# Strong Compliance Systems Support Profitable Lending While Reducing Predatory Practices

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## Highlights

- **The subprime mortgage market, the fastest growing sector in financial services, has thrived even while states have enacted laws to protect citizens from lending abuses.**
- **Between 2000 and 2003, subprime mortgage lending grew by 293 percent in states with anti-predatory lending laws, compared to 212 percent in states without anti-predatory lending laws.**
- **With the use of automated compliance, the estimated direct cost of compliance is about one dollar per loan.**
- **Strong compliance programs help lenders avoid foreclosure costs while boosting confidence among investors and customers.**

## Introduction

> *"…compliance systems have become a critical component of the underwriting and quality control process, and the investment in these systems and reliance on them has grown accordingly."*
>
> —"Fitch Revises RMBS Guidelines for Antipredatory Lending Laws," Business Wire (Feb. 23, 2005).

During recent years, predatory lending concentrated in the subprime mortgage market has spurred a number of states to pass laws to protect homebuyers and homeowners. These states have shown impressive results in reducing abusive lending practices, preserving millions of dollars in home equity for families and stemming high rates of home foreclosures.[1] At the same time, the subprime mortgage market has continued to grow at an extraordinary rate, increasing from $35 billion in 1994 to over $500 billion in 2004.[2]

One of the driving forces behind the growth of subprime lending is better technology. Today, lenders have much more sophisticated capabilities for assessing and pricing risk, processing and managing loans, and complying with investor and legal requirements. The latter issue –

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compliance – is particularly important for national or regional subprime mortgage lenders that are subject to state anti-predatory lending laws.

Conscientious compliance with state predatory lending laws demonstrates a lender's commitment to responsible lending practices. While lenders may prefer the convenience of a uniform federal law,[3] experience shows that states are better suited for protecting consumers while supporting subprime credit for families with weaker credit. Federal predatory lending law quickly becomes outdated and is slow to change, while states can adapt to market conditions more quickly and respond to local lending issues as they arise. **Experience also clearly demonstrates that state laws do not hamper subprime lending growth, considering the remarkable increase in volume during the period in which 24 states passed laws protecting subprime borrowers.**[4] A Morgan Stanley survey of 280 subprime branch managers found that "tougher laws and revised lending practices are not crimping growth."[5] Rather, state laws have reduced predatory lending while allowing a more responsible market to flourish.

In spite of the advantages of state laws, some lenders claim that the cost of complying with them is overly burdensome. However, a review of existing cost data shows that compliance costs are relatively low and becoming even lower through automated systems. Following the successful precedent of loan origination systems, automated compliance engines are being adopted throughout the mortgage lending industry as a cost-effective aid and offer responsible lenders a competitive advantage.

CRL has examined state anti-predatory lending compliance issues from several perspectives and concluded the following:

- Many other industries flourish in a national marketplace with varying state laws, and the financial services industry can thrive as well. In fact, lenders already comply with a variety of state-specific mortgage laws and other requirements from various investors and third parties.

- The rapid growth of the subprime mortgage market in recent years indicates that compliance requirements have not hindered the industry in any significant way. Since the first state predatory lending law was enacted in 1999, subprime lending has more than tripled, increasing from $160 billion to $529 billion. Over this period, the 24 states that passed predatory lending laws have produced higher growth in subprime mortgages than states that have not enacted such laws. **Between 2000 and 2003, subprime mortgage lending grew by 293 percent in states with anti-predatory lending laws, compared to 212 percent in states without anti-predatory lending laws.**

- The cost of compliance is a small percentage of mortgage lending expenses. We estimate that the use of automated systems lowers predatory lending law compliance costs to about one dollar per loan.

- Strong compliance also may reduce lenders' expenses by lowering the incidence of time-consuming and expensive foreclosures. Based on the average subprime mortgage amount in 2004, every loan that forecloses cost lenders and investors more than $20,000.

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Most important, the cost of complying with state laws is dwarfed by the millions of dollars in homeowner equity that is saved each year by these laws. In 2001, the Center for Responsible Lending estimated that predatory mortgage lending costs borrowers $9.1 billion each year, an amount that is likely rising with the huge expansion of the subprime mortgage market.

## What Is Compliance?

For purposes of this paper, "compliance" refers to a mortgage lender's systems, procedures or general activities aimed at abiding by regulations or laws governing mortgage loans. Given the complexity of mortgage finance and the importance of homeownership to the economic security of families and communities, compliance has been a crucial element of American mortgage lending for decades. With respect to predatory mortgage lending, lenders and investors must be able to identify loans designated as "high-cost" (and thus subject to special protections) and also loans that are illegal under relevant predatory lending statutes.

