TO: Board of Governors

FROM: Division of Research and Statistics
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SUBJECT: Regulatory Analysis of Proposed Revisions to Regulation Z Concerning Predatory Lending Practices

DATE: November 28, 2001

SUMMARY

Staff has developed a draft proposal that would amend Regulation Z (Truth in Lending) in a variety of ways to address “predatory lending.” Regardless of how it is defined specifically, the term “predatory lending” generally is applied to what is believed to be a small portion of subprime mortgage lending. The staff draft would address ongoing concerns about predatory lending by: 1) extending coverage of the Home Ownership and Equity Protection Act of 1994 (HOEPA), sometimes known as the high-cost mortgage section of the Truth-in-Lending Act, to more mortgage loans; 2) requiring a new disclosure on refinancings covered by HOEPA provisions; and 3) prohibiting certain acts and practices believed to be prevalent in predatory types of lending and requiring documentation of other actions to demonstrate that they are in the best interests of the consumer or are not illegal.

With available information it is not possible to determine the extent of lending that might be considered “predatory” under common definitions. As noted, predatory lending is believed to involve only a small portion of the subprime lending market, which constitutes an estimated 10-13 percent of the residential mortgage market. The staff proposal likely would have some chilling effect on lenders that engage in predatory activities, causing them to curtail such lending. Because the regulatory revisions also would likely affect other subprime credits, they could make some subprime lending more costly for consumers and relatively less attractive to other lenders considering entering this segment of the mortgage market.

DISCUSSION

Subprime lending, as the term is commonly used, has no strict definition. In common usage the term is often defined according to:

1) consumer or borrower circumstances (e.g. consumers with unconventional sources of income or consumers considered to pose elevated credit risk due to poor or undocumented credit histories);

2) type of credit (e.g. very high loan to value mortgages or short-term cash advances not related to credit cards, such as so-called "payday loans" or pawn loans); or

3) combinations of consumer circumstances and type of credit (e.g. unsecured loans or secured loans such as mortgage or used-car loans extended to credit-impaired consumers or other consumers believed to pose an elevated risk of default).

In contrast, the term "predatory lending" typically is defined according to specific features of individual credit accounts (e.g. especially high interest rates or loan fees, high prepayment penalties) or specific practices of the creditor in individual cases (e.g. high-pressure marketing, a focus on available equity in property owned by unsophisticated borrowers rather than on their ability to pay, frequent refinancing of the loans on a property on terms unfavorable to the borrower, and illegal practices). Many practices associated with predatory loans are already illegal under state laws, (e.g. deception, fraudulent failures to account for payments or refunds properly, falsification of documents, etc.).

Most commentators contend that subprime lending is a necessary but not sufficient condition for predatory lending. Thus, to most observers not all subprime is predatory, but most or all predatory lending is subprime. They argue that the reason predatory lending occurs mostly in the subprime area is that there is less competition in the subprime market, many borrowers of subprime loans are not financially sophisticated, and some of these borrowers are in difficult financial circumstances and may be taken advantage of more easily. Frequently, there is an accompanying contention that the reason for lower levels of competition in subprime lending is insufficient presence of prime lenders in local markets where subprime lending is common.

The Congress first addressed the issue of predatory lending in 1994 with the enactment of the Home Ownership and Equity Protection Act (HOEPA), which amended the Truth in Lending Act. There was a view at the time that further regulatory action to curtail such lending activities might be warranted and the Board was given some discretionary authority to take such actions. Staff has proposed a variety of approaches to address further the issue of predatory lending in three general categories:[1] 1) expanding the number of loans subject to provisions of HOEPA; 2) requiring an additional disclosure on refinanced mortgage loans that are subject to HOEPA provisions; and 3) making certain acts and practices unlawful under federal law and requiring documentation for others. These approaches in the staff proposal would potentially also encompass some unknown number of subprime but not necessarily predatory loans, as well as predatory loans.

1) <u>Extending HOEPA coverage</u>.

There is a two part test for coverage under the HOEPA provisions of Truth in Lending. Under the first test, if the annual percentage rate (APR) on a mortgage loan exceeds the interest rate on United States Treasury securities of comparable maturity by more than ten percentage points, the loan is subject to the HOEPA provisions. The staff proposal would lower this threshold to eight percentage points for first-lien loans, but retain the ten point APR test for junior-lien loans. Under the second test, loans with non-interest fees (not paid to unaffiliated third parties for reasonable closing costs) more than the greater of 8 percent of the loan amount or an amount that adjusts yearly ($465 in 2001) also are subject to the special provisions of

[1] A related but separate staff proposal to amend Regulation C that would gather more information about mortgage markets, including subprime lending, was proposed by the Board for public comment on November 29, 2000. This proposal will return to the Board as a separate item.

