Subcommittee on Financial Institutions and Consumer Credit
Subcommittee on Housing and Community Opportunity
Joint Hearing Entitled "Subprime Lending: Defining the Market and Its Customers"

March 30, 2004

Prepared Testimony of Eric Stein,
Senior Vice President, Center for Responsible Lending

Chairman Bachus and Chairman Ney, Ranking Member Sanders and Ranking Member Waters, thank you for the opportunity to testify today on the promise and challenges of the subprime market. I am here representing the Center for Responsible Lending (CRL), which is a nonprofit, nonpartisan research and public policy organization working on predatory lending issues and an affiliate of Self-Help. My positions with both CRL and Self-Help provide me with both the perspective of an experienced lender and an understanding of market failures inherent in today's subprime home lending, along with policy solutions that have been crafted to address these failures.

Self-Help is a North Carolina-based nonprofit community development lender that includes a credit union and a loan fund. Initially founded to improve access to credit for communities that could not obtain the financing they needed from traditional financial institutions, we are committed to the idea that ownership allows people to improve their economic position and provides communities with a solid foundation on which to grow and prosper. In particular, we have found that homeownership is the bedrock for economic security, as homeownership has been the primary way for families to build wealth. In the U.S. today, one-half of all homeowners hold at least 50 percent of their net worth in home equity.[1] And home

[1] See, e.g., Joint Center for Housing Studies of Harvard University. State of the Nation's Housing 1997: p.18.

equity comprises over 60 percent of the net worth of minority and low-income families.[2] This equity is used by families to send children to college, start new businesses, or weather crises such as job loss or extended illness.

Self-Help has provided more than $3.5 billion in financing to borrowers in 47 states since its founding in 1980, and has enabled more than 38,000 families to become homeowners. Through our commercial loans, we have created or maintained approximately 20,000 jobs, allowed child care providers to create space for 20,000 children, and enabled more than 9,000 students to attend public charter schools. Because we seek to serve those who have traditionally been denied access to credit, Self-Help's loans go disproportionately to women, African Americans, Latinos, and rural borrowers. However, we are not in the business of giving money away. **Our overall loan loss rate is less than one-half of one percent per year, and our assets have grown to more than $1 billion.**

Self-Help has succeeded because of our high-quality lending process and the fact that our borrowers are determined to succeed. Our loan officers are trained to encourage borrowers to ask questions, and to take the time to provide clear answers and complete explanations of borrowers' options and actual loan terms. Self-Help has also learned that low-wealth borrowers buying their first home who become late on their payments almost always recover. We have learned that a mother will work three jobs before she will give up her children's home.

In the late 1990s, we and others in North Carolina became increasingly aware that, while subprime lending presented unprecedented opportunities for borrowers who lacked access to credit from traditional sources, it also presented substantial dangers. We began to see borrowers come through our doors in search of help in staving off foreclosure. However, to our dismay,

---

[2] "Net Worth and Asset Ownership of Households, 1998 and 2000," at 15 tbl. I (U.S. Census Bureau, P70-8, May 2003).

abusive terms in their existing loans routinely prevented us from refinancing their loan. We recognized that unscrupulous lenders were taking advantage of vulnerable homeowners to strip equity and steal hard-earned wealth, using terms of credit that were not commensurate with risk-based pricing.

I'd like to offer a story that illustrates the examples of abusive lending we saw in North Carolina. Mrs. V., a Durham Public School System employee, was contacted in 1998 by Green Tree Mortgage Services and encouraged to refinance her existing home loan into a debt consolidation loan. Green Tree charged her over $16,000 in fees on a $99,000 loan (16%), including a $5,002 loan origination fee (4.5%), a $2,142 loan discount fee (2.17%) and a $9,089 credit insurance premium. Mrs. V. was unaware of the credit insurance policy until she met with an attorney, and could not refinance the loan for three years without incurring a substantial prepayment penalty.

