State and Local Anti-Predatory Lending Laws: The Effect of Legal Enforcement Mechanisms

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Financing Community Development from the Past, Looking to the Future
Introduction

- Subprime lending’s growth has raised concerns
  - General performance
  - Predatory issues
- Federal and state governments have responded by enacting laws and regulations for these activities
Anti-Predatory Lending Laws

• Type I: HOEPA and Mini-HOEPA laws
  – If a loan is “high cost,” terms and practices are restricted
  – “High cost” defined in terms of APR or total points and fees as fraction of loan amount

• Type II: Direct restrictions on terms and practices
  – Prepayment, balloons common targets
Current Research

• Do these state-level laws materially impact subprime lending markets?
  – Follow Harvey and Nigro (2004), Ho, and Pennington-Cross (2006)
  – Research innovations
    • New, more comprehensive canvas of laws including Type II laws
    • Consideration of enforcement details
    • More refined assessment of nature of specific mechanisms
The New Legal Dataset Dimensions

- **Coverage**
  - Loan type, two APR triggers, points and fees trigger

- **Restrictions**
  - Prepayment penalty restrictions, balloon payment restrictions, credit counseling requirements, mandatory arbitration limits

- **Enforcement mechanisms**
  - Assignee liability, enforcement against originators

- **Coding:** More stringent gets higher score
The New Index

• Step 1
  – For each subcomponent, rate state against the maximum score

• Step 2
  – Sum up subcomponents within category

• Step 3
  – Compare state to average category score

• Step 4
  – Sum across categories
Index Example: Alabama

- Steps 1 and 2 for Coverage

<table>
<thead>
<tr>
<th>Loan type</th>
<th>APR I</th>
<th>APR II</th>
<th>Points</th>
</tr>
</thead>
<tbody>
<tr>
<td>2/4 = 0.5</td>
<td>4/4 = 1</td>
<td>5/5 = 1</td>
<td>4/5 = 0.8</td>
</tr>
</tbody>
</table>

- Coverage score = \((0.5+1+1+0.8)/2.1954 = 1.5\)
- Total across categories

<table>
<thead>
<tr>
<th>Coverage</th>
<th>Restrictions</th>
<th>Enforcement</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.50</td>
<td>1.50</td>
<td>0.40</td>
<td>3.40</td>
</tr>
</tbody>
</table>
The Research Methodology

- Use HMDA data
- Restrict sample to those loans in counties geographically along a state border
  - Use a random sample of 225,000 such loans
- Include controls for border pair, borrower and location characteristics
- Key variables are state anti-predatory lending law characteristics
  - In effect, total index, category indexes
Empirical Results: Effect of the Laws

• In effect variable
  – Odds of applying for and using subprime loan rises by 5-10 percent
  – No impact on probability of subprime rejection

• Full index variable
  – Subprime originations rise by 3 percent
  – No impact on applications
  – Subprime rejection reduced by 3 percent
Empirical Results: Effect of the Law Components

• Coverage index variable
  – Broader coverage increases odds of applying for (2 percent) and originating a subprime loan (4-5 percent)
  – Likelihood of being rejected falls (2 percent)

• Restrictions index variable
  – Tighter restrictions reduce odds of applying for (-4 percent) and originating a subprime loan (-1-4 percent)
  – No impact on likelihood of being rejected

• Enforcement index variable
  – Same pattern as coverage: originations and applications increase, rejections depressed
Conclusions

• Anti-predatory lending laws do impact subprime lending activity
  – Originations and applications increase, denials fall
  – Suggests that some creditworthy borrowers apply that would not have otherwise

• Implication
  – Properly designed anti-predatory lending laws might actually enhance the subprime lending market