HOEPA. The staff proposal would change this latter test to include premiums on financed credit insurance and related products.

Size of the subprime market. Although there is no generally agreed-upon single definition of a subprime mortgage or comprehensive and consistent data collection on subprime lending, there are estimates of market size using a variety of definitions and methodologies. One estimate is derived from data collected under the Home Mortgage Disclosure Act (HMDA), based upon activity of lenders identified as subprime lenders by staff of the Department of Housing and Urban Development. Necessarily this estimate includes any prime loans that may be made by these subprime lenders and excludes any subprime loans made by lenders classified as prime lenders. The estimate of subprime mortgage lending using this approach is about 1.1 million loans originated in 1999 for $99.5 billion and 963 thousand loans in 2000 for $84.7 billion (first panel of Table 1). These yearly amounts are a bit over 10 percent of total mortgage originations subject to HMDA in the two years.

Another estimate is from Inside Mortgage Finance Publications (IMFP), Inc., a private publishing organization that surveys large lenders including subprime lenders. This source estimates subprime mortgage originations of $160 billion in 1999 and $140 billion in 2000, about 12.5 percent and 13.4 percent, respectively, of their estimate of total mortgage originations in the two years (second panel of Table 1).[2]

Both the HMDA and IMPF data indicate a decline in the amount of subprime mortgage lending from 1999 to 2000. Both data sources also suggest, however, that this market segment has grown substantially since the mid 1990s. IMPF data indicate, for example, that this market segment has more than doubled in yearly volume from 1995 levels.

Coverage of HOEPA. The number of additional mortgage loans that would be covered by HOEPA as a consequence of the proposed regulatory changes is unknown, but information that has become available recently from two surveys of mortgage loans at some large companies active in the subprime mortgage market suggests that coverage likely would increase more than previously believed. Neither survey involves a scientific sample of subprime mortgage lenders or mortgage loans; rather, each consists of a complete census of loans at participating companies. In each case it seems the size of the sample is large enough that it provides some indication of the order of magnitude of the likely impact of the proposed changes in the HOEPA coverage definitions.

First, a public comment from the American Financial Services Association (AFSA) provides some results of a survey of nine large member companies active in the subprime mortgage market undertaken in the second half of 2000 by PriceWaterhouse Coopers. Survey coverage was about 1.4 million first and second lien mortgages with an origination volume of $63.1 billion (third panel of Table 1). Data include all of the mortgage loans originated by these companies from the second half of 1995 through the first half of 2000.

[2]Inside Mortgage Finance Publications, Inc., The Mortgage Market Statistical Annual, Year 2001 Edition.

In 1999 (the last full year of the AFSA information) the sample included 377,523 loans totaling about $19 billion. These loans are about 34 percent of the estimate of the number of subprime mortgage loans that year using the loan number estimate from the HUD list of subprime lenders that are HMDA reporters and about 19 percent of their dollar volume. The volume in the AFSA sample for 1999 is about 12 percent of the dollar volume estimate for that year from the IMFP source. Although there are inconsistencies of definition and method among the sources making the components of these ratios not strictly comparable, the finding of a much larger proportion of the HMDA figure for the number of loans in the AFSA sample than for the volume suggests that the loans in the AFSA sample are on average smaller than subprime loans generally. This, in turn, argues the probability that the loans made by this group of subprime lenders would also be HOEPA loans somewhat more frequently than subprime loans generally, since, due to fixed origination costs, smaller loans tend to carry higher interest rates, other things equal.

Over the six years recorded in the AFSA sample of loans (four full years and two half years), 12.4 percent of the number of first-mortgage loans originated were subject at origination to the current HOEPA provisions of Regulation Z (Table 2). (In 1999, the latest full year, the proportion was 10.7 percent, not shown in the table.) For junior-lien loans, 49.6 percent of the loans originated by these companies over the period (and 53.9 percent of the loans originated in 1999) were HOEPA loans.

Under the proposed revision to the regulation, 37.6 percent of the AFSA sample of first mortgages originated during the sample period would have been subject to the regulation if the proposed revision had been in effect over the period, approximately a tripling. For second liens, 61.0 percent of the loans would have been HOEPA loans, approximately 23 percent higher.

