States Fight Predatory Lending in Different Ways

By Giang Ho and
Anthony Pennington-Cross

To restrict predatory lending in the subprime (high cost) mortgage market, Congress enacted in 1994 the Home Ownership and Equity Protection Act (HOEPA). This law restricts some types of lending and requires lenders to disclose additional information about loans that have predatory features. Following the lead of federal regulations, at least 23 states, beginning with North Carolina in 1999, have introduced their own predatory lending laws, using HOEPA as a template.[1]

Perhaps not surprisingly, research focusing on the impact of the North Carolina law found that the rate of applications and originations for subprime loans declined after the law took effect. We extend prior research, which focused on the North Carolina law, and find large variations in market responses to the state predatory lending laws. These results suggest that a closer look at the design of the laws is needed. If market responses are contingent on how a law is written, then policy-makers may be able to craft predatory lending laws to either stimulate or depress the subprime market.

Beyond HOEPA

HOEPA is designed in two phases. First, loans are covered by HOEPA if they meet the law's definition of high-cost loans. Second, for covered loans, certain product types and lending practices are restricted. The state predatory lending laws, although styled after HOEPA in terms of the coverage and restrictions approach, have aimed to go beyond the federal law.

In terms of coverage, the state laws are typically designed to cover a broader segment of the mortgage market. Loans covered under HOEPA include closed-end home equity loans (refinance and second mortgages only) that have an annual percentage rate (APR) and/or finance points and fees exceeding a certain threshold. The state laws typically extend the coverage of HOEPA by including both closed-end and open-end mortgages (lines of credit, refinance and for-purchase mortgages), as well as lowering the APR and/or fee trigger.[2] However, the extent of coverage increase varies among laws, ranging from almost no extension beyond HOEPA (for example, the Florida law) to almost full market coverage (for example, the Colorado law, which applies to loans of almost all purposes and types).

For covered loans, each law identifies different types of restrictions. Typically, state predatory lending laws strengthen restrictions beyond those required by HOEPA. These restrictions usually include additional limits on allowable prepayment penalties and balloon payments, prohibitions of joint financing of various insurance products with the mortgage, and requirements that borrowers participate in loan counseling.[3] Again, there is substantial variation among the state laws in terms of expanding the law's restrictions. For example, Maine and Nevada largely leave HOEPA restrictions intact, while Georgia is much more restrictive of balloon payments and prepayment penalties.[4]

Impacts of Laws on Flow of Credit

Predatory lending laws are in large part designed to restrict the availability of high-cost credit because of evidence, although anecdotal, of abusive practices associated with certain product types. Therefore, holding everything else constant, we should anticipate a reduction in originations of subprime loans after a law is implemented. This reduction could come from more applicants being rejected or fewer households applying for subprime loans.

A series of studies has used tables of mortgage conditions before and after the North Carolina law took effect and compares these metrics with growth rates in nearby states and the nation as a whole. Using the Home Mortgage Disclosure Act (HMDA) data set, economists at the Center for Responsible Lending in North Carolina concluded that the volume of loan originations declined in North Carolina relative to the rest of the country.[5] However, a group of economists at the Center for Community Capitalism (University of North Carolina at Chapel Hill) used a different data set and found no volume impact on purchases or low credit score loans, but a decline in the volume of refinanced loans.[6]

Other studies have used regression analysis to identify the impact of the laws in North Carolina, Chicago and Philadelphia.[7] (Since publication, the Philadelphia law is no longer in effect.) All of the studies found evidence that the introduction of the North Carolina law substantially reduced the flow of subprime credit. The impact seems to be larger for low-income borrowers and minority borrowers. Also, the volume reduction was largely attributed to lower application rates rather than to increased rejection rates. The lower application rates could result from potential applicants being deterred by the tightened lending standards under the new law or from lenders increasing pre-screening to comply with the law's restrictions.

Going Beyond North Carolina

Using a treatment-control framework, we examine the impacts in a variety of locations to see if the North Carolina experience was representative of other states. For the treatment group, we sample only border counties in the state with a predatory lending law. The control group includes border counties in neighboring states that do not have a law in effect during the examined time period (the year before and the year after the introduction of the law). This sample design and HMDA availability reduce the sample to 10 state predatory lending laws.[8]

Following previous research, for each law sample (treatment and control loans), we estimate the probability of three separate outcomes: applying for a subprime loan, originating a subprime loan and being rejected on a subprime application. In our sample, which spans from 1999 to 2003, approximately 20 percent of the applications were for a subprime loan, while only 10 percent of loans originated were subprime. In addition, over 40 percent of the subprime applications were rejected. We control for various location and borrower characteristics using proxies, such as county unemployment rate, population growth, and borrower income and minority status. On most of these dimensions, subprime applications were very similar to prime applications. However, subprime applications on average are associated with lower borrower income and are more likely to come from locations with more minority households.

