

Impact of “Predatory Lending” Legislation on Availability of Credit:



The Unintended Consequences

March 23, 2003

Recent studies on the impact of North Carolina's 1999 "predatory lending" legislation were utilized in this presentation to show the impact of the legislation on the availability of credit to North Carolina consumers, especially subprime borrowers.

What is “Predatory Lending?”

- The concept of “predatory lending” is difficult to define. Some believe that certain products are “predatory;” however, it is how certain products are utilized that can be “predatory.”
 - Many try to equate subprime loans and “predatory loans.” The two are not synonymous.
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A Misperception

Subprime does NOT equal “Predatory”



The Expansion of the Subprime Market

- Prior to the emergence of the subprime lending market, many Americans had been unable to obtain mortgage loans and participate in the dream of homeownership.
 - The subprime market provides access to credit for many Americans who would not otherwise be able to obtain a mortgage loan.
 - Homeownership continues to remain at record high-levels. Recent figures from Fannie Mae place homeownership at a record high 68%.
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The Foreclosure Myth

- Myth:
 - Lenders are in the business to foreclose on properties.
- Fact:
 - Lenders incur losses as a result of foreclosures.



The Foreclosure Myth

- Myth:
 - The subprime market developed for lenders to have a means to foreclose on properties.
 - Fact:
 - Many see foreclosure rates as indicative of the failure of the subprime market. However, many subprime loans are prime loans that have been refinanced by consumers who are already in financial trouble (such as those who have lost jobs, or have other debt). Thus, there are a number of factors behind any foreclosure rate.
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Profitability of Subprime Loans

- Overall, the subprime market does not generate excessive profits to lenders.
- On average, a subprime loan generates:
 - Pre-Tax: .50-.75 basis points (a basis point is a percentage of the gross loan amount; in other words, .50 represents .5% of the gross loan amount)
 - After-Tax: .30-.40 basis points

[Source: Decision One]

Consumer protections
already exist to protect consumers



In an attempt to protect consumers...

- Congress enacted a federal statute, HOEPA, that created additional restrictions and requirements for high cost loans in 1994. The Federal Reserve Board created regulations to implement this legislation, Section 32.
 - The Federal Reserve Board held a series of hearings in 2001 to determine what amendments to the Section 32 regulations were necessary to protect consumers. The Federal Reserve Board amended the regulations, which amendments were effective October 2002.
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State “Predatory Lending” Initiatives

- Prior to 1999, few states maintained “high cost loan” statutes or regulations. Those that did mirrored the federal HOEPA.
 - In 1999, North Carolina became one of the first states to enact a “high cost loan” law.
 - This law differed from the federal HOEPA; the North Carolina law captured more loans than HOEPA and created additional requirements and restrictions for those loans that fell within the confines of the statute.
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Since the Passage of the North Carolina law, Subprime Originations Have Decreased

- A study¹ has shown that subprime lending in North Carolina has fallen compared to the national average since the enactment of the high cost loan law:
 - In 1998, North Carolina originated 33% more subprime loans than the national average.
 - In 2000, North Carolina originated 18% more subprime loans than the national average.

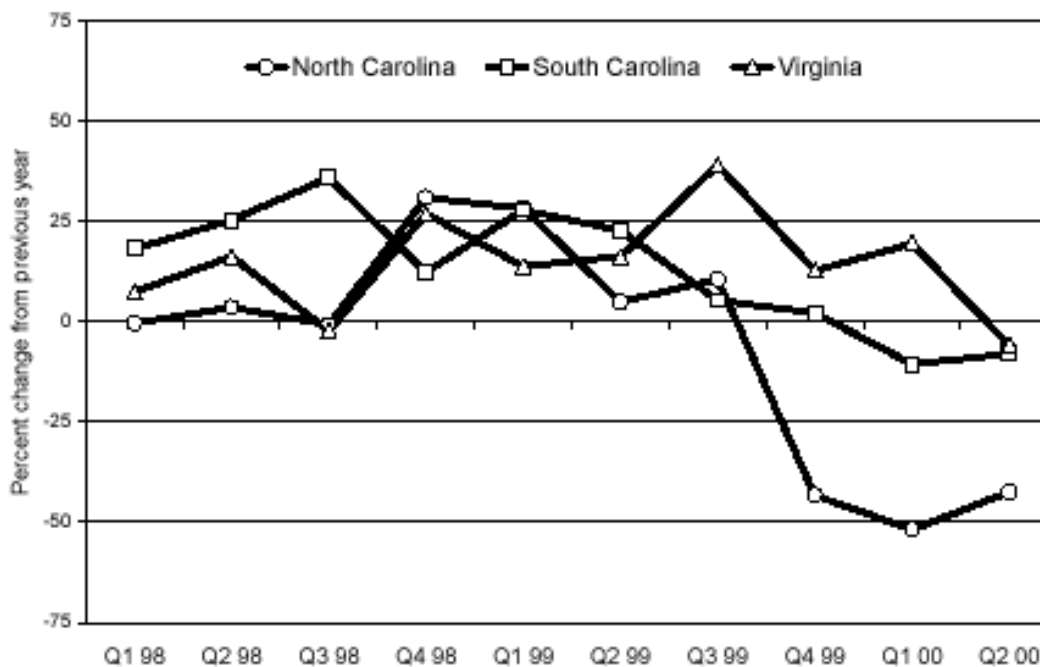
¹Source: HMDA (Staten Review¹)

Further...

