(b).

<sup>155</sup> 15 U.S.C. §1691 ff. and implementing regulations 12 C.F.R. §203.1ff.

<sup>156</sup> 12 U.S.C. §2901ff., implemented by 12 C.F.R. §§ 25.1ff., 228.1ff., 345.1ff., 563e.1ff.

<sup>157</sup> United States Department of Justice, Fair Lending Enforcement Program, January 2001, located at [www.usdoj.gov/crt/housing/bl\\_01.htm](http://www.usdoj.gov/crt/housing/bl_01.htm) (January 2001).

<sup>158</sup> Title V of the Depository Institutions Deregulation and Monetary Control Act of 1980, P.L. 96-221 §501 ff., 94 Stat. 132 (1980).

<sup>159</sup> Garn St. Germaine Federal Depository Institutions Act of 1982, Title VIII, P.L. 97-320 §801ff, 12 U.S.C. §3801 ff.

## **VIII. Conclusion**

For some time, there has been general recognition that the mechanisms of the consumer credit marketplace works much better in the long run to regulate the supply, price and terms of credit than efforts to control any of this by legislative fiat. There is also widespread acceptance of regulation's role as a support for that marketplace, whether in the form of antitrust, consumer disclosure regulation (like the Real Estate Settlement Procedures Act and Truth in Lending), deceptive practices statutes (like section 5 of the Federal Trade Commission Act and various state deceptive practices acts), or anti-discrimination statutes (like the Fair Housing Act and the Equal Credit Opportunity Act and equivalent state statutes). More intrusive regulation is usually looked at skeptically, particularly at the federal level, because the experience has been that such regulation rarely delivers its promised benefits, and almost always has unintended and unwanted side effects. Direct regulatory intervention in a marketplace, exemplified by the AARP Proposal which in effect caps interest rates (prices) and significantly narrows credit terms, is usually not adopted in this country unless there is evidence of significant market failure which the regulation is then tailored to address.

This article has presented new empirical evidence on subprime lending which suggests strongly that the market mechanism approach described above is working and will continue to work well in the subprime mortgage market. After rapid initial growth of subprime mortgage lending, a market has developed that seems to correlate credit prices with borrower risk. There is no evidence that it is a market with significant market failure. And, there is ample evidence that stringent regulatory proposals like those enacted in Georgia and North Carolina, and the even

more stringent proposals advocated by the AARP Proposal, will impair the availability of credit in these markets without delivering the benefits promised to consumers.

## Appendix A

<b>Table: Comparison of HOEPA and AARP Proposal</b>		
<b>A. Coverage</b>		
	<b>HOEPA</b>	<b>AARP Proposal</b>
<p>What creditors and loans are regulated?</p>	<p>Any "creditor" that originates "certain closed-end mortgages". The term "creditor" covers anyone who "regularly"<sup>160</sup> extends consumer credit <i>and</i> to whom the obligation is payable on its face. It does not cover true brokers.</p> <p>"Certain closed-end mortgages" includes only mortgages on the borrower's principal dwelling (a residential structure with 1-4 units). In addition, the loan must exceed one of two independently operating credit cost thresholds. The threshold is exceeded (1) if the annual percentage rate at consummation exceeds by more than 8 points for a first lien mortgage and 10 points for a second lien mortgage the yield on comparable U.S. Treasury securities as of the 15th day of the month prior to the one in which the loan is originated; or (2) if the points and fees charged on the loan exceed 8% of the amount financed or \$400, whichever is greater. 226.32(a); 226.2(17)("creditor").</p>	<p>Much broader coverage than HOEPA.</p> <p>Any "creditor" that originates open end or closed-end "home loans"<sup>161</sup>.</p> <p>The term "creditor" is broader than HOEPA's equivalent term. It covers anyone who extends consumer credit and to whom the obligation is payable <i>at any time</i>. A homeowner who sells his or her home and takes back a mortgage is covered.</p> <p>"Home loans", covers all mortgage loans secured by residential property containing 1-4 units and containing the borrower's principal dwelling. Thus prime as well as subprime loans are regulated. Manufactured homes that are the borrower's principal dwelling are also covered.</p> <p>Especially stringent provisions apply to "high-cost home loans", which are open end and closed-end loans (including purchase money loans) which exceed one of three independently operating credit cost thresholds.</p> <p>1. The "trigger rate"<sup>162</sup> exceeds, for a first mortgage 6% and for a</p>

<sup>160</sup> More than 25 times in a year.

<sup>161</sup> Apparently by drafting error, section 3(d) severely restricting late fees literally applies to all types of consumer credit.