As a result of this widespread understanding of the problems in the subprime market, a remarkable coalition of bankers, credit unions, brokers, mortgage bankers, consumer advocates, the NAACP, AARP, and other community organizations came together from 1998 to 1999 to develop a state law of strong standards to preserve the important benefits of the subprime market while weeding out the worst abuses.

The coalition operated on two principles. First the coalition agreed that consumer education and disclosures could not correct the market abuses we were witnessing. As recently explained in report issued by the Government Accounting Office, "Even an excellent campaign of consumer education is unlikely to provide less sophisticated consumers with enough information to properly assess whether a loan contains abusive terms."[3] Moreover, in the

---

[3] "Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending" GAO-04-280 (January 2004), 13.

blizzard of paper generated for a home loan closing, even lawyers can lose track of what they are signing. Disclosures often offer nothing more than a defense for unscrupulous lenders. Second, the coalition recognized the need to deter exorbitant (often hidden and confusing) fees and to encourage lenders to instead garner their compensation through interest rates, which are more transparent and easy-to-shop for. By reshaping the subprime market in this way, North Carolina could rely on competition among lenders to protect borrowers. Lenders who overreached would lose market share to those that charged reasonable risk-based prices for credit.

The law passed almost unanimously in 1999. We could not help Mrs. V. with a refinance when she came to us because she had no equity left in her house. However, we see cases like hers much less often today, since the abusive products and terms that were included in her loan are either illegal or have been driven out of the North Carolina market by the law.

Since enactment of the law, Self Help has established an affiliate, the Center for Responsible Lending (CRL), a nonprofit, nonpartisan research and policy organization that promotes responsible lending practices and access to fair terms of credit for low-wealth families. CRL draws on Self-Help's experience as a lender in advocating common-sense approaches to market failures and lender abuses that harm homeowners--and those who want to become homeowners--in their pursuit of security and opportunity.

I hope today to be able to touch on the key benefits promised by an efficient subprime home loan market, highlight the abuses that too often take place without clear standards, and, in connection with each abuse, briefly explain how North Carolina and other states have balanced strong standards with a vibrant market.

I. An efficient subprime home loan market provides homeowners with opportunity through risk-based pricing.

The U.S. mortgage market for "prime" loans – those loans made to borrowers with solid credit – is the envy of the world. The market for prime mortgage loans is marked by intense competition among lenders on the basis of rates and terms. The market competition has led to innovative loan products and technological advancements to reduce costs to borrowers. This market competition works to enable more borrowers to afford homeownership.

The "subprime" market is intended to serve those who do not qualify for these "prime" loans, primarily due to impaired or limited credit histories. To account for less-than-stellar credit, responsible subprime lenders charge a premium in the form of higher interest rates to compensate for the increased risk associated with their lending activities. Accordingly, when the subprime market operates efficiently, it offers an opportunity to expand homeownership opportunities to borrowers that would otherwise be unable to obtain credit in the prime market. Unfortunately, the subprime market is not as efficient as the prime market and is marred by market failures that severely undermine its potential benefits. Unlike the prime market, there is little evidence that subprime lenders compete on the basis of price. In fact, evidence shows that a substantial portion of borrowers with subprime home loans would actually qualify for prime loans.[4] In addition, the prevalence of certain abusive loan terms and lending practices in the subprime market not only have limited the equity-building potential for homeownership, but have led families to lose their homes and their accumulated life savings.

[4] Freddie Mac, a federally chartered corporation that purchases mortgages, found that 10% to 35% of the borrowers in its subprime portfolios should have received loans in the prime market and cites a poll of 50 subprime lenders who estimate that half could have qualified for prime loans. Automated Underwriting: Making Mortgage Lending Simpler and Fairer for America's Families. Washington, D.C. September 1996. See also Anthony Pennington-Cross, Anthony Yezer, and Joseph Nichols, Credit Risk and Mortgage Lending: Who Uses Subprime and Why? Washington, D.C.: Research Institute for Housing America, Working Paper 00-03 (finding that probability of

As a result of these abusive practices in the subprime market, Self-Help's original focus to increase access to homeownership credit has been supplemented with CRL's concerns about the terms on which credit is offered. We have seen our borrowers first-hand build their family wealth by playing by the rules – making their mortgage payments every month – only to have that wealth stolen through abusive refinances. Without strong standards in place to encourage responsible lending, the subprime mortgage market will fail to fulfill its potential to help low-wealth families achieve and maintain economic security.