- When comparing neighboring states (South Carolina, and Virginia) to North Carolina for the same period of time, a study¹ shows that the law restricted loan availability to subprime borrowers.
 - According to the same study,¹ originations to borrowers with lower income levels incomes fell in North Carolina more dramatically than in neighboring states. However, the disparity was much less extreme at higher income levels.
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Originations to Borrowers with Incomes Below \$25,000

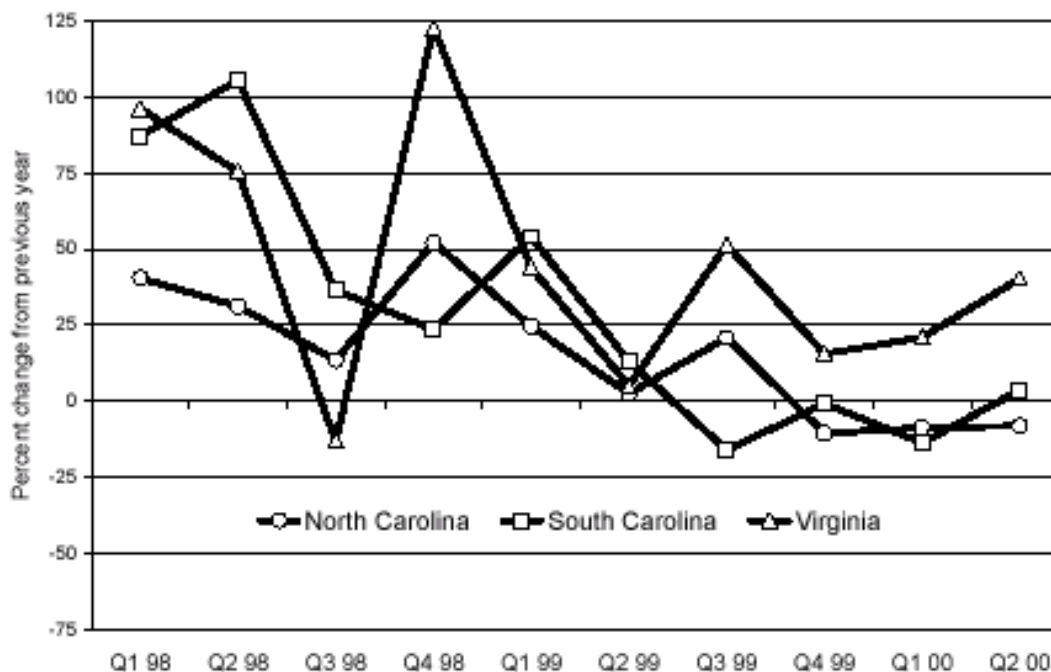
Chart 1
Year-over-Year Change in Originated Loans
First Liens: Borrower Income < \$25,000



Source: Elliehausen
 and Staten Review

Originations to Borrowers with Income \$50,000 - \$74,999

Chart 2
Year-over-Year Change in Originated Loans
First Liens: Borrower Income \$50,000-\$74,999



Source: Elliehausen
 and Staten Review

The Impact on North Carolina Consumers

- The decrease in subprime originations demonstrate that the North Carolina law has created a reduction in the availability of credit for borrowers with less than perfect credit records.
 - However, as all subprime loans are not “predatory loans,” North Carolina’s “shotgun approach” has captured many “non-predatory” subprime loans within the confines of the law and as such, many “non-predatory” subprime loans were not originated.
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North Carolina's "Predatory Lending" Law Has Not Been Effective

- Any reductions in "predatory lending" were achieved at the expense of legitimate loans to deserving homebuyers or homeowners. The law captures more than just "predatory loans" within its confines.
 - Further, it is difficult to quantify whether there was an actual reduction in "predatory lending" in North Carolina. Certain studies² that claim that the law has reduced "predatory lending" equate the reduction in subprime originations as a reduction in "predatory lending."
 - Reductions in the number of subprime loans originated in North Carolina since the enactment of the law are a clear signal that many homeowners may find access to subprime mortgages limited there by denying them a chance at the "American Dream" of homeownership.
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What can be learned from North Carolina's mistakes?

- While it is true that the majority of mortgage lenders have not exited the North Carolina mortgage market, this does not translate to a thriving subprime market (as shown earlier). Many have adapted their business models, credit risk policies, and underwriting to avoid making loans that fall within the confines of the North Carolina law.
 - Less subprime loans are being made in North Carolina, and thus, the availability of this type of credit has decreased, to the detriment of North Carolina homeowners.
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Georgia Experienced a Similar Situation

- In October 2002, the Georgia Fair Lending Act became effective. This is one of the most aggressive and far-reaching “predatory lending” laws ever enacted.
 - Standard and Poor’s and Moody’s publicly stated that they would no longer rate “high cost loans” in Georgia.
 - Certain lenders are no longer originating these loans in Georgia.
 - A group of minority mortgage lenders brought suit in Georgia alleging that members of the community have been denied credit due to this law.
 - Emergency legislation was enacted due to the immediate needs for available credit in Georgia.
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It is Premature to Enact Additional Laws

- Is predatory lending of “sufficient magnitude that it requires new legislation rather than more intensive enforcement of existing laws and regulations?”³ Existing laws and regulations should be rigorously enforced prior to enacting new legislation.
 - Restrictive loan terms, and interest rate thresholds, in effect act as usury ceilings, which cut off credit to consumers.³
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References

- ¹ Elliehausen, Gregory and Michael Staten, “Regulation of Subprime Mortgage Products: An Analysis of North Carolina’s Predatory Lending Law.” McDonough School of Business, Georgetown University, Washington, D.C. (September 23, 2002).
 - ² Ernst, Keith, John Farris and Eric Stein, “North Carolina’s Subprime Home Loan Market After Predatory Lending Reform.” Center for Responsible Lending, Durham, North Carolina. (August 13, 2002).
 - ³ Litan, Robert E., “Unintended Consequences: The Risks of Premature State Regulation of Predatory Lending.” Brookings Institution, Washington, D.C.
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