The distribution of contract interest rates (coupon rates) from the AFSA survey of loans appears reasonably consistent with the comparable distribution of contract rates on subprime mortgages in a data set made available by the Office of Thrift Institutions using information from the Mortgage Information Corporation's (MIC) sample of 27 subprime mortgage lenders.[3] Contract rates in this sample of subprime mortgage loans are a bit lower than in the AFSA sample, except for shorter-term second-lien loans (Table 3). The somewhat higher contract rates generally in the AFSA sample could arise if the AFSA loans are either somewhat smaller or of somewhat higher risk than the MIC sample of loans.

The MIC sample does not contain information on APRs, fees, or credit insurance penetration, and so HOEPA coverage cannot be estimated directly for the loans in this sample, either before or after the proposed regulatory revision. Based solely on the contract-rate information available in the MIC sample it appears, however, that a substantial portion of the loans, especially junior liens, would currently be HOEPA loans. This proportion would increase by an unknown amount following implementation of the revision to Regulation Z as proposed,

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[3]Subsequent to preparation of these data, the Mortgage Information Corporation has changed its name to LoanPerformance, but the name MIC is used here indicating the source name at construction of the data. MIC data include information on about 1.5 million subprime mortgage loans from the 27 companies. As with the AFSA data, these data may not be representative of the subprime mortgage market as a whole.

but it could approach the increase projected in the AFSA sample, especially among the smaller junior-lien loans.[4]

Impact on the HOEPA loan market. Covering more loans under the HOEPA provisions would extend to more loans the protections of that Act, including more disclosures, a longer waiting period associated with generating the credits, and prohibitions on some practices such as balloon-payment provisions on loans of maturity less than five years or negative-amortization payment schedules. Because HOEPA loans appear to be more costly to make and, in the view of some observers, carry a stigma in the secondary market, greater coverage could have a chilling effect and raise regulatory costs in a segment of the subprime mortgage market. This might deter interest of some predatory lenders in this market. It seems unlikely this effect would be restricted to predatory lenders alone, however. Expanded HOEPA coverage may cause some subprime lenders to curtail lending activities in this market segment, and it could cause some potential new legitimate competitors to forego entry into this market where competition currently is alleged to be less than in the market for prime mortgage loans. It is also possible, however, that some lenders may see an opportunity to expand HOEPA lending if a reduction in competition creates new opportunities.

Only about 20 public comments specifically mentioned securitization of subprime loans; most of these comments were from lending institutions. No investors in asset-backed securities or securities underwriting firms commented on the proposal. Absence of any comments from investors and underwriters suggests that the level of concern may not be great among these entities, likely in part because markets have already adjusted to increasing prevalence of subprime mortgage lending, some of which is subject to HOEPA. Informal contacts with underwriters indicate that there are investors who will not invest in securities backed by pools of loans that contain HOEPA loans because of the legal and reputational risks arising from funding such lending. Together with failures and contractions among active securitizers of subprime mortgage loans, waning interest of investors apparently already has contributed to fewer securitizations that contain HOEPA loans. In the view of these observers, if HOEPA coverage increases further, then funding subprime lending will become more difficult. They suggest that even portfolio lenders will need to become more wary of HOEPA loans because making them may tend to limit access to the securitization market for funding, which may be important under uncertain market conditions. In contrast, other observers mention that funding HOEPA lending currently depends on representations and guarantees that compliance systems are in place and that problem credits will be repurchased. To them HOEPA lending is really a pricing issue that works itself out through adjusting pricing and coupons; more HOEPA lending really means just further adjustments in these areas.

It is difficult to evaluate these claims and contentions fully, since it is not possible to know in advance the impact on business judgments concerning the risk-return tradeoff if more loans become subject to HOEPA. Certainly there currently are lenders who engage in HOEPA lending to a substantial degree, and it seems likely they will continue to do so. Reputational

[4]Previous staff estimates of HOEPA coverage among loans in the MIC sample were much lower because data previously available were for long-term first mortgages only, a market segment where HOEPA coverage is relatively small.

risks together with funding complications may also cause some other lenders whose subprime lending is a small or marginal portion of their business plan to withdraw from this market. It further seems likely that the proposed HOEPA revisions, if approved, will cover a sufficiently large portion of subprime lending that others, including those with only a small proportion of HOEPA loans at present, may indeed expand their portfolios in this area if they are to continue to be active in the subprime market.

