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## Remarks by Governor Edward M. Gramlich

At Cleveland State University, Cleveland, Ohio

March 23, 2001

*Governor Gramlich presented identical remarks at the Neighborhood Reinvestment Corporation luncheon, Raleigh, North Carolina, March 26, 2001*

### Tackling Predatory Lending: Regulation and Education

I am pleased to participate in today's conference on predatory lending. This seems to have become a major problem around the country, as in Ohio. Conferences such as this provide a valuable opportunity to learn more about this very complex topic. One of the welcome developments in recent years is the expansion of the home mortgage market to a broader socioeconomic range of borrowers. Studies of urban metropolitan data submitted under the Home Mortgage Disclosure Act (HMDA) have shown that lower-income and minority consumers, who have traditionally had difficulty in getting mortgage credit, have been taking out loans at record levels in recent years. Specifically, conventional home-purchase mortgage lending to low-income borrowers nearly doubled between 1993 and 1999, whereas that to upper-income borrowers rose 56 percent. Also over the same period, conventional mortgage lending increased by about 120 percent to African-American and Hispanic borrowers, compared with an increase of 48 percent to white borrowers.

Much of this increased lending can be attributed to the development of the subprime mortgage market. Again using HMDA data, the number of subprime home equity loans has grown from 66,000 in 1993 to 856,000 in 1999, a thirteen-fold increase. Over this same period, the number of subprime loans to purchase homes increased sixteen-fold, from 16,000 to 263,000. This rapid growth has given credit access to consumers who have difficulty in meeting the underwriting criteria of prime lenders because of blemished credit histories or other aspects of their profiles. This expansion of credit gives people from all walks of life a shot at the twin American dreams of owning a home and building wealth.

But along with these positive developments have come disquieting reports of abusive lending practices, targeted particularly at female, elderly, and minority borrowers. These practices, many of which can result in consumers' losing much of their equity in their home, or even the home itself, are commonly referred to as "predatory lending." Predatory lending can damage these same hardworking but low-income people and the communities in which they live. Its growth is a noticeable blight in this otherwise attractive mortgage-lending picture.

The term "predatory lending," much like the terms "safety and soundness" and "unfair and

deceptive practices," is far-reaching and covers a potentially broad range of behavior. As such, it does not lend itself to a concise or a comprehensive definition. But typically predatory lending involves at least one, and perhaps all three, of the following elements:

- making unaffordable loans based on the assets of the borrower rather than on the borrower's ability to repay an obligation ("asset-based lending")
- inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced ("loan flipping")
- engaging in fraud or deception to conceal the true nature of the loan obligation from an unsuspecting or unsophisticated borrower.

Some of these practices are clearly illegal and can be combated with legal enforcement measures. But some are more subtle, involving the misuse of practices that most of the time can improve credit market efficiency. For example, the freedom for loan rates to rise above former usury law ceilings is generally desirable in that it matches relatively risky borrowers with appropriate lenders. But sometimes the payments implicit in very high interest rates can spell financial ruin for borrowers. Most of the time, balloon payments make it possible for young homeowners to buy their first house and match payments with their rising income stream. But sometimes balloon payments can ruin borrowers who do not have a rising income stream or who are unduly influenced by an immediate need for money. Most of the time, the ability to refinance mortgages permits borrowers to take advantage of lower mortgage rates, but sometimes easy refinancing invites loan flipping, resulting in high loan fees and unnecessary credit costs. Often credit life insurance is desirable, but sometimes the insurance is unnecessary, and at times borrowers pay hefty up-front premiums as their loans are flipped. Generally advertising enhances information, but sometimes it is deceptive. Most of the time, disclosure of mortgage terms is desirable, but sometimes disclosures are misleading, with key points hidden in the fine print.

Predatory lending entails either fraud or the misuse of these and other complex mortgage provisions that are generally desirable and advantageous to a borrower, but only when the borrower fully understands them.