Some industry representatives are apparently threatened by the legislative activity in a number of states that wish to deter the worst abuses. However, the subprime market continues to grow rapidly. Both subprime lending and the securitization of subprime loans increased by over 50 percent in 2003 over 2002 – volume increased to $332 billion from $213 billion, while subprime securities rose to $203 billion from $135 billion.[5] As reported by an industry publication, "Subprime lenders should continue to see strong demand for their product in the secondary market this year, analysts predict."[6] Furthermore, "Fitch anticipates few problems from 'pending or existing' predatory lending laws, as both sellers and issuers have significantly stepped up their due diligence efforts."[7]

II. Abusive terms and practices common to the subprime market strip hard earned equity, result in risk-rate disparities, and lead to needless foreclosures.

While by no means are all subprime home loans predatory, most predatory home loans are subprime. Without standards in place, the subprime market often malfunctions in three primary ways. First, lenders can strip equity from homeowners through excessive fees, often

---

African American borrower receiving subprime loan increased by 1/3 compared with white borrower, controlling for risk). See also note 17, infra.

[5] Inside B & C Lending. Jan. 12, 2004, p.3 and Feb. 9, p.1. The growth rate over ten years has been astounding: in 1994, subprime lending totaled just $34 billion, while only $11 billion of that was securitized.

[6] Inside B & C Lending. Jan. 12, 2004, p.3.

financed into the loan. Excessive fees can be in the form of single premium credit insurance, exorbitant origination fees, discount points that do not reduce interest rates, or hidden "back-end" prepayment penalties that function as a deferred fee when a borrower refinances into a better-priced loan and pays off an existing loan early. Second, brokers and lenders can overcharge borrowers through interest rate steering, pricing loans on the basis of perceived financial sophistication rather than risk. Third, lenders can engage in a range of practices, including asset-based lending, that lead directly to the high foreclosure rates that are currently devastating neighborhoods across the country. I will address each of these problems in turn, and then I will describe how the standards enacted in North Carolina have been helpful in addressing some of the worst abuses to the benefit of homeowners and responsible lenders.

A. Exorbitant and anti-competitive fees can strip home equity and prevent borrowers from accessing better priced loans.

At the outset, it should be noted that the subprime market is predominately a refinance market—approximately three-quarters of subprime originations in 2001 and 2002 were refinances.[8] In fact, "a majority of mortgages in the subprime market are used for consumer debt rather than housing purposes."[9] Homeowners rarely confront the costs of refinance loans directly, since the fees are taken from the equity in their homes, making refinance loans particularly susceptible to equity-stripping practices. High fees are deceptively "costless" to many borrowers because the borrower does not feel the pain of counting out thousands of dollars in cash at closing. The borrower parts with the money only later, when the loan is paid off and the equity remaining in his or her home is reduced by the amount of fees owed. In addition, the fees last forever, because the borrower's wealth is permanently stripped away even if he or she

---

[7] Id. at 4.
[8] SMR Research Corp., Analysis of 2001 and 2002 Home Mortgage Disclosure Act data.

manages to refinance just one week after closing. Not satisfied with high interest rates, abusive lenders charge excessive fees—often equal to five percent or more of the loan amount, five times the average fees associated with prime loans.

One of the most prevalent and disturbing trends in the subprime market is the startlingly high percentage of subprime loans with exorbitant prepayment penalties. Prepayment penalties are fees that borrowers are obligated to pay if they choose to pay off a debt before the end of the scheduled term of the loan—for example to refinance at a better rate. Some of the worst charge six months' interest for five years. In the context of a subprime loan with an interest rate of 12 percent, this means that the prepayment penalty amounts to approximately 5 percent of the loan balance. For a $150,000 loan, this fee is $7,500, which is about 40 percent of the total net wealth of the median African-American family as of 2001.[10]

The cost of prepayment penalties in subprime home loans is actually three-fold. First, paying the penalty strips equity from a borrower's home. Second, the penalty itself can trap a borrower in a bad loan when he or she could otherwise refinance into a better-priced product. Finally, collecting the fee facilitates kickbacks that encourage brokers to place borrowers in higher interest loans than those for which the borrowers qualify.

