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

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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 reported instances of 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 not illegal.

With available information it is not possible to determine the extent of lending that might be considered "predatory" under common definitions. 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 some other subprime credits, they could make some subprime lending more costly and relatively less attractive to other lenders engaged in mortgage lending.

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. high loan to value mortgages, 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 lending or used-car loans to low income or credit-impaired consumers).

In contrast, the term "predatory lending" typically is defined according to specific features of individual credit accounts (e.g. especially high interest rates or fees, high prepayment penalties) or specific practices of the creditor in individual cases (e.g. high-pressure marketing, 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 HOEPA. It was contemplated 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 further address 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 mortgage loans that are refinancings and 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) Extending HOEPA coverage. 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 special provisions. The staff proposal would lower this threshold to eight percentage points. 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 and an amount that adjusts yearly ($451 in year 2000 and $465 in 2001) also are subject to the special provisions of HOEPA. The staff proposal would change this latter test to include premiums on single-premium credit insurance and related products. The number of additional mortgage loans that would be covered by HOEPA as a consequence of this change is unknown, but likely would include a high proportion of mortgages that include single-premium credit insurance.

Relatively little information is publicly available on the distribution of mortgage loans by APR or fees. Consequently, the proportion of such loans currently covered by either of the tests is not known. Some information about the distribution of subprime mortgage loans by coupon rate (but not by APR or fees) is available from the Mortgage Information Corporation (MIC).[2] These data indicate that about one percent of subprime mortgage

[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.

[2]MIC data include information on about 1.5 million subprime mortgage loans from a limited number of large subprime lenders. These data may not be representative of the subprime mortgage market as a whole.

loans carry a coupon that is more than ten percentage points above the 30-year Treasury rate and, consequently, would currently be subject to the HOEPA provisions on this basis (if the APR is near the coupon rate, which is generally the case for longer-term mortgages). These data also indicate that an additional 4 to 5 percent of such loans carried a coupon rate 8 to 10 percentage points above the 30-year Treasury rate.

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 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, and it could cause some potential new legitimate competitors to forego entry into this market where competition currently is alleged to be low.

2) New disclosure. The staff proposal also requests comment on an additional disclosure (total loan amount) to be included among the early HOEPA disclosures for refinancing loans subject to the Act. (The proposal also asks for comment on a generic disclosure for consumers to seek additional independent financial advice when appropriate.) The proposal notes 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 borrowers. The new item would be transaction specific and would require system changes by creditors to produce the correct document. (The disclosure recommending seeking independent financial advice could be preprinted.)

3) Prohibiting and requiring specific acts and practices. The staff proposal would 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 rapidly or 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.

Second, the staff proposal would prohibit creditors within five years of an origination from refinancing with higher-rate loans certain zero-interest-rate and other low-cost loans from mortgage-assistance programs unless the creditor could demonstrate that the refinancing is in the interest of the borrower. This approach also should have the effect of making the most egregious examples of abuse more difficult to perpetrate, again at some risk of making the financial situation of those consumers with some real need to refinance a credit somewhat more difficult.

Third, 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 frivolous 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.

Fourth, 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.