Today mortgage lenders comply with a variety of laws on the state and federal level. The Truth in Lending Act and the Real Estate Settlement Procedures Act are examples of two prominent federal laws that govern general disclosure issues in lending. Other laws are rooted in the inherently local nature of property ownership. For example, lenders have long been accustomed to adhering to various state laws covering real estate foreclosure, deed recording requirements, and property tax regulations. Such local authority and flexibility is crucial for addressing geographic variations in pricing and market-specific concerns, such as local or regional spikes in foreclosures.[6]

The growth of the secondary mortgage market has been a key driver in the development of comprehensive, accurate systems for identifying specific loan characteristics among mortgages in large portfolios. Investors, such as Fannie Mae, Freddie Mac, Ginnie Mae and private-label companies, all have their own loan requirements that many lenders manage routinely. The volume of subprime mortgages that are securitized has grown substantially over the past decade, from $10 billion in 1994 to over $400 billion in 2004,[7] increasing the importance of effective compliance in the subprime market. Responding to these market conditions, many mortgage lenders have adopted technologies that automate compliance reviews and quality control to meet investor and legislative requirements.

## The Growth of Predatory Lending and States' Responses

During recent years, predatory lending in the subprime mortgage market has become a major problem for American families, costing homebuyers and homeowners an estimated $9.1 billion each year.[8] Federal law (the Home Ownership and Equity Protection Act [HOEPA], passed in 1994) does not address many current lending practices associated with predatory lending. For example, HOEPA is inadequate in addressing abusive loan terms such as prepayment penalties and yield spread premiums, which combined can cost borrowers over $5.2 billion annually.[9]

In response to high rates of foreclosure and equity-stripping in local markets, a number of states have adopted legislation designed to curb predatory mortgage lending. Studies have shown that strong state laws are effective in preventing harmful loans before they happen, keeping wealth in

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the hands of homeowners while at the same time not restricting access to subprime credit.[10] A 2002 Morgan Stanley survey concluded that there is "no evidence to support the view that regulatory pressure, the threat of legal action, or changes to lending practices have dampened growth prospects. To the contrary, many believe that new lending practices will boost volume."[11]

Recent state laws have focused on some of the most egregious practices in the subprime mortgage market, including excessive fees, abusive prepayment penalties, unnecessary fee-laden refinances and the fact that borrowers have no ability to save their home from foreclosure when an originator has sold a loan in the secondary market. These laws were passed at different times in different geographic and market areas with varying concerns.[12] While the majority of state laws share many common elements, such as restrictions on negative amortization, balloons, and excessive fees, it is not surprising that states with widely different market conditions do not always develop uniform provisions. For instance, states that establish protections for high-cost loans may differ on the specific definition of "high cost." States also may take a different approach to issues such as how a lender determines the borrower's ability to repay the loan or whether a loan can require a borrower to pay a prepayment penalty before refinancing into a better-priced loan. Such variations can be expected among states where median income, property values, historic approaches to lending issues, and other critical factors vary enormously.

Given the differences in state requirements, some lenders claim that complying with state anti-predatory lending laws poses a significant burden. They have expressed concerns about costs, the lack of uniformity and the difficulties of staying abreast of new laws or amendments. These concerns have prompted some lenders to support federal legislation that would override, or preempt, existing state laws.[13] However, a review of the actual costs and capabilities of current compliance tools suggests that the arguments for overruling state laws are not persuasive.

## State Protections vs. a Growing Market: Not a Zero-Sum Game

At first glance, the debate over state anti-predatory lending laws seems to involve competing interests. Lenders want simplicity, convenience and a business environment that supports growth and profitability. Consumer advocates want strong protections for homebuyers and homeowners. Families want the ability to buy a home or draw on their home equity without the risk of exorbitant fees or abusive lending practices.

