Predatory Lending Practices and Subprime Foreclosures – Distinguishing Impacts by Loan Category

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(Standard disclaimer applies)

Do we understand enough?

- “When we understand how to distinguish well enough between predatory and legitimate lending, probably a federal statute would be a good idea.”
  - Chairman Ben Bernanke, Feb. 15, 2007

- Results suggest we do not yet understand enough
  - Caution warranted on *national* restrictions on particular loan features.

Some questions we need answered:

- What is the relationship between predatory loan features and the probability of foreclosure?
- Does the relationship vary according to loan category?
- Do combinations of loan features impact foreclosures differently than single features?
- Is the relationship consistent across subprime markets nationwide?

Data

- LoanPerformance subprime data for Chicago
  - 1999QI-2003QII
  - 31,300 loans, over 200,000 loan-quarter observations
- Predatory loan features under study:
  - Long (> 3 years) prepayment penalty period
  - Balloon payment
  - Low- or no-documentation

Change in probability of foreclosure relative to a loan with no predatory features – **Refinance FRMs**

- **Long Prepayment Period: -38%**
- **Balloon Payment: +78%**
- **Low/No Documentation: +54%**
- **Prepay + Balloon: +52%**
- **Prepay + LowNoDoc: +227%**
- **Balloon + LowNoDoc: +66%**
- **All Three PLPs: +108%**

Change in probability of foreclosure relative to a loan with no predatory features – **Purchase FRMs**

Long Prepayment Period:	+3%
Balloon Payment:	+1%
Low/No Documentation:	-15%
Prepay + Balloon:	**+78%**
Prepay + LowNoDoc:	-54%
Balloon + LowNoDoc:	**-47%**
All Three PLPs:	+20%

Change in probability of foreclosure relative to a loan with no predatory features – **Refinance ARMs**

Long Prepayment Period:	**+16%**
Balloon Payment:	----
Low/No Documentation:	**+21%**
Prepay + Balloon:	----
Prepay + LowNoDoc:	+22%
Balloon + LowNoDoc:	----
All Three PLPs:	----

Change in probability of foreclosure relative to a loan with no predatory features – **Purchase ARMs**

Long Prepayment Period:	+0.4%
Balloon Payment:	----
Low/No Documentation:	-4%
Prepay + Balloon:	----
Prepay + LowNoDoc:	+20%
Balloon + LowNoDoc:	----
All Three PLPs:	----

Results and policy implications

- Impact of a predatory feature on subprime foreclosures:
  - Highly dependent on loan category
  - Highly dependent on presence of other features
- Subprime market appears segmented along multiple lines, in ways not clearly understood
- Broad-brush regulation likely too blunt a policy tool
  - May eliminate potentially valuable contractual possibilities that in many cases do not seem problematic
- Regulation that does not differentiate among loan categories will be especially prone to causing unwelcome distortions

Caveats

- Analysis does not address equity stripping
  - Quantitative data not available
  - No compelling reason why complex effects on foreclosures would not apply to equity stripping
- Data from Chicago only
  - Problematic for *national* policy implications if:
    - Relationship between predatory features and subprime foreclosures is generally consistent nationwide, and
    - Chicago is somehow anomalous

Conclusions

- We do not yet know enough to confidently craft effective *national* anti-predatory lending regulation

- Recommend continued development of state and municipal regulation
  - More tailored to local market circumstances
  - Generate greater knowledge of what works