The table reports the impact of each law for each of the three measures on the flow of credit (application, origination and rejection).[9] The impact represents the change in predicted probability of the outcomes as the laws become effective. Consistent with the literature, the results indicate that the North Carolina law did reduce the flow of subprime credit through a reduction in both application and origination probabilities. However, the experience in North Carolina is replicated in only one-half of the laws examined. In the other half, the introduction of the law was found to increase the flow of subprime credit, as measured by application or origination.

Further examination of the design of the laws sheds some light on these inconsistent results. Each state's predatory lending law extends HOEPA in a different way. Some laws have broader market coverage, while others are more restrictive of certain lending practices; broad coverage does not necessarily translate into more restrictions, and vice versa. Most of the laws that were found to reduce the flow of credit, like the North Carolina, Georgia and Massachusetts laws, tend to have stronger restrictions, which could reduce the availability of loan types and lead to lower application and origination rates. On the other hand, laws that are associated with an increase in the flow of credit, like the ones in California and Maryland, tend to cover a larger segment of the subprime mortgage market. One way to interpret these results is that if borrowers view better coverage as a sign of better protection against predatory lending, then they will be more confident and, hence, more likely to apply for subprime loans.

Because state predatory lending laws are not created equal, future research should test in a more complete model whether coverage encourages more applications in the subprime market and the extent that these additional applications may be able to counteract any reductions in the flow of credit due to stronger lending restrictions.

Anthony Pennington-Cross is a senior economist, and Giang Ho is a research associate, both at the Federal Reserve Bank of St. Louis.

Impacts of State Laws on the Flow of Credit

Law Sample (treatment and control loans)	Application	Origination	Rejection
California	3.2	6.7	–25.8
Connecticut	1.4	2.3	1.3*
Florida	–3.0	0.8	–5.7
Georgia	–5.6	–0.7	–11.0
Massachusetts	–7.4	–3.2	–3.0
Maryland	2.9	1.8	–6.6
North Carolina	–6.9	–4.2	–4.8
Ohio	–0.5*	–0.4*	–2.2
Pennsylvania	3.7	3.2	3.2
Texas	18.9	10.7	14.8

The impact of a law is measured as the percentage point change in the share of subprime applications (first column), the percentage point change in the share of subprime originations (second column) and percentage point change in the share of subprime applications rejected (third column). In addition, * indicates that the estimated change could not be distinguished in terms of its statistical properties from zero—in other words, the law had no measurable impact.

ENDNOTES

1 As of the end of 2004, the following states had a predatory lending law in effect: Arkansas, California, Colorado, Connecticut, Florida, Georgia, Illinois, Kentucky, Maine, Maryland, Massachusetts, Nevada, New Jersey, New Mexico, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, South Carolina, Texas, Utah and Wisconsin.

2 A refinance mortgage replaces an existing mortgage with a new mortgage, whereas a for-purchase mortgage provides a new mortgage for buying a new home. Lines of credit typically do not have an amortization schedule and, therefore, are considered open-end credit.

3 A prepayment penalty charges the borrower a fee if the loan is paid off early. A balloon payment is payment made at the end of the mortgage to cover any outstanding principal and is typically much larger than the prior monthly payments. A loan with a balloon payment is by definition not fully amortizing.

4 For a detailed description of the local laws, see Appendix A in Ho and Pennington-Cross (2005), "The Impact of Local Predatory Lending Laws." Federal Reserve Bank of St. Louis Working Paper, WP 2005-049B. Available at www.research.stlouisfed.org.

5 See Ernst, Farris and Stein (2002)

6 See Quercia, Stegman and Davis (2003 and 2004)

7 See, for example, Harvey and Nigro (2003 and 2004) and Elliehausen and Staten (2004)

8 California, Connecticut, Florida, Georgia, Maryland, Massachusetts, North Carolina, Ohio, Pennsylvania and Texas.

9 Detailed results on other variables are available upon request.

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