A closer analysis reveals these interests are not mutually exclusive, and in fact are being resolved at the state level. First, there's plenty of precedent for success. **Many industries flourish in a national marketplace that includes a diversity of state laws**, and some of these industries argue vigorously *against* federal preemption. For example, historically the insurance industry opposed a national regulatory scheme, maintaining that a universal federal law would constrict market competition and investment and create inefficiency that would cost more to taxpayers.[14] "Despite the obvious shortcomings of regulation of insurance rates and policy forms in some states, optional federal chartering of property-casualty insurers is not in the best interests of policy holders and taxpayers," claims Tom Miller of the CATO Institute, a conservative think tank in Washington D.C. "Congress should avoid creating new federal insurance and reinsurance schemes and strive to make existing government programs more efficient."[15]

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Second, **even with a variety of state and local lending laws on the books, the subprime mortgage market has increased lending volume at a record-breaking pace**. Companies that have doubled their loan volume since 2002 include nationwide businesses such as Ameriquest, First Franklin Financial, Countrywide, and Wells Fargo Home Mortgage.[16] According to *Inside B&C Lending*, issuances of subprime mortgage-backed securities grew to $401 billion during 2004, a remarkable 98 percent increase from just the previous year.[17]

The table below shows lending growth between 2000 and 2003 in select states with some version of anti-predatory lending protection. The twenty-four states with predatory mortgage lending laws actually saw higher growth in subprime mortgage lending than states that did not have such laws: 293 percent versus 212 percent. This is not a surprising result. According to the respondents of a Morgan Stanley survey of subprime branch managers and brokers, "the changes they have made to comply with the new lending laws may have increased origination volume, as potential customers feel more at ease with the loan process."[18]

**Table 1: Subprime Lending Growth Under Predatory Lending Laws Between 2000 and 2003[19]**

| States with Anti-Predatory Lending (PL) Laws | SUBPRIME LENDING ($ in 000) | | |
|---|---|---|---|
| | 2000 | 2003 | Incr '00-'03 |
| Arkansas | $ 288,210 | $ 581,728 | 102% |
| California | $ 17,766,535 | $ 103,655,695 | 483% |
| Colorado | $ 2,462,790 | $ 8,045,730 | 227% |
| Connecticut | $ 992,963 | $ 4,881,693 | 392% |
| District of Columbia | $ 177,249 | $ 514,268 | 190% |
| Florida | $ 5,148,803 | $ 21,511,515 | 318% |
| Georgia | $ 2,863,715 | $ 7,521,419 | 163% |
| Illinois | $ 3,892,760 | $ 12,727,848 | 227% |
| Kentucky | $ 707,021 | $ 1,641,050 | 132% |
| Massachusetts | $ 2,178,847 | $ 10,133,792 | 365% |
| Maine | $ 193,586 | $ 907,796 | 369% |
| Michigan | $ 3,308,593 | $ 8,349,441 | 152% |
| Minnesota | $ 1,318,713 | $ 5,637,783 | 328% |
| North Carolina | $ 2,718,782 | $ 5,147,775 | 89% |
| New Jersey | $ 2,699,226 | $ 10,135,292 | 275% |
| New Mexico | $ 465,124 | $ 914,342 | 97% |
| New York | $ 4,272,490 | $ 19,433,632 | 355% |
| Ohio | $ 3,661,946 | $ 7,512,688 | 105% |
| Oklahoma | $ 647,798 | $ 1,382,763 | 113% |
| Pennsylvania | $ 2,797,272 | $ 6,918,877 | 147% |
| South Carolina | $ 1,345,501 | $ 2,184,971 | 62% |
| Texas | $ 3,760,328 | $ 12,779,470 | 240% |
| Washington | $ 2,380,794 | $ 7,480,998 | 214% |
| West Virginia | $ 244,448 | $ 321,111 | 31% |
| **States with Anti-PL laws** | **$66,293,494** | **$260,321,677** | **293%** |
| **Other States** | **$19,675,478** | **$ 61,334,906** | **212%** |
| **U.S. TOTAL** | **$85,968,972** | **$321,656,583** | **274%** |

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## Compliance Costs: a Minimal Expense for Lenders

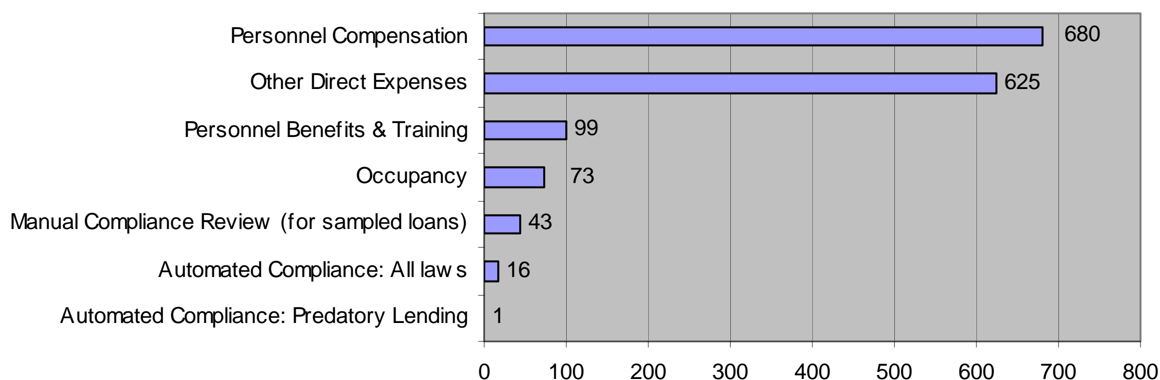
A review of compliance tools available to lenders suggests that compared to other lending costs, the cost of compliance with state anti-predatory lending laws is minimal. From a policy perspective, the benefits of investing in the financial well being of families and their communities, especially those in economically vulnerable populations, may well outweigh any potential costs associated with predatory lending compliance. However, to assess industry arguments that compliance imposes an undue burden, it is useful to quantify the actual direct costs.[20]

The most time-consuming and cumbersome method of compliance involves manually checking each loan (or, more typically, a sample of loans) to ensure adherence to applicable laws. In general, manual compliance reviews are the exception in mortgage lending, as most originators have implemented automated origination systems. However, even assuming a lender uses this high-effort method of compliance, we estimate it would cost about $43 per loan.[21] As shown in Figure 1 below, based on cost studies by the Mortgage Bankers Association (MBA), this cost represents less than three percent of total expenses per loan originated.

The cost of manual compliance is rapidly becoming less relevant as automated compliance systems replace manual methods. The low costs and speed of automatic systems makes this shift inevitable. *Mortgage Technology* magazine reports that automated systems can review a loan for compliance in 1.4 seconds.[22] Based on this speed and the average personnel cost of $57 per hour, we estimate that automated systems bring the cost down to approximately one dollar per loan (see Chart 1 below), including cost reductions achieved by requiring less time from compliance officers.[23]

MBA cost studies show that the expense of compliance is quite small compared to other mortgage lending costs. According to 2003 survey data, total loan production expenses were $1,505 on average for all lenders surveyed. As shown in Chart 1, salaries make up the greatest part of lender costs, comprising over 40 percent of origination expenses per loan. The next largest expense is “other direct expenses,” which include costs for processing and acquiring loans from brokers. As described in Figure 1, using data based on the 2004 MBA Cost Study, manual and automated compliance costs are negligible next to these expenses, each representing a very small fraction of origination expenses per loan.[24]

**Figure 1. Compliance Costs vs. Other Mortgage Production Costs, Per Loan Originated** [24]

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These data indicate that compliance costs do not pose a financial burden that would impair business. Moreover, given that strong compliance programs help avoid litigation arising from predatory lending violations, the associated expenses could be offset by significant cost savings.

An even greater source of cost savings for lenders may come from fewer foreclosures. Studies have shown a correlation between subprime lending and the prevalence of foreclosures, especially for refinanced mortgages.[25] In fact, some states that lack strong predatory lending laws are struggling with unusually high rates of foreclosure.[26]

For example, in Pennsylvania, where predatory lending laws are weak, a number of counties have reported alarming rates of foreclosures. Recently the Pennsylvania Banking Department released a study showing that the state's foreclosure rate, especially among subprime mortgages, is higher than other states, even controlling for economic factors. In fact, the Pennsylvania subprime foreclosure rate for 2003 (11.9 percent) is at least three percentage points higher than can be explained by traditional factors causing foreclosure. In one of the hardest hit areas, Monroe County, the number of foreclosures tripled between 1995 and 2003.[27] Given the state's weak laws, predatory lending is likely a key culprit behind these disturbing trends.

Foreclosures may result in significant losses for lenders and investors through the write-off of the principal loan balance as well as the loss of future revenues from mortgage payments, processing and servicing. According to the Mortgage Insurance Corporation of America (MICA), the cost of foreclosure to lenders and investors is approximately 15 percent of the original loan amount.[28] With the average subprime loan in 2004 totaling $142,279, this would equal a loss of $21,342 per loan.[29]

## Improving Efficiency and Accuracy with Technology

*A leading compliance vendor "can render a compliance decision in 1.4 seconds."*
—Anthony Garritano in *Mortgage Technology* (Jan./Feb. 2005)[30]

With the prevalence of new predatory lending laws, a new niche has developed within mortgage origination software to assist lenders with compliance, making compliance procedures even cheaper to conduct. Automated compliance engines (ACEs) are software programs that electronically scan an entire loan portfolio for lending law violations. ACEs both simplify the compliance process for lenders and provide greater objectivity and cost effectiveness. Within a matter of minutes ACE software can flag loans that include illegal terms or those covered by pertinent laws, including high-cost loans purchased through the secondary market.