Unfortunately, prepayment penalties have become increasingly prevalent in the subprime market since 1996, at a level far out of proportion to the conventional or "prime" mortgage market. In contrast to an 80 percent prevalence of prepayment penalties in subprime home loans,[11] in the competitive, conventional market, less than 2 percent of borrowers accept

---

[9]Joint HUD/Treasury Report on Recommendations to Curb Predatory Home Mortgage Lending (April 20, 2000), p.3.

[10] Aizcorbe, Ana M., Arthur B. Kennickell, and Kevin B. Moore, January 2003, *Recent Changes in U.S. family finances: Evidence from the 1998 and 2001 Survey of Consumer Finances*, Federal Reserve Bulletin, 1-32.

[11] See Standard & Poor's, NIMS Analysis: Valuing Prepayment Penalty Fee Income, at http://www.standardandpoors.com (January 3, 2001); see also Standard & Poor's, Legal Criteria Reaffirmed for the

prepayment penalties.[12] The disparity is particularly telling, since a subprime borrower should logically be more interested in refinancing into a better rate once his or her credit score improves. According to Lehman Brothers' prepayment assumptions, over half of subprime borrowers will be forced to prepay their home loans—and pay the penalties—during the typical five-year lock-out period.[13]

In short, subprime prepayment penalties in home loans decrease consumer options and diminish competition in the marketplace. The rate at which subprime borrowers supposedly "choose" loans with prepayment penalties also demonstrates the tremendous asymmetry of information and bargaining power that characterizes the typical subprime mortgage transaction.

Finally, equity-stripping is exacerbated by unscrupulous lenders who not only charge high fees, but also "flip" loans through repeated refinances that generate income without providing the borrower with a tangible net benefit. Products that may be used responsibly in other lending contexts, such as balloon payments or adjustable rates, can in some contexts be used to facilitate flipping. Predatory lenders initially disguise such features in order to create the impression of an affordable loan through low monthly payments, only to inform the borrowers of a feature soon after closing to convince them to refinance into a new and "better" loan. A study of California subprime borrowers found that 40 percent had refinanced their homes six times in the two-year period before receiving their current loan,[14] a strong indication of significant flipping. Flipping is a particular problem with mortgage brokers, who often engage in push

---

Securitization of Prepayment Penalties, at http://www.standardandpoors.com (May 29, 2002); Prepayment penalties prove their merit for subprime and 'A' market lenders, http://www.standardandpoors.com (January 3, 2001).

[12] See Freddie offers a new A-, prepay-penalty program, Mortgage Marketplace, at 1-2 (May 24, 1999); see also Joshua Brockman, Fannie revamps prepayment-penalty bonds, American Banker at 16 (July 20, 1999).

[13] *See* A. Chu & K. Kwan, Lehman Brothers, *Asset-Backed Securities*, MBS and ABS Weekly Outlook, at 2.

[14] Kevin Stein and Margaret Libby, Stolen Wealth: Inequities in California's Subprime Mortgage Market. California Reinvestment Committee, Nov. 2001.

marketing; an AARP study of elderly borrowers found that 56 percent of those receiving brokered loans reported that the broker initiated contact.[15]

B. Brokers secure bonus payments for steering borrowers into loans with excessive interest rates, exacerbating rate-risk disparities.

