



The Federal Reserve Board

Remarks by Governor Edward M. Gramlich

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Predatory Lending

Thank you for inviting me to participate in today's conference. These gatherings serve as important information-sharing opportunities to further our understanding of important issues. In my remarks today, I would like to address an issue that has been of critical concern to housing advocates across the country--predatory lending.

Over the past decade, there have been significant efforts to promote increased access to credit for homeownership by various government agencies, the mortgage industry, and community groups. Great progress has been made, as evidenced by new highs in homeownership rates for nearly all racial and income groups. Many factors have contributed to this success. In particular, advances in technology, increased competition, deregulation, and low interest rates have served as important catalysts in improving access to credit, particularly for lower-income and minority populations and communities. The result has been an expansion of the home mortgage market to a much 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, groups that traditionally have had difficulty in getting mortgage credit, have been taking out housing loans at record levels in recent years. Specifically, the number of conventional home-purchase mortgage loans to lower-income borrowers nearly doubled between 1993 and 2000, whereas the number of loans to upper-income borrowers rose 66 percent. Also over the same period, the number of conventional mortgage loans increased 122 percent to African-American borrowers and 147 percent to Hispanic borrowers, compared with an increase of 35 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 658,000 in 2000, a tenfold increase. Over this same period, the number of subprime loans to purchase homes increased nineteenfold, from 16,000 to more than 306,000. This rapid growth has given access to consumers who were not previously served by credit markets, either because they had difficulty in meeting the underwriting criteria of prime lenders or for other reasons.

However, the rise in the use of credit by lower-income homeowners has not come without cost. It has been accompanied by increasing reports of abusive, unethical, and in some cases

illegal, lending practices. These reports raise questions about the numbers just presented, and more broadly, jeopardize the twin American dreams of owning a home and building wealth. These reports tell of lenders who extend credit to borrowers unable to repay the debt (so-called asset-based lending); repeatedly refinance, or "flip," loans for the purpose of collecting fees; incorporate credit terms and products that are of questionable value to the borrower but significantly increase the cost of credit; and in some cases resort to outright fraud. These reports also tell of victims losing hard-earned equity in their homes and sometimes even losing their homes to foreclosure. Of particular interest to you today is that lenders often target elderly homeowners, who tend to have the highest levels of equity in their homes. Other groups that have disproportionately been prey for unscrupulous creditors are women, minorities, and lower-income households. The activities, referred to collectively as predatory lending, are a scourge on the mortgage industry.

Understanding Predatory Lending

In understanding the problem, it is particularly important to distinguish predatory lending from generally beneficial subprime lending. Predatory lending refers to activities and practices just cited--asset-based lending, loan flipping, packing of unnecessary fees and insurance, fraudulent or deceptive practices. Subprime lending, on the other hand, refers to entirely appropriate and legal lending to borrowers who do not qualify for prime rates, those rates reserved for borrowers with virtually blemish-free credit histories. Premiums for extending credit to these borrowers compensate lenders for the increased risk that they incur and range several percentage points over rates charged on prime loans. Although some have argued that these premiums are excessive, market forces should eliminate inappropriate spreads over time.

Some predatory lending involves outright fraud and deception, practices that are already illegal. But some predatory lending is more subtle, involving the misuse of conventions that most of the time can improve credit market efficiency. For example, the flexibility in loan rates that allows them to rise above former usury law ceilings is generally desirable in that it permits relatively risky borrowers to be matched with appropriate lenders. But sometimes the payments implicit in very high interest rates can spell financial ruin for borrowers. As another example, the ability to refinance mortgages allows borrowers to take advantage of lower mortgage rates, but sometimes easy refinancing invites loan flipping, which generates high loan fees and unnecessary credit costs. And again, credit life insurance is often desirable, but sometimes the insurance is unnecessary, and at times borrowers pay hefty up-front premiums as their loans are flipped.

Responses to Concerns

The disturbing accounts of borrowers becoming financially crippled by unaffordable mortgage arrangements have generated a demand for action. In turn, these demands have provoked heated debates about particular policy responses because of the complexity of mortgage lending and concerns that unduly onerous legal and regulatory barriers could diminish the availability of credit in the subprime market.

Several states and cities have enacted laws restricting or prohibiting the use of certain credit provisions commonly associated with predatory lending, such as prepayment penalties and financing of up-front fees and credit insurance premiums. Such laws typically define high-cost mortgage loans in terms of thresholds for pricing and fees. Further, some local governments have adopted ordinances declaring a moratorium on business relationships with financial institutions that originate loans with rates and terms that their rules define as "predatory" or "high cost."

The major purchasers of mortgage loans in the secondary market, an important source of housing liquidity, have also gotten into the act. Both Fannie Mae and Freddie Mac have defined specific questionable credit-related activities and business practices and have not purchased loans containing those characteristics.

Regarding the federal level, the Congress in 1994 passed the Home Ownership and Equity Protection Act (HOEPA) to help curb predatory lending. The basic approach of HOEPA is to shine a spotlight on the high-cost segment of the subprime mortgage loan market. HOEPA defines high cost in terms of threshold levels for interest rate, points, and fees. For these high-cost loans, HOEPA bans some practices--balloon payments in the first five years, prepayment penalties generally after five years, and a pattern and practice of asset-based lending. 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 HOEPA borrowers as long as six days 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.

HOEPA also brings the Federal Reserve into the fray. First, the law requires the Fed to hold periodic public hearings on mortgage lending practices, with an emphasis on lower-income groups. We held such hearings in 1997 and again in 2000. Second, the law gives the Fed authority to tighten some of the HOEPA provisions. After careful consideration of the material from our 1997 and 2000 hearings, and a large number of comment letters and e-mail responses from interested parties, we announced some changes on December 12, 2001.

The New HOEPA Amendments:

Our new HOEPA amendments can be grouped into four areas:

- Extending the scope of HOEPA's protections
- Restricting certain acts or practices
- Strengthening HOEPA's prohibition on asset-based lending
- Enhancing HOEPA disclosures received by consumers before closing.

In increasing the scope of HOEPA's protections, the Board adjusted the two triggers that define high-cost loans--the annual percentage rate (APR) and the points and fees test. Currently, a mortgage loan is subject to the provisions of HOEPA when the APR exceeds

the rate on a Treasury bond of comparable maturity by more than 10 percentage points. In our recent rulemaking, the Board exercised its legal authority to lower this threshold to 8 percentage points for first-lien HOEPA loans.

When considering the adjustment of the APR trigger, the Board balanced the risk of diminishing credit availability against the need to protect consumers. In fact, there is not a great deal of evidence that changes in the HOEPA threshold would affect subprime credit availability--since the passage of HOEPA in 1994, the number and value of HOEPA loans have increased just as rapidly as the number and value of non-HOEPA subprime loans. Given this important fact, we felt that lowering the APR trigger to expand HOEPA's protections to more loans could be defended. But we did try to differentiate between first-lien and second-lien mortgages, adjusting the trigger for the former but not the latter.

In choosing to adopt this two-tiered approach, the Board was heavily influenced by new survey data from a trade association for nondepository-institution lenders. The survey showed that when including changes made in the points and fees test discussed below, a reduction of the APR trigger for first-lien loans from 10 to 8 percentage points is likely to result in 38 percent of these loans falling under the HOEPA protections, more than triple the rate of 12 percent that is now estimated to be covered. For second-lien loans, whose rates are usually higher than first-lien mortgages, dropping the trigger rate from 10 to 8 points, also within our legal authority, would have increased the coverage share from 61 percent to 81 percent, again including changes made in the points and fees test. Such coverage would be well beyond what might be considered the high-cost segment of the subprime market. These data, coupled with evidence indicating that the most serious lending abuses involve refinancing of first-lien mortgage loans, led the Board to lower the APR trigger to 8 percent for first-lien mortgages only, leaving coverage rates at 38 percent and 61 percent respectively.

The rule also amends the formula for the points and fees test to include the amount paid for optional single-premium credit insurance (SPCI), a fee previously not included in the test. The premium often represents a significant addition to the cost of the transaction to the borrower and is often not well understood by the borrower. When the premium is financed in connection with a subprime mortgage loan, as is typically the case, it can represent a significant addition to the loan balance and thus to the size of the lien on the borrower's home. In many cases the cost to the borrower continues well after the time when the insurance itself has lapsed. But our rule covers only the single-premium product--borrowers can still get credit insurance on a pay-as-you-go basis without coming under the HOEPA points and fees test.

SPCI has become one of the primary subjects of anecdotes about predatory lending. In making the change, the Board is not outlawing SPCI, but it is making it virtually impossible for lenders to offer the product and not have the loan fall under the HOEPA protections. Since making HOEPA loans allegedly carries a stigma, and since selling HOEPA loans in the secondary market is difficult, the change is likely to induce subprime lenders to drop the product and switch to pay-as-you-go insurance. In the past year, the largest subprime lender

and two other large lenders have already announced their intention to do so.

In an effort to remedy some of the specific business practices characteristic of predatory lending, the rule also contains provisions to reduce loan flipping and asset-based lending. With respect to loan flipping--frequent high-fee refinancings, of questionable value to the borrower--the amendments generally provide that for one year after making a HOEPA loan, the original creditor is prohibited from refinancing that loan unless doing so is clearly in the borrower's interest. As for asset-based lending, the rule strengthens the prohibition by forcing creditors to verify and document consumers' repayment ability.

These HOEPA changes represent an important regulatory action to address unscrupulous and abusive credit practices. As with the legislative and financial remedies discussed earlier, this response is designed to curtail abusive mortgage lending practices without hampering the growth of the legitimate subprime market.

Consumer Education

Throughout our process of collecting opinions on how to address predatory lending, one strategy that has been unanimously embraced is consumer financial education. 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. Significant efforts have been made to equip consumers with the knowledge required to make them aware of their credit options. Indeed, this strategy has served as a galvanizing force and has resulted in important collaborations among government agencies, the mortgage industry, the secondary market, and consumer advocacy groups.

Educational campaigns by these groups have been designed not only to increase awareness of the perils of predatory lending but also to provide consumers with information on how to evaluate and manage their finances. For example, in collaboration with financial institutions and national and local community advocates, Freddie Mac has complemented its anti-predatory-lending campaign with a curriculum that promotes consumers' understanding of building and maintaining better credit. The Neighborhood Reinvestment Corporation, a publicly funded entity that is known for its community training and homebuyer counseling programs, has embarked on a national education project for low-income homeowners. The American Bankers Association has formed a working group to educate bankers and local communities about predatory lending.

We in the Federal Reserve System have also launched projects designed to promote community and consumer education and financial literacy. Board staff members have been active in an interagency task force convened to identify strategies for combating predatory lending. Our Community Affairs and Public Information offices have recently embarked on a national initiative to highlight the importance of financial literacy and heighten the visibility of economic education programs.

Our twelve Reserve Banks have published articles devoted to predatory lending in their

Community Affairs newsletters. In the aggregate, these newsletters reach tens of thousands of community development and housing organizations nationwide. The Federal Reserve Banks of Atlanta, Philadelphia, and Cleveland have sponsored seminars for community leaders and lenders focusing on the differences between legitimate subprime lending and predatory lending. The Chicago Fed has formed a task force of area advocacy groups, lenders, and real estate industry representatives to help develop recommendations for combating predatory lending. The Dallas Fed has published "Building Wealth," a manual designed to help individuals and families develop a plan for building personal wealth.

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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