Another benefit of ACE software is its ability to accelerate the loan review process while also being less expensive and more comprehensive. The software makes it feasible and cost effective to screen all loans, not just a sample.[31] Screenings that used to take 45 minutes per loan can now be reduced to a matter of seconds. This speed is achieved at lower cost. Based on average personnel cost of $57 per hour, compliance costs per loan can be reduced from $43 to **about one dollar per loan**, including cost reductions achieved by requiring less time from compliance officers.

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Using compliance and automation software is not a new practice for the mortgage industry. Even before state predatory lending laws existed, software for property valuation and fraud detection were already utilized as essential tools.[32] Software to handle federal regulations such as the Truth in Lending Act, Home Mortgage Disclosure Act, and Real Estate Settlement Procedures Act have also been accepted as part of the normal compliance process prior to state laws.[33] Therefore, using technology to comply with standards such as predatory lending laws is not a foreign concept to responsible mortgage lenders.

In addition, ACE software screens for compliance with requirements other than state predatory lending laws, including these listed below:

1. Community Reinvestment Act
2. OCC and OTS requirements
3. Fannie Mae and Freddie Mac point and fee limitations
4. Appraisal and insurance reviews
5. Truth in Lending Act (TILA) disclosures
6. Fair Lending/Equal Credit Opportunity Act
7. Home Mortgage Disclosure Act (HMDA) management
8. HOEPA points and fees triggers
9. Flood hazard status
10. U.S. Patriot Act
11. Usury caps on interest rates and fees

Compliance software companies have legal and technology experts on staff that stay abreast of the shifting lending environment, and can continually update the software as needed. Some software companies are so confident about their product that they offer guarantees to cover any losses incurred by a lender due to predatory loans not recognized by the software.[34]

As shown in Table 2 below, lenders of all sizes already are taking advantage of automated compliance technology. Most compliance software companies will customize their product around the needs of each particular client, and will price the software accordingly instead of using flat fees. The software also can be tailored according to the geographic scope of a lender's business, as well as the loan volume the lender needs to review.[35] This ability to adjust capabilities according to lenders' needs makes ACE software less cost-prohibitive for smaller lenders that do not generate many loans.

**Table 2: A Sample of Mortgage Lenders and ACE Providers**

| Lender | No. of Loans Originated in 2003[36] | ACE Provider/ Software Name |
|---:|---:|---|
| Countrywide Financial | 1,113,180 | Clayton/High Cost Analyzer |
| Washington Mutual | 1,042,503 | Clayton/High Cost Analyzer |
| Chase Manhattan Mortgage | 619,368 | Clayton/High Cost Analyzer |
| National City Mortgage Corp. | 506,183 | Mavent/2Comply |
| GreenPoint Mortgage | 126,239 | Mavent/2Comply |
| Sovereign Bank | 39,635 | ComplianceEase/Predator Analyzer |
| Fifth Third Bank | 14,079 | PCi Corporation/Wiz Sentinel |

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## Lower Risk and Higher Confidence from Investors and Customers

> *"An originator's use of a technology-based filter in the compliance process is viewed positively by Fitch. In fact, Fitch cannot provide credit for the compliance process without it."* [37]

We expect ACEs will only become more commonplace because of their affordability, effectiveness and ability to reduce lenders' risks—an important factor for rating agencies. According to the latest MBA Technology Study, spending on mortgage technology increased 14 percent in 2004, of which 9 percent was directly related to regulatory and compliance. As said by Doug Duncan, MBA senior vice president, "Mortgage companies are making technology investments in order to gain efficiencies and reduce costs, especially at a time when the mortgage market is changing after several unprecedented years."[38]

One important way the software reduces risk is by screening loans acquired from brokers, which helps identify any brokers with a tendency to refer loans with predatory terms. Regulators have made it clear that lenders need to take responsibility for the quality of the loans they fund. For example, the Office of the Comptroller of the Currency has issued guidance instructing national banks to monitor third-party relationships to guard against predatory loans.[39] According to the *ABA Banking Journal*, "there is an increasing emphasis on holding banks and other lenders liable for the conduct of third parties. This means that a compliance officer should, to the extent possible, verify that key third parties with whom the lender conducts business are also in compliance."[40] For a lender dealing with larger numbers of brokers that they may not know well, ACEs become a valuable safeguard.