Most of the lenders who mentioned secondary markets and a few consumer advocacy organizations commented that subjecting a larger proportion of mortgage loans to provisions of HOEPA will lead to reduced availability of subprime mortgage credit because of the legal risks, higher operating costs, and stigma associated with HOEPA lending. A few commentators contended that even if the overall subprime mortgage credit did not diminish in size, it could pass more completely into the hands of portfolio lenders instead of securitizers. In their view, these developments could increase concentration in subprime lending to the detriment of competition and consumers.

Number of small entities affected. The number of lenders, large or small, likely to be affected by the proposal is unknown. In the June 2001 Call Report, 4547 small banks (assets less than $100 million) had first-lien mortgage credit outstanding, and 3477 small banks had junior-lien loans outstanding. At the same time there were 228 small thrifts that report to the Office of Thrift Supervision which had closed-end first mortgage credit and/or junior-lien loans outstanding. The number either of banks or thrifts active in subprime lending or HOEPA loans cannot be determined from information in the Call Reports.

There is no comprehensive listing of consumer finance companies, but informal industry contacts indicate that there may be about 2000 such institutions nationwide. Most of these companies are small entities, but apparently many, perhaps most, of the small institutions do not engage in mortgage lending, preferring to concentrate on unsecured lending and sales finance. An unknown number of small institutions does engage in mortgage lending, but there is no comprehensive listing of these institutions or estimate of their number.

There also is no comprehensive listing of mortgage banks or mortgage brokers, but informal discussion with industry sources indicates that there are more than 1200 mortgage banking firms with annual mortgage originations of less that $100 million, which are also members of a national trade association. Some of these companies are primarily mortgage servicing companies and generate few or no new mortgages, but there is also an unknown number of other mortgage banks that do not belong to the association.

Any institutions that originate subprime mortgages, including small entities, will have to become aware of the new definitions that, if implemented, would expand HOEPA coverage. As needed, they will have to comply with the additional disclosures and other consumer protection provisions that HOEPA status entails. In many cases this will mean internal review and other actions by attorneys, programmers and systems specialists, employee trainers, and senior managers. Some small entities may be able to rely on current personnel for these specialized skills, while others likely will find it necessary to acquire these services from consultants or vendors retained for the purpose.

2) <u>New disclosure(s)</u>.

The staff proposal would also require an additional disclosure among the early HOEPA disclosures for refinancing loans subject to the Act. The additional disclosure is the "amount borrowed," which the proposal defines as the face amount of the note. It is the sum of the "amount financed," currently a TIL disclosure, and prepaid finance charges that are financed (typically financed "points"). If credit insurance premiums are included in the amount financed and the amount borrowed, a further new disclosure would alert consumers to this fact. The initial proposal in December 2000 noted that both creditors and consumer advocates question the benefit of additional early disclosures to prevent predatory lending, although some additional disclosure might be in the interest of some borrowers. The new item(s) would be transaction specific and would require both system changes by creditors to produce the correct document and retraining of staff who interact with HOEPA loan customers or potential customers.

3) <u>Prohibiting and requiring specific acts and practices</u>.

The staff proposal would also address a number of specific acts and practices. First, the staff proposal would specifically prohibit a creditor holding a loan subject to HOEPA from refinancing the loan within twelve months of its origination, unless the creditor can demonstrate that the refinancing is in the borrower's interest. This provision is specifically intended to address the issue of "loan flipping," a practice believed to be common in predatory lending, whereby a lender refinances a loan frequently, charging fees each time, but where the borrower does not achieve much benefit, if any. This approach should have the effect of making the most egregious examples of flipping more difficult to undertake, at some risk of making the financial situation of those consumers with some real need to refinance a credit somewhat more difficult, in that their familiar lender might be less willing to refinance the credit.

Second, the staff proposal would require that creditors assemble documentation demonstrating a consumers' ability to repay HOEPA loans to rebut a presumption that absence of such information amounts to engaging in an illegal pattern or practice of making asset-based HOEPA loans. Because a pattern or practice of making asset-based HOEPA loans currently is impermissible, legitimate lenders in this market presumably have procedures in place to show that they are not lending illegally. Consequently, this provision is not likely to have any substantial effect on the substantive practices of legitimate lenders, although they may feel the necessity to increase documentation to prevent possible litigation. The proposal likely will have a deterrent effect on truly predatory asset-based lenders who will have difficulty demonstrating the legitimacy of such credits.