### **Home Ownership Equity Protection Act (HOEPA)**

The Congress has passed a number of consumer protection statutes in this area. One important law is the Home Ownership and Equity Protection Act (HOEPA) of 1994, an amendment to the earlier Truth in Lending Act. Among other things, HOEPA requires that the Federal Reserve Board periodically conduct public hearings to gather information about trends within the home equity market. This summer the Board held a second round of HOEPA hearings in Charlotte, Boston, Chicago, and San Francisco. Earlier hearings had been held in 1997 and had led to a joint report to the Congress from the Board and HUD.

The basic approach of HOEPA is to shine a bright spotlight on high-cost mortgage loans. For these high-cost loans, certain practices--balloon payments in the first five years, prepayment penalties, and a pattern and practice of asset-based lending--are banned. In addition, for HOEPA-covered loans, creditors must provide a short disclosure to borrowers three days before the loan is closed; loans under HOEPA are also subject to the normal

three-day rescission period that pertains to other home equity loans. This gives many HOEPA borrowers twice as long to change their minds about possibly unwise mortgage contracts. HOEPA is not a usury law--high-cost loans can still be made--but borrowers' protections are significantly greater for HOEPA loans than for other subprime mortgage loans.

Last December 13 the Board solicited comments on proposed revisions to our Regulation Z, the regulation implementing HOEPA. The goal of the changes was to curb some abuses we were made aware of during our hearings and through other sources. At the same time, we tried to make our amendments narrow and selective so as not to impede the general growth of the legitimate subprime mortgage market. The important changes involved broadening the scope of mortgage loans subject to HOEPA coverage and prohibiting specific acts and practices.

With respect to loans subject to HOEPA, the law lays out a two-part test for coverage. The first involves interest rates. If the annual percentage rate (APR) on a mortgage loan exceeds the Treasury rate on a bond of comparable maturity by more than 10 percentage points, the loan is subject to HOEPA protections. The Board has the legal authority to lower this threshold to 8 percentage points, and the proposal recommends doing that. Data on this segment of the mortgage market are sparse, but a special survey by the Office of Thrift Supervision (OTS) estimates that the portion of subprime mortgage loans falling within the HOEPA's APR trigger is currently about 1 percent, with this segment of the market rising to about 5 percent under the proposal. From this standpoint, the effect of this change on the general growth in subprime mortgage lending should be modest.

But these percentages are based on rates alone, and many subprime lenders feel that the coverage percentages are higher when the second HOEPA test enters in. Under this second test, loans with non-interest fees of more than 8 percent of the loan amount, or \$465, are covered by HOEPA. Although the Board cannot change these amounts, it can alter the items included in this points and fees test.

The proposal recommends adding premiums on single-premium credit insurance to the points and fees test. Premiums for this insurance are generally financed in the loan amount, the insurance is often unnecessary, and premiums may be difficult to recover if the loan is cancelled. When loans are flipped, financed single-premiums for credit insurance can be a way to strip equity from a homeowner. We do not know how many additional mortgage loans this change would bring under HOEPA, but it is likely to greatly constrict the selling of single-premium credit insurance. Under the proposal, the provisions regarding other ways of selling credit insurance would not change, and these alternative ways of selling credit insurance would thereby be encouraged.

These changes would extend the coverage of HOEPA and its consumer protection provisions. Presumably, the number of subprime foreclosures would be lessened. But because HOEPA loans are already more costly to make and they carry a stigma in the secondary market, these changes may also constrict lending in the very high cost segment of the subprime market. Many consumer advocates have said that they are aware of this

possible tradeoff and accept it. Now that the proposed revisions to the regulation are out for public comment, we will be able to examine the responses in more detail.