Standard & Poor's has published a Predatory and Abusive Lending Compliance Review, requiring all firms submitting transactions for rating to detail their internal compliance practices.[41] These practices must meet certain requirements including:

1. Ability to identify "exposed loans," i.e. those subject to assignee liability
2. Ability to identify predatory loans in violation of state law
3. Creditworthiness to determine if a lender is willing and able to repurchase a loan if it is found to be predatory

Like Fitch, Standard & Poor's requires lenders to meet certain criteria regarding predatory lending law compliance. The lender's compliance review must have "sufficient process and procedures to determine what loans are covered by the applicable jurisdiction and to ensure that laws are not violated."[42] High cost and covered mortgages in particular must be flagged at the loan level in the portfolios. For lenders reviewing significantly large portfolios on a loan level basis, having compliance software is no longer an aspiration, but a necessity. As noted by Mike McClelland of EMC Mortgage Corporation, automated due diligence "not only add[s] value to better risk management but also [contributes to] better execution in the capital markets."[43]

A final point is that strong compliance results in higher confidence among lenders' customers. The benefit of a solid reputation in the marketplace cannot be underestimated. Predatory lending ultimately harms the entire lending industry. As a corollary, responsible lending supported by

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strong compliance strengthens the industry by conferring the intangible benefits of goodwill, repeat customers, and referrals.

## Conclusion

The advantages and growth of the use of compliance tools, particularly ACEs, are relevant as policymakers consider future actions to curb predatory mortgage lending and responsible lenders consider how to avoid doing business with unscrupulous actors. One in five subprime refinance mortgages ends up in foreclosure.[44] Concerns about the costs of complying with state laws must be weighed against ensuring the economic security of vulnerable families. At stake is also the legal question of states' abilities to shield their own citizens from abusive lending practices. With fast, flexible and cost-effective automated compliance systems, mortgage lenders can originate loans profitably while complying with state laws that provide strong protections for American homeowners.

While it is clear that compliance costs are already minimal, lender concerns about costs are further addressed by the fact that compliance software companies have recognized a growing demand in the mortgage lending industry—the need for fast and accurate compliance with predatory lending laws. With the recent surge in subprime lending, high costs of manual compliance processing, and increased media scrutiny of predatory lenders, smart lenders will rely on automated compliance technologies to detect any questionable or abusive lending practices. In the end, the lender benefits from a more streamlined and cost-efficient origination process, and the consumer benefits from having greater access to homeownership and credit free of predatory terms.

**About the Center for Responsible Lending**

The Center for Responsible Lending (CRL) is a national nonprofit, nonpartisan research and policy organization dedicated to protecting home ownership and family wealth by working to eliminate abusive financial practices. CRL is affiliated with Self-Help, the nation's largest community development financial institution.

For additional information, please visit our website at **www.responsiblelending.org**.