<sup>162</sup> This is a simple interest rate. "Trigger rate" is defined to treat variable rate transactions significantly more broadly than HOEPA for coverage purposes. For the AARP proposal, the rate for trigger purposes is the highest rate

		<p>subordinate mortgage 8% over the weekly average yield on 5 year (not comparable maturity) Treasuries.</p> <p>2. Points and fees<sup>163</sup> exceed --</p> <p>(a) if the loan amount is \$30,000 or more, 3% of the loan amount, but 2 "bona fide discount points" can be excluded from the 3%.</p> <p>(b) if the loan amount is less than \$30,000, the lesser of 6% of the total loan amount or \$900, but 2 "bona fide discount points" can be excluded from the 6%.</p> <p>3. A prepayment penalty of more than 2% of the loan amount if it can be collected more than 30 months after closing.</p> <p>§2.</p>
Exemptions	Certain types of loans are exempt: 1. a purchase money mortgage loan; 2. a reverse mortgage transaction; or 3. an open end loan. 226.32(a).	Only reverse mortgage transaction loans are exempt. §2.
<b>B. Regulation of Prime Loans and Subprime Loans <i>Below</i> the Threshold</b>		
Encouraging default	No equivalent provision.	Creditor must not recommend that the borrower default. §3(c).
Restrictions on fees and charges	No equivalent provisions.	1. Restrictions on late fees: Cannot charge late fees of more than 4% of the amount past due or earlier than 15 days after the payment due date. The way late fees can be assessed is also regulated. For example, notice to the borrower is required, and the borrower can dispute the late fee. §3(d).

that theoretically could be charged on the loan at any time. HOEPA uses index plus margin as of the date of the loan plus points in calculating the APR.

<sup>163</sup> "Points and fees" are defined to include much more than HOEPA includes for the purpose of determining if the threshold has been exceeded, including the maximum prepayment fee that theoretically could be collected if the loan is prepaid plus all prepayment fees paid to pay off a loan that this loan refinances if the lender on this loan is the same or is affiliated with the lender on the paid off loan.

		2. Creditor cannot charge a fee for providing a payoff balance. A request for a payoff balance must be responded to in 7 business days. §3(f).
Restrictions on Refinancing	No equivalent provision.	Cannot refinance a loan unless results in a "reasonable, tangible net benefit to the borrower", as determined in later litigation. There is a presumption that a loan is not beneficial if the primary benefit is a lower interest rate that would take more than 4 years to recoup the fees and points cost from interest rate savings on the new loan, or if the loan refinanced is a below market interest rate or non-standard loan terms and is made through a special program. §3(b)
Restrictions on what can finance	No equivalent provision.	Cannot finance credit insurance or equivalents, whether health, life, unemployment or property. §3(a).
Cure Right; Acceleration Restrictions; Foreclosure Restrictions	No equivalent provision.	<ol style="list-style-type: none"> <li>1. Creditor must give a borrower in default a right to cure the default by paying what is past due, up to the time the property is transferred to a 3d party in a foreclosure. Creditor must provide a notice of the cure right 30 days prior to starting foreclosure, and cannot charge fees for reinstatement. §5 (a), (b), (c).</li> <li>2. Creditor cannot accelerate in its discretion. §3(e).</li> <li>3. Must foreclose using a judicial procedure. In that procedure, debtor must have the opportunity to assert all claims and defenses. §3(d).</li> <li>4. Attorneys' fees in a foreclosure proceeding are limited. No fees can be charged prior to the 30 days after sending the notice of cure. \$100 can be charged for the period</li> </ol>

		between then and filing foreclosure. During foreclosure only a reasonable and actually incurred attorney fee can be charged. §3(c).
<b>C. Regulation of Subprime Loans <i>Above the Threshold</i></b> Features of the AARP Proposal that apply both to loans above the threshold and loans below the threshold are shown in bold italics.		
Disclosures	1. Special HOEPA disclosures must be given prior to 3 days before loan closing; for loans not subject to HOEPA, such disclosures can be given at the closing. 226.31(c). 2. The special HOEPA disclosures include the annual percentage rate; disclosure of each payment amount that can be required on the loan, including any balloon payment; in a variable rate transaction, disclosure of the maximum payment amount that could be required based on the maximum interest rate possible, and if there is a reduced payment period, the full payment based on the index plus margin in effect at closing; and the total amount borrowed. 3. If a covered mortgage is assigned, there must be a special notice that states: "Notice: This is a mortgage subject to special rules under the federal Truth in Lending Act. Purchasers or assignees of this mortgage could be liable for all claims and defenses with respect to the mortgage that the borrower could assert against the creditor." 226.34(b).	None.
Encouraging default	No equivalent provision.	<b><i>Creditor must not recommend that the borrower default. §3(c).</i></b>
Restrictions	1. No equivalent provision.	1. <b><i>Restrictions on late fees:</i></b>