The Board proposal also prohibits a number of specific acts and practices. There are two provisions to reduce loan flipping. The proposal would prohibit a creditor that holds a HOEPA loan from refinancing the original credit with another high-cost loan within twelve months of origination. The proposal would also prohibit creditors from refinancing with higher-rate loans certain zero-interest loans or other very low cost loans originated through mortgage assistance programs. Both provisions have an escape clause that permits these refinancings if the creditor can show that the loan is in the borrower's interest, a provision likely to come into play in foreclosures or other legal proceedings in connection with the loan. Together these provisions should reduce the most egregious instances of loan flipping—where creditors either flip loans immediately on origination or refinance very low interest loans at much higher rates.

The proposal also tries to stem the practice of making loans that are not based on the borrower's ability to repay an obligation, so-called asset-based lending. The proposal would require that lenders document and verify consumers' ability to repay HOEPA loans. Because a pattern or practice of making asset-based HOEPA loans is already prohibited, legitimate subprime lenders presumably already have procedures to show that they are not engaged in a pattern or practice of making asset-based loans. Consequently, this provision should not affect legitimate subprime lenders, though it should deter predatory lenders, who will have difficulty proving the legitimacy of their asset-based credit decisions.

These recommendations often reflect hard tradeoffs with potentially significant effects on creditors and consumers alike. The Board will have to undertake a difficult balancing effort when it adopts a final rule. It will be essential that we receive thoughtful comments from all segments of the public and from the industry to help us make an informed final decision.

### **Home Mortgage Disclosure Act**

About the same time, last November 29, the Board also solicited comments on proposed revisions to our Regulation C, which implements the Home Mortgage Disclosure Act (HMDA). HMDA requires depository and certain for-profit nondepository institutions to collect, report, and disclose data about applications for, originations of, and purchases of home-mortgage and home-improvement loans. From these data denial rates can be inferred. Data now reported include the type, purpose, and amount of the loan; the race or national origin, gender, and income of the loan applicant; and the location of the property. The purposes of these HMDA reports include helping us to determine whether financial institutions are serving the housing needs of their communities and to enforce fair lending.

The Board's proposal incorporates suggestions received in response to an earlier Advance Notice of Proposed Rulemaking, as well as from discussions with a wide range of interested parties. In evaluating potential changes, the Board considered whether the changes would improve the quality and utility of the resulting data to enhance understanding of the home mortgage market. At the same time, the Board attempted to minimize the increase in data-collection costs and reporting burden by limiting proposed changes to those likely to have

significant benefits. As we have done in the past, we will make available software to help reduce the reporting burden for financial institutions.

The three fundamental changes in the proposal would

- increase the number of nondepository lenders required to submit data
- clarify and expand the types of reportable transactions
- specify new loan elements to be included in the data.

First, with respect to the coverage of nondepository lenders, the Board's proposal would alter definitions to require all nondepository lenders whose annual home purchase and refinancing activity comprises at least 10 percent of the dollar value of all their loan originations (mortgage- and nonmortgage-related), or \$50 million, to report HMDA data. The new element is the \$50 million reporting floor, which extends HMDA coverage to very large nonbank lenders with relatively small percentages of mortgage loans in their portfolios. Because the added coverage affects very large mortgage lenders, it seems consistent with any reasonable test of determining whether a lender is "engaged in the business of mortgage lending," the statute's test for coverage.

Second, the expansion of the types of transactions covered is intended to improve the integrity of the data by establishing consistency in reporting requirements. Right now, data on refinancings and home improvement loans are unclear, and quite likely incomplete, because the regulation provides lenders with much flexibility in determining which loans to report. For example, lenders may avoid reporting closed-end home improvement loans by not classifying them as such in their records. Lenders also may choose not to report open-end home equity lines of credit, even if used for home improvement. The proposal would tighten these definitions so that the resulting data would be more complete and more consistent from one lender to the next. This change, too, certainly seems consistent with the spirit of HMDA.

Third, the proposal specifies that three new items be reported from a consumer loan or application: the APR, whether the loan is subject to HOEPA, and whether the loan involves a manufactured home. Having APR and HOEPA information will assist in the identification of subprime loans, enabling better analysis of the high-cost subprime market. We will be able, among other things, to ascertain with much more precision the extent of present HOEPA coverage and the way that coverage might change were the Board to extend its HOEPA coverage, as discussed above.

