



State Anti-Predatory Lending Laws and Federal Preemption

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Classifying borrowers and loan products

	Prime Mortgages	Subprime Mortgages
Prime Borrowers	Typically prime FRM	Alt-A, option ARMs
Subprime Borrowers	CRA FRM products	ARMS, 2/28, 5/25, others



Subprime loans are characterized by...

- High interest rates
- High points and fees
- Prepayment penalties, balloon payments
- Lending based largely on asset value, not the repayment ability of borrowers
- Exotic mortgages
 - Interest only, option payments, hybrids (e.g., 2/28)
- Desirable securitization products (not after crisis)

Subprime Lending: What Do We Know?

- It represented about 13% of U.S. mortgage market--~\$625 billions of \$5 trillions in 2006 (peak)
- Target: minority, low income, elderly borrowers
- Target: Areas with high concentration of minority, low income, and elderly residents
- Risky mortgage products

Subprime and Predatory Lending

- While not all subprime loans are predatory, most (if not all) predatory loans are subprime.
- Is subprime lending bad?
 - Lending to subprime borrowers is not bad
 - Lending using subprime products seems to be

Defining Predatory Lending

- Cost to borrower $>$ risk to lender
 - In predatory transactions, the cost charged to borrowers exceeds the risks to the lender
- Fees are excessive
 - In predatory transactions, the fees borrowers pay are often excessive (e.g., 10 or more points)
- Default/foreclosure/refinancing is inevitable
 - Predatory transactions are often structured to lead inevitably to refinance; this generates more fees for broker/lender and eventually default



Practices Typically found in Predatory Loans

- Misrepresenting or hiding information
- Establishing repayment terms lenders know borrowers cannot meet without refinancing
- Charging undisclosed and/or excessive fees
- Adjustable interest rates that “explode”
- Inflated rates from brokers - yield spread premiums
- Including prepayment penalties
- No escrow of taxes and insurance
- Stated income
- Promises to fix problems with future refinances
- Requiring mandatory arbitration



Federal response:

Home Ownership Equity Protection Act -HOEPA

- HOEPA addresses certain deceptive practices in home equity lending
- It amends the Truth in Lending Act (TILA)
- It establishes requirements for certain loans with high rates and/or high fees
- Rules for these loans are contained in Section 32 of Regulation Z, so high costs loans are called Section 32 loans



Home Ownership Equity Protection Act – HOEPA (Amended July 2008)

- A loan is classified as a high cost loan by HOEPA if it satisfies either part of a two part test
 - APR test: if annual percentage rate on loan exceeds the rate on a U.S. treasury security of comparable maturity by 8 percentage points or more
 - Fees test: if fees and points are larger than \$583 or 8 percent of the loan
- Full disclosures required
- <http://www.ftc.gov/bcp/edu/pubs/consumer/homes/rea19.shtm>

Federal response:

Home Ownership Equity Protection Act -HOEPA

- Some practices prohibited:
 - Most prepayment – there are some exceptions
 - Balloon payments
 - Negative amortization
 - Default interest rates higher than pre-default rates
 - A due on demand clause – there are some exceptions
 - Make loan without regard to borrower ability to pay
 - Refinance a HOEPA loan with another HOEPA loan within 12 months unless it is in the borrower's best interest

State Policy Responses

- Long before the crisis, states started to fill the void they saw in consumer protection at the federal level by enacting their own anti-predatory lending laws (APLs)
- State anti-predatory laws
 - Strong APLs (26 states)
 - Weak APLs - weak protection
 - Some state laws replicate HOEPA
 - Some state laws extend HOEPA a little

NC Anti-Predatory Lending Laws

- Passed in 1999, the nation's first anti-predatory lending law -- the North Carolina statewide measure took effect fully in July 1, 2000
- 2007 NC Lending Law strengthened the 1999 law
- Aimed at curbing predatory lending abuses

2003 NC Anti-Predatory Lending Laws

- Major provisions prohibited 3 practices:
 - Financing single premium credit insurance,
 - Making fee-loaded refinance loans ("flipping"),
 - Charging prepayment penalties on loans of less than \$150,000.