<p>on fees and charges.</p>	<p>2. Prepayment penalties for a period longer than the first 5 years of the loan are not permitted. If a loan prepays before 5 years, a prepayment penalty can be charged by a lender that is not the same as or affiliated with a refinancing lender if the borrower's total monthly debt does not exceed 50% of the borrower's verified gross income. Rule of 78s rebates are treated as prepayment penalties. 226.32(d)(6), (7).</p> <p>3. The interest rate cannot increase after default. 226.32(d)(4).</p> <p>4. In any precomputed transaction, the actuarial method must be used to calculate rebate of unearned interest if the loan is accelerated after default. 226.32(d)(5).</p> <p>5. No equivalent provision.</p>	<p><i>Cannot charge late fees of more than 4% of the amount past due or earlier than 15 days after the payment due date. The way late fees can be assessed is also regulated. For example, notice to the borrower is required, and the borrower can dispute the late fee. §3(d).</i></p> <p>2. Prepayment penalties are forbidden after the second year. Before then, they are forbidden if they exceed 2% of the prepaid amount in the first year or 1% of the prepaid amount in the second year. §4(b).</p> <p>3. The interest rate cannot increase after default. §4(e).</p> <p>4. No equivalent provision.</p> <p>5. <i>Creditor cannot charge a fee for providing a payoff balance. A request for a payoff balance must be responded to in 7 business days. §3(f).</i></p>
<p>Restrictions on Refinancing</p>	<p>Neither the original lender nor an assignee can refinance a borrower within 1 year unless the refinance is in the borrower's "interest", unless the refinance loan is not</p>	<p><i>Cannot refinance a loan unless results in a "reasonable, tangible net benefit to the borrower", as determined in later litigation. There is a presumption that a loan</i></p>

	over the threshold. Affiliates and other lenders are subject to this prohibition if part of a pattern and practice to evade it. 226.34(a)(3)	<i>is not beneficial if the primary benefit is a lower interest rate that would take more than 4 years to recoup the fees and points cost from interest rate savings on the new loan, or if the loan refinanced is a below market interest rate or non-standard loan terms and is made through a special program. §3(b).</i>
Restrictions on What Can Finance	No restriction.	1. Cannot finance points or fees. §4(a).  2. <i>Cannot finance credit insurance or equivalents, whether health, life, unemployment or property. §3(a).</i>
Underwriting	A lender cannot engage in a pattern or practice of lending without regard to the borrower's ability to repay. A presumption of violation arises if the lender does not verify and document repayment ability. 226.34(a)(4).	Lending without "due regard for repayment ability" is forbidden. A pattern or practice of such lending is not required. There is a safe harbor for following the VA underwriting guidelines. §4(i).
Loan Counseling	No requirement.	Before a borrower can obtain a loan, he or she must attend counseling from a HUD approved counselor (or equivalent) and be certified as having been counseled. §4(h).
Arbitration	No equivalent provision.	Arbitration of disputes cannot be required.
Balloon mortgages	Balloon payments cannot be required on a loan shorter than 5 years, except for bridge loans. 226.32(d)(1).	Balloon payments are forbidden; no exception for bridge loans. §4(c).
Negative Amortization	Forbidden. 226.32(d)(2).	Forbidden §4(d).
Disbursement to a contractor	The loan cannot be disbursed directly to a home improvement contractor. It must be paid out either by joint check to borrower and contractor, directly to the borrower only, or into an escrow account under written agreement with the borrower. 226.34(a)	The loan cannot be disbursed directly to a home improvement contractor unless the lender is given a signed and dated completion certificate showing the home improvements have been completed. Otherwise, it must be paid out either by joint check to

		borrower and contractor, directly to the borrower only, or into an escrow account under written agreement with the borrower. §4(j).
Cure Right; Acceleration Restrictions; Foreclosure Restrictions	<p>1. No equivalent provision.</p> <p>2. Creditor cannot accelerate based on its own discretion. Acceleration must be triggered by fraud, material misrepresentation, default in repayment, or impairment of the security for the loan as a result of the borrower's action or inaction. 226.32(d)(8).</p> <p>3. No equivalent provision.</p> <p>4. No equivalent provision.</p>	<p>1. <b><i>Creditor must give a borrower in default a right to cure the default by paying what is past due, up to the time the property is transferred to a 3d party in a foreclosure. Creditor must provide a notice of the cure right 30 days prior to starting foreclosure, and cannot charge fees for reinstatement. §5(a)(b)(c).</i></b></p> <p>2. Creditor cannot accelerate based on its own discretion. §4(e).</p> <p>3. <b><i>Must foreclose using a judicial procedure. In non-judicial foreclosure states, must obtain a declaratory judgment that can foreclose. In all states, debtor must have the opportunity to assert all claims and defenses. In effect, this may make an assignee liable for all claims and defenses the borrower has. §5(d).</i></b></p> <p>4. Attorneys' fees in a foreclosure proceeding are limited. No fees can be charged prior to the 30 days after sending the notice of cure. \$100 can be charged for the period between then and filing foreclosure. Only a reasonable and actually incurred attorney fee can be charged based on time spent after foreclosure is filed. §4(c).</p>
Advance	The borrower cannot pay in	The borrower cannot pay in

Payments	advance, <i>from the proceeds of the loan</i> , more than 2 periodic payments. 226.32(d)(3).	advance more than the amount of 2 payments. §4(f).
Creditor Liability for Violations by Third Parties	No equivalent provision.	A creditor which personally participated in the making or approving of a loan is liable for any violation of the act, regardless of knowledge or fault. This makes lenders strictly liable for act violations by third parties. §6(b).