The collection of data on mobile or manufactured home loans will contribute to an improved understanding of this type of lending, which employs different underwriting criteria from those for loans secured by conventional homes. Because manufactured home loans have much higher denial rates than other mortgage loans, such data would also enhance understanding of denial patterns in this market.

Again, the Board tried to balance competing interests in fashioning this proposal. As with HOEPA, it will be critical that the Board receives thoughtful public comment on the

proposal to assist it in making its final rule on this regulation.

Other steps may need to be taken, and may be taken, to deal with predatory lending. But these proposals should represent important first steps. The HOEPA changes extend the coverage and protections of HOEPA and limit some current practices that may end in abuse. The HMDA changes should greatly improve our information about lending practices for high-cost mortgages. Both proposals may limit abusive practices in the short-run and should greatly improve our knowledge and enforcement ability in the long-run. At the same time, the HOEPA proposal is designed to interfere minimally with the vast bulk of subprime lending, and the HMDA proposal is designed to gather useful data while limiting reporting burden.

### **Consumer Education**

Going beyond these regulatory and data-collection measures, we should all recognize that in the long-run the very best defense against predatory lending is probably in neither of these approaches. Rather, it is in a thorough knowledge on the part of consumers of their credit options and resources. Educated borrowers who understand their rights under lending contracts and who know how to exercise those rights put up the best defense against predatory lenders. As the knowledge base of consumers grows, the market for credit-at-any-cost diminishes.

Unfortunately, as is often the case, the best long-run solutions can be the most difficult to implement. A massive educational campaign is needed to bring about this expanded consumer knowledge, particularly within the socioeconomic groups most likely affected by predatory lending. Many efforts are under way. As one example, the Neighborhood Reinvestment Corporation, a publicly funded entity that is known for its community training and homebuyer counseling programs, has embarked on a huge low-income-homeowner education project. As another, the American Bankers Association has formed a working group to educate bankers and local communities about predatory lending.

We in the Federal Reserve System are also trying to do our part. We have undertaken many projects designed to promote community and consumer education and financial literacy. Board staff have been active in an interagency task force convened to identify strategies for combating predatory lending. This group is also looking for ways to support the broad array of organizations that offer consumer and community education to complement homeowner education efforts. We have also been active in planning conferences on the topic, similar to today's conference.

Further, nearly every one of the twelve Reserve Banks has published articles devoted to predatory lending in its Community Affairs newsletters. In aggregate, these reach tens of thousands of community development and housing organizations nationwide. The Federal Reserve Banks of Atlanta, Philadelphia, and right here in Cleveland have sponsored seminars to educate community leaders and lenders on the differences between legitimate subprime lending and predatory lending. These meetings have also provided a forum for groups assisting victims to report the most egregious practices of unscrupulous lenders and the devastating impact of these loans on their clients. Federal Reserve Bank of Boston staff

members have worked closely with a secondary market purchaser to promote an educational campaign through local community groups. Chicago Reserve Bank officials have facilitated a task force of area advocacy groups, lenders, and real estate industry representatives to help develop recommendations for combating predatory lending. The Chicago Fed has also launched "Project Money Smart," a resource on its web site that provides a comprehensive overview of consumer information on personal finance topics, including managing credit, understanding mortgages, and protection against fraud. And the Dallas Fed has published "Building Wealth," a manual designed to help individuals and families develop a plan for building personal wealth. This Bank's web site offers an interactive tool for customizing wealth-building strategies by setting financial goals, seeking guidance, budgeting, saving and investing, and managing debt.

These are a few examples of ways in which the Federal Reserve is trying to improve financial literacy in all segments of the population. The educational challenge is difficult, but these initiatives and other collaborative education efforts can greatly improve financial market efficiency. In the long run, they provide the best defense against predatory lending.

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