2007 NC Anti-Predatory Lending Law

- The law uses the Federal Home Mortgage Disclosure Act (HMDA) definition of subprime loans. As of 12/07, loans with an interest rate of 8% or higher would be covered (3% over the comparable Treasury rate).
- For subprime loans, new protections apply:
 - Prohibit prepayment penalties;
 - Require underwriting to ensure ability to repay at the fully indexed rate, not the teaser rate; and
 - Require verification & documentation of income

2007 NC Anti-Predatory Lending Law

- Includes yield spread premiums in the 5% fee trigger for high cost home loans
- Strengthens broker duties
- Gives the NC Commissioner of Banks new authority. to ban practices that the Commissioner finds to be “unfair, deceptive, designed to evade the laws of this state, or which are not in the best interest of the borrowing public.”

Concerns about the 1999 NC Law

- Restricts the credit available to those with least options: borrowers with low credit scores and low- and moderate income borrowers
- Increases the cost of credit for these borrowers

2003 study documents that predatory lending down sharply after enactment of the NC law

- Number of subprime home purchase loans in North Carolina increased
 - 43 percent increase in first lien purchase loans

- Number of subprime refinance loans with predatory terms dropped significantly
 - Refinances dropped 20 percent, consistent with "weeding out" of bad loans

2003 study documents sharp fall-off in loans with prepayment penalties

- A prepayment penalty can often cost a homeowner 5 to 7 % of the loan balance when attempting to refinance into a lower cost home loan.
- Loans with prepayment penalties of three years or more dropped 72 percent in North Carolina after the 1999 law's passage (while rising in neighboring states)

2003 study documents sharp fall-off in balloon payment loans

- A balloon loan requires payment of a large lump sum at the end of the loan term, often requiring families to refinance, costing extra fees
- Subprime refinance loans with balloon payments dropped 53 percent after the NC law's enactment, compared to a drop of 15 percent on average across the nation and neighboring states

No negative impact on credit availability

- Subprime loans to NC borrowers with low credit scores (below 580) increased by almost one-third (31 percent) since 2000
- Subprime home purchase loans increased by 43 percent during the same period.

No negative impact on the cost of credit

- NC's subprime interest rates actually increased less than rates nationally after the 1999 law went into effect
- This indicates there was no reduction in supply of credit in NC relative to other states.

2003 Study: Summing up impacts of NC Law

- Law had no detrimental impact on the supply of subprime credit to borrowers perceived to be high risk, or to families attempting to buy homes.
- Law had no impact on the cost of credit



Federal Preemption

- What it is?
 - When there is a conflict between the Federal and state law, the Federal law is said to preempt - win over - state law thereby displacing the effect of the state law
- When did it happen?
 - 1999 Office of Thrift Supervision
 - Preempted Federal thrifts
 - 2004 Office of the Comptroller of the Currency
 - Preempted national banks

2009 study documents the impacts of APLs and OCC Preemption

- Using HMDA data, we compared
 - Foreclosure rates for states with/without strong APLs
 - Trends in subprime applications and originations before and after the OCC preemption
 - Trends for different types of institutions
 - Trends for states with or without APLs

Impacts of APLs

- States with strong APLs, such as NC, fared better during the foreclosure crisis
 - As of June 2008, the foreclosure rate was 12 percent higher in states without strong APLs
 - Lower rates for neighborhoods in strong APL states...
 - Requiring verification of borrowers' repayment ability
 - With laws with broader coverage of points and fees
 - With more restrictive regulation of prepayment penalties

Impacts of APLs

- Mortgage loans made in states with strong APLs were less risky
 - Average credit scores were higher
 - Average debt to income were lower
 - Average loan to value ratios were lower

Impacts of Federal Preemption

- National banks increased subprime lending after the OCC preemption
 - From 2004 to 2007, their share of subprime lending (high cost loans) jumped from 9 to 20 % in states with strong APLs
- These banks gained a competitive advantage against other lenders who remained subject to higher state standards

Summing up

- It appears that state laws did a better job of ensuring home loan quality than federal regulation, these impacts diminished with the OCC ruling
- State laws can only provide patchy protection if different types of lenders within a state are subject to different rules.



Implications of Findings

- Federal regulators should set minimum standards – a floor, rather than a ceiling – and allow states to enact and enforce higher standards
- Federal preemption legislation now being considered in DC incorporates the above
- Creation of a consumer financial protection agency

If interested...

- You can find copies of the studies and other related materials at our website
 - www.ccc.unc.edu