Third, the proposal would prohibit HOEPA demand loans and would prohibit the structuring of what is essentially a closed-end loan into an open-end plan merely to avoid the restrictions of HOEPA. It seems that examples of these practices will be uncommon among legitimate subprime lenders and so the impact on the legitimate subprime market should not be great. As with the other regulatory provisions, there may be some legal risks associated with the possibility of additional litigation.

Table 1

Total and Subprime Mortgage Originations
(Number amounts in thousands, dollar amounts in billions)

A. Estimates from the Home Mortgage Disclosure Act (HMDA) Data[1]

Year	Total HMDA Originations		Subprime HMDA Originations		Ratio of Subprime to total (percent)	
	Number	Volume	Number	Volume	Number	Volume
1995	5372	$457	199	$12.1	3.7	2.7
1996	6610	$574	326	$20.1	4.9	3.5
1997	6853	$651	622	$40.1	9.1	6.2
1998	11267	$1222	1218	$103.3	10.8	8.4
1999	9143	$988	1119	$99.5	12.2	10.1
2000	7141	$792	963	$84.7	13.5	10.7

B. Estimates from Inside Mortgage Finance Publications (IMFP)[2]

	Total Originations	Subprime Originations	Ratio of Subprime to total (percent)
	Volume	Volume	Volume
1995	$636	$65	10.2
1996	$785	$96	12.3
1997	$859	$125	14.5
1998	$1430	$150	10.5
1999	$1275	$160	12.5
2000	$1048	$140	13.4

C. Subprime Loans, American Financial Services Association Sample

	AFSA Sample Originations		Ratio of AFSA Sample to Subprime Total (percent)		
	Number	Volume	AFSA Number/ HMDA Number	AFSA Volume/ HMDA Volume	AFSA Volume/ IMFP Volume
1995[3]	75.4	$2.1	76.5	34.7	6.5
1996	191.1	$6.7	58.6	33.3	7.0
1997	253.5	$10.4	40.8	25.9	8.3
1998	306.5	$14.7	25.2	14.2	9.8
1999	377.5	$18.7	33.7	18.8	11.7
2000[3]	206.7	$10.2	42.9	24.1	14.6

Notes:

[1]Source: Federal Financial Institutions Examination Council, “Home Mortgage Disclosure Act Data,” 1995-2000.
[2]Inside Mortgage Finance Publications, Inc., The Mortgage Market Statistical Annual, Year 2001 Edition.
[3]Half year for AFSA sample; denominators of ratios use half of corresponding amounts from panels A and B of table.

Table 2

HOEPA Coverage in AFSA Sample of Loans

A. First-Lien Loans
(Percent)

	Current HOEPA Provisions	Proposed HOEPA Provisions
HOEPA Loan Under APR and Fees Tests:	12.4	37.6
HOEPA Loan Under APR Test Only:	8.9	25.8

B. Junior-Lien Loans
(Percent)

	Current HOEPA Provisions	Proposed HOEPA Provisions
HOEPA Loan Under APR and Fees Tests:	49.6	61.0
HOEPA Loan Under APR Test Only:	46.8	46.8

Source:

Docket R-1090, Comment of the American Financial Services Association.

Table 3

Comparison of Contract Interest Rates on Loans Made in June 2000
MIC and AFSA Samples of Subprime Loans

A. First-Lien Loans
(Percent)

Contract Rate	Original Maturity 15 Years or Less MIC	Original Maturity 15 Years or Less AFSA	Original Maturity More than 15 Years MIC	Original Maturity More than 15 Years AFSA
Less than 10%	16.0	11.5	26.8	16.2
10.01-12.00%	38.8	28.1	49.0	39.7
12.01-14.00%	29.4	29.2	20.1	29.9
More than 14%	15.1	31.1	4.0	14.2
Total	100.0	100.0	100.0	100.0

B. Junior-Lien Loans
(Percent)

Contract Rate	Original Maturity 15 Years or Less MIC	Original Maturity 15 Years or Less AFSA	Original Maturity More than 15 Years MIC	Original Maturity More than 15 Years AFSA
Less than 10%	3.4	3.0	3.0	1.2
10.01-12.00%	11.9	20.6	16.9	18.6
12.01-14.00%	32.5	28.8	43.2	23.9
More than 14%	52.1	47.7	37.0	56.2
Total	100.0	100.0	100.0	100.0

Note:

Parts may not sum exactly to totals because of rounding.