**D. Enforcement**

Liability Rules; Damages; Penalties; Punitive Damages	<p>Violations of HOEPA can be enforced under special provisions of the Truth in Lending Act.</p> <p>Civil Penalties: A violation of HOEPA or any other part of Truth in Lending regulation results in civil damages plus attorney fees. 15 U.S.C. §1640. However, for a <i>material</i> violation of HOEPA requirements, the penalties are increased. In addition to recovering a penalty of two times the finance charge up to \$1,000, the borrower can recover all finance charges and fees the borrower has paid. 15 U.S.C. §1640(a)(4).</p> <p>Rescission: In addition to the right of rescission that arises in any mortgage on the principal dwelling of the borrower that is not to secure a purchase money loan, in a HOEPA transaction the borrower has a right to rescind if the loan contract contains a provision forbidden by HOEPA or if material disclosures are not given. 15 U.S.C. §1641; §1639(j).</p> <p>Statute of limitations is one year for disclosure violations and 3 years for the right of rescission.</p>	<p>Generally, liability is much broader, damages more easily recoverable, and penalties much larger than under HOEPA.</p> <p>Any violation of the act results in</p> <ol style="list-style-type: none"> <li>1. A violation of the state unfair and deceptive practices law; and</li> <li>2. Actual damages including consequential damages, and reliance need not be demonstrated to recover;</li> <li>3. A penalty of the finance charges agreed to in the contract (whether paid or unpaid) plus 10% of the amount financed;</li> <li>4. Punitive damages for a malicious or reckless violation;</li> <li>5. Costs and a reasonable attorneys' fees.</li> <li>6. Injunctive, declaratory and equitable relief as the court deems appropriate.</li> </ol> <p>An intentional violation of the act results in the loan being void, and the creditor is liable for all amounts already paid.</p> <p>An effort is made to extend the right of rescission so that it lasts for the life of the loan rather than expiring after 3 years. All other remedies will be exempt from any</p>
--	---	--

		otherwise applicable statute of limitations as long as the loan is outstanding. §7.
Assignee Liability	<p>Prime and subprime loans not over the threshold:</p> <p>1. An assignee is liable for damages and civil penalties under Truth in Lending only if the violation is apparent on the face of the disclosure statement and the assignment was voluntary. 15 U.S.C. §1640(e).</p> <p>Assignee liability for other claims and defenses not involving damages and civil penalties under TILA is determined by state and other applicable law.</p> <p>Subprime loans over the threshold:</p> <p>Generally, any assignee of a HOEPA mortgage takes subject to claims and defenses the borrower has against the original creditor. 15 U.S.C. §1640(d)(1).</p>	<p>Generally, assignees have much broader liability than under HOEPA.</p> <p>Prime and subprime loans not over the threshold:</p> <p>1. An assignee of any loan takes subject to the borrower's right to assert a violation of the act by way of offset. §6(c).</p> <p>2. A lender, any assignee or any owner of the loan is liable for any claim or defense the borrower has against a manufactured home seller or home improvement contractor paid by the loan. §6(a).</p> <p>Subprime loans over the threshold:</p> <p>In addition to the assignee liability described above, an assignee of a subprime loan over the threshold, including an involuntary assignee, takes subject to all claims and defenses the borrower could assert against the original creditor or broker. §6(b).</p>
Servicer Liability	<p>1. Servicers are not liable either as owners of the loan or as assignees. 15 U.S.C. §1641(f).</p> <p>2. No equivalent provision.</p>	<p>1. No equivalent provision.</p> <p>2. A servicer of a subprime loan over the threshold is liable for any claim or defense the borrower has against a manufactured home seller or home improvement contractor paid by the loan. §6(a).</p>

Other Third Party Liability	None	With respect to subprime loans over the threshold, anyone who is a director, officer, employee or controlling stockholder, or any agent of a creditor, is liable for any violation of the act if he, she or it personally participated in the making or approving of the loan, regardless of knowledge or fault. This makes employees of lenders, closing agents and closing attorneys liable if there is a violation of the act without regard to knowledge or fault. §6(b).
-----------------------------	------	---