The substantial growth of predatory practices in the subprime market has had a disproportionate impact on low-income homeowners, particularly members of minority groups. After analyzing almost one million mortgages reported to HMDA in 1998, HUD found that subprime loans are five times more likely in black neighborhoods than in white neighborhoods. Homeowners in high-income black neighborhoods are twice as likely as homeowners in low-income white neighborhoods to have subprime loans.[16] Part of what lies behind these numbers is the practice known as steering. In brief, some lenders and brokers provide borrowers with unnecessarily costly loans when they think they can get away with it—by steering customers to certain lenders and/or to selected products. In fact, studies show that a significant percentage of subprime borrowers could qualify for mainstream, "prime" loans.[17]

In part, rate-risk disparities in the subprime market are due to the increased use of brokers in making loans and compensation methods that encourage brokers to take advantage of less savvy customers. Brokers account for 48 percent of subprime originations, versus 28 percent of

---

[15] Kellie Kim-Sung and Sharon Hermanson, Experiences of Older Refinance Mortgage Loan Borrowers: Broker- and Lender-Originated Loans, AARP Public Policy Institute, Jan. 2003.

[16] "Unequal Burden: Income & Racial Disparities in Subprime Lending in America," U.S. Department of Housing and Urban Development (April 2000).

[17] "A study using an industry survey of mortgages with subprime pricing found that almost 29 percent of subprime-priced loans had credit scores above 640, generally considered the point at which prime lenders become quite comfortable with loans." Dan Immurgluck & Geoff Smith, "Risky Business: An Econometric Analysis of the Relationship Between Subprime Lending and Neighborhood Foreclosures," Woodstock Institute (March 2004), pp. 1-2 (citation omitted). A recent Joint Center for Housing Studies at Harvard University study cites numerous studies concluding that African American borrowers receive subprime loans at a greater rate than risk can justify, and conducts its own econometric analysis leading to the same conclusion. See "Credit, Capital and Communities: The Implications of the Changing Mortgage Banking Industry for Community Based Organizations," (March 9, 2004), pp. 36-59. See also note 4, supra.

conventional loans.[18] The high percentage of loans that are originated through a broker contributes to abuses. While borrowers may believe that a mortgage broker has a legal duty to find them the best loans available, in most states, a broker has no fiduciary duty to the borrower. Rather than looking out for the borrower's interest, the broker is generally looking out for his or her own bottom line.

This fundamental misunderstanding of the broker-borrower relationship is perpetuated by compensation that encourages brokers to take advantage of less-knowledgeable customers. Brokers are frequently paid indirectly by the lender/investor based on the yield of the mortgage loan through a "yield spread premium" (or "YSP"). A yield spread premium is a back-end kickback paid to a broker by a lender based on the difference between the interest rate of the loan the broker entered into with the borrower, and the par rate offered by the lender to the mortgage broker for that particular loan. In other words, such payments create an incentive to steer certain consumers—those viewed as unsophisticated—into particularly costly loans.

In testimony before the Senate Committee on Banking, Housing, and Urban Affairs in January 2002, Professor Howell E. Jackson of Harvard Law School discussed the conclusions of his research into yield spread premiums. According to Professor Jackson, borrowers "never understand that the interest rate is higher than it needs to be or that the higher interest rate is used to finance a payment to the mortgage broker." Despite arguments that yield spread premiums allow borrowers to bring down closing costs, "With the highest degree of statistical confidence, [Professor Jackson's] studies refute the proposition that borrowers receive a dollar for dollar offset for yield spread premiums…. [B]orrowers, on average, enjoy 25 cents of benefit for each dollar paid in yield spread premiums."

As one study recently stated:

---

[18] Inside B&C Lending, March 22, 2004.

> Disturbingly, the tendency of brokers to charge excessive fees or present misleading information is not 'corrected,' but rather priced in the market. . . In a world in which the broker is detached from the lender and the lender is detached from the investor, market feedback loops are broken, or at best are slow to operate. Rather than work to root out abuse under the current industry structure, some buyers pay more, brokers earn a premium return, and investors are compensated. . . . The result is that the impact of foreclosures to borrowers and communities is ignored by the capital markets. [19]

C. <u>**Predatory practices should be of the utmost concern because, in addition to stripping wealth from individual families, they lead to heightened foreclosures that harm entire communities.**</u>

For some years, researchers have reported a high correlation between an increased number of subprime loans and foