CRL COMMENT ON OCC WORKING PAPER #2006-1, "FORECLOSURES OF SUBPRIME MORTGAGES IN CHICAGO: ANALYZING THE ROLE OF PREDATORY LENDING PRACTICES"

Revised 10/04/06

In a working paper released last month, Morgan Rose, a researcher from the OCC, analyzes a set of subprime loans originated in Chicago to determine the impact of selected lending terms on the likelihood of foreclosure. The study finds that loans with prepayment penalties and balloon payments are 22 to 117 percent more likely to foreclose than those without such terms.[1] However, after an extended analysis, the author concludes that the impact of those terms on foreclosure varies widely. He therefore advocates for regulatory tightening of underwriting and pricing practices, as opposed to legislation that targets specific loan terms. The conclusions of the Rose paper are unconvincing for several reasons:

1. LIMITED DATA AND VARIABLES UNDERCUT THE REPORT'S SWEEPING CONCLUSIONS.

The Rose study looks at fewer than 33,000 loans originated in Chicago between 1999 and the second quarter of 2003 and analyzes their performance over the same time period. This is problematic for several reasons.

- The terms and performance of loans originated in one metropolitan area are unlikely to be representative of loans originated across the country.

- The analyses performed by the author omit several key variables, including economic indicators such as housing prices and unemployment rates. Such variables are widely recognized to affect foreclosure rates and, consequently, their omission may produce biased results.

- The study limits its analysis of prepayment penalties to those of more than 36 months. A very small percentage of subprime loans contain prepayment penalties that are longer than 36 months (only 7 percent of loans in the study sample have such penalties) while a much greater proportion of loans have shorter prepayment penalties. By comparing loans with such a long prepayment penalty term to all other loans (including those with shorter prepayment penalty terms), the study likely underestimates the overall impact of prepayment penalties on foreclosures.

2. THE FINDINGS ARE CONTRADICTED BY A LARGER, NATIONAL STUDY.

Researchers from the University of North Carolina have found that subprime refinance loans with prepayment penalties and balloon payments are, in fact, more likely to foreclose than those without such terms—by about 20 percent and 50 percent, respectively—even after controlling for key risk factors such as credit score. Unlike the Rose study, the UNC study is based on a nationwide sample, includes key economic variables that are omitted from the Rose study, such as the interest rate of the mortgages and economic conditions over time and analyzes prepayment penalties of all terms.

3. ABUSIVE LOAN TERMS TARGETED BY PREDATORY-LENDING LAWS HAVE NEGATIVE CONSEQUENCES BEYOND FORECLOSURES.

The Rose paper implies that the sole purpose of anti-predatory lending legislation is to reduce foreclosures and implies that specific loan terms should be permitted if they do not have a consistent impact on foreclosures. In fact, to date, anti-predatory lending laws have typically aimed to reduce the *stripping of home equity* that harms many subprime borrowers, not just those who lose their homes to foreclosure. Prepayment penalties (which trap borrowers in higher-cost loans than that for which they may qualify) and unaffordable balloon payments can strip thousands of dollars in equity away from an individual subprime borrower, regardless of whether such terms result in foreclosure.

[1] See OCC Working Paper #2006 –1 at Table 6.