## Notes

[1] See e.g., Roberto G. Quercia, Michael A. Stegman & Walter A. Davis, *The Impact of North Carolina's Anti-Predatory Lending Law: A Descriptive Assessment*, Fannie Mae Foundation Housing Policy Debate, Vol. 15 Issue 3 (2004).
[2] *Top 25 B&C Lenders in 2004*, 2005 Mortgage Market Statistical Annual, Vol. 1 (March 2005).
[3] See, e.g., testimony of Steve Nadon, Chairman of the Coalition for Fair and Affordable Lending (CFAL) & Chief Operating Officer of Option One Mortgage, before the U.S. House of Representatives Committee on Financial Services' Subcommittees on Housing and Community Opportunity & Financial Institutions and Consumer Credit (May 24, 2005).
[4] 2005 Mortgage Market Statistical Annual, Vol. 1 (March 2004). For a list of the states, see Table 1.
[5] Kenneth A. Posner & Athina L. Meehan, *Channel Check: Surprisingly Strong Subprime Growth,* p1 Morgan Stanley Industry Overview (August 1, 2002).
[6] In fact, businesses often benefit from the relative speed, flexibility and opportunities for innovation provided by state regulation. *See* Baher Azmy, *Squaring the Predatory Lending Circle: A Case for States as Laboratories of Experimentation*, p390-404 57 Fla. L. Rev. 295 (April 2005), for a discussion about the value of innovation and experimentation at the state level in addressing predatory lending, as well as the "countervailing, but insufficient value of uniformity."
[7] *Top Subprime MBS Originator/Issuers in 2004,* p95 2005 Mortgage Market Statistical Annual, Vol. II.
[8] Eric Stein, *Quantifying the Economic Cost of Predatory Lending,* Coalition for Responsible Lending (2001) at *http://responsiblelending.org/pdfs/Quant10-01.pdf*.
[9] See Stein, note 8.
[10] *See* Quercia, Stegman & Davis, note 1.
[11] *See* Posner & Meehan, note 5 at p6.
[12] In recent years, North Carolina, New Jersey, Georgia, Massachusetts and New Mexico have been among the states to pass strong laws aimed at specific abuses in the subprime mortgage market.
[13] In March 2005, Congressional Representatives Ney of Ohio and Kanjorski of Pennsylvania introduced federal anti-predatory lending legislation (H.R. 1295) that would preempt state anti-predatory lending laws and impose some standards that are weaker than current federal law.
[14] In 2000, some trade associations began to call for an optional federal charter (much like the current U.S. banking system). *See* Sheila Bair*, Consumer Ramifications of an Optional Federal Charter for Life Insurers*, A Report by the University of Massachusetts Isenberg School of Management, http://www.isenberg.umass.edu/finopmgt/uploads/basicContentWidget/8631/bair-cons-ramifications.pdf at p2 and note 3 for a discussion of the debate over optional federal chartering in the insurance industry; *see also* Independent Insurance Agents & Brokers of America, *Statement of the Independent Insurance Agents & Brokers of America to the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Financial Servicies Committee,* p12 United States House of Representatives (June 18, 2002) for the view that a "one-size-fits-all regulatory approach" will eliminate market responsiveness and will not serve the best interests of the industry or the borrowers.
[15] Scott E. Harrington & Tom Miller, *Insurance Regulation and Government Insurance*, p395-396 CATO Handbook for Congress: Policy Recommendations for the 108th Congress (January 16, 2003).
[16] *Top 25 B&C Lenders in 2003* p141 2004 Mortgage Market Statistical Annual, Inside B&C Lending (2004).
[17] *Top Subprime MBS Originator/Issuers in 2004,* p2 Inside B&C Lending (January 17, 2005).
[18] *See* Posner & Meehan, note 5 at p2.
[19] Table 1 displays loan volumes based on Home Mortgage Disclosure Act (HMDA) data. "Subprime loans" are defined as any loan reported to federal regulators under HMDA as originated by a subprime lender identified by the U.S. Department of Housing and Urban Development for the year in which the loan was reported. We recognize this data has some limitations, particularly in efforts to tally subprime lending. (Limitations include: (1) Many lenders are exempt from HMDA reporting requirements due to asset size, branch locations, or share of business attributable to home lending; (2) Subprime loans may not be included in HMDA data because they are made by lenders that primarily make prime loans and are consequently excluded from HUD's list of subprime and manufactured housing lenders; and (3) HMDA does not mandate reporting of all second mortgages and home equity loans.) However, even with these limitations, HMDA data remains the most complete and readily accessible data on U.S. home loans. One particularly competent estimate placed HMDA's total coverage of subprime loans at between

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48 and 79 percent. (See Randall M. Scheessele, "1998 HMDA Highlights," Appendix D p10 Housing Finance Working Paper Series, Office of Policy Development and Research, U.S. Department of Housing and Urban Development (October 1999) at www.huduser.org/publications/hsgfin/workpapr9.html.) Even within this range, HMDA data is adequate for measuring relative changes in lending patterns over time, since it is not expected that any of its limitations have more effect on the data in one state than another.

[20] The following discussion excludes start-up costs for implementing automated compliance. These costs vary depending on the vendor, the size of the lender, and other factors. Vendor information indicates that the start-up cost for large clients may be significant, but for small clients quite low or negligible. Because of advances in technology and the increasing popularity of web-based solutions, it is likely that start-up costs are declining over time.

[21] This estimate is based on information presented by James Gazdecki, Option One Vice President of Government Relations, "Impact of Predatory Lending Laws on Compliance Rules," speaking at the 5th National Predatory Lending Conference (November 14, 2003). Mr. Gazdecki said that complying with predatory lending laws costs $57 an hour, or $0.95 per minute. According to Roger Fendelman, Compliance Director of AppIntell, Inc., (*The Predatory Lending Compliance Trap,* Mortgage Banking; see full citation at note 40), manual compliance checks can take between 30 to 45 minutes per loan to complete. Ninety-five cents multiplied by 45 minutes equals $42.75 per loan (rounded up to $43).

[22] Anthony Garritano, *Automating the Law*, Mortgage Technology, Vol. 12, No. 1 (January/February 2005).

[23] *See* Garritano, note 23 at p2. Garritano states that automated systems can review a loan for compliance in 1.4 seconds. Conservatively rounding this time up to one full minute yields a compliance cost of $0.95 per loan. (Fifty-seven dollars divided by 60 minutes.)

[24] *Table 5: Loan Production Income and Expenses Per Loan Originated (Retail & Purchased)*, p14 2004 MBA Cost Study: Income and Cost for Origination and Servicing of 1-to-4 Unit Residential Loans (2003 data), Mortgage Bankers Association (2004); and *Table II: Production Technology Expenditures*, pA5 2005 MBA Technology Study Highlights, Mortgage Bankers Association (2005). Manual compliance and automated predatory lending compliance figures estimated by Center for Responsible Lending.

[25] Roberto Quercia, Michael A. Stegman & Walter A. Davis, *The Impact of Predatory Lending Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments,* Center for Community Capitalism, University of North Carolina at Chapel Hill (January 25, 2005) at http://www.kenan-flagler.unc.edu/assets/documents/foreclosurepaper.pdf. *See also* Dan Immergluck and Geoff Smith, *Risky Business: An Econometric Analysis of the Relationship Between Subprime Lending and Neighborhood Foreclosures*, Woodstock Institute (March 2004).

[26] *See e.g.,* D. Immergluck, *There Goes the Neighborhood: The Effect of Single-Family Mortgage Foreclosures on Property Values*, Woodstock Institute (June 2005) and William Apgar & Mark Duda,, *Collateral Damage: The Municipal Impact of Today' Mortgage Foreclosure Boom*, Homeownership Preservation Foundation (May 11, 2005).

[27] Secretary of the Pennsylvania Department of Banking, *Losing the American Dream: A Report on Residential Mortgage Foreclosures and Abusive Lending Practices in Pennsylvania* (March 15, 2005).

[28] *See* http://www.biipier.org/presentations/PAC_Meeting/Summary413.PDF.

[29] National Mortgage News Quarterly Data, 1st- 4th quarters (2004).

[30] *See* Garritano, note 23.

[31] *Automated Mortgage Compliance Solutions*, ComplianceEase presentation, American Conference Institute: 5th National Predatory Lending Conference (November 14, 2003).

[32] Mary McGarity, *The Values Debate*, Mortgage Banking, Vol. 65, Issue 6 (March 2005).

[33] Steve Cocheo, *Is Compliance Y2K Compliant?,* ABA Banking Journal, Vol. 90, No. 4 (April 1, 1998).

[34] *Preventing Exposure to Predatory Practices—Limiting Risk at Loan Origination*, Mavent NHEMA Conference presentation (June 17, 2004). For example, ComplianceEase has contracted with an A++-rated insurer that would cover losses due to fines, penalties, judgments, as well as losses in the secondary market resulting from compliance defects.

[35] Jason Roth, Vice President of Product Design for ComplianceEase, telephone interview (April 7, 2005).

[36] Home Mortgage Disclosure Act raw data (2003).

[37] Steve Grundleger and Michael Nelson, *Can You See Me Now?: Screening for RMBS Predatory Lending Loans*, p1 Fitch Ratings Structured Finance (November 12, 2003).

[38] *2005 Technology Study Highlights*, Mortgage Bankers Association press statement (June 27, 2005).

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[39] *See*, e.g., OCC Advisory Letter AL 2003-3. *Also, see* Roger Fendelman, *The Predatory Lending Trap*, Mortgage Banking Vol. 64, Issue 12 (September 1, 2004).
[40] Anand S. Raman, Joseph L. Barloon & Matthew D. Michael, *Cutting the Risks Built into Third-Party Lending Relationships*, p61 ABA Banking Journal (July 2003).
[41] Natalie Abrams and Maureen Coleman, *Evaluating Predatory Lending Laws: Standard & Poor's Explains its Approach,* Standard & Poors RatingsDirect (April 15, 2003).
[42] M. Scott Mason (Standard & Poor's Director), *Evaluating Anti-Predatory Lending Laws: S&P's Approach,* American Conference Institute: Avoiding Exposure to Regulatory and Civil Actions for Predatory Lending (March 30, 2004).
[43] Erick Bergquist, *Some Lenders Turning to Compliance Software*, American Banker (April 1, 2003).
[44] *See* Quercia, Stegman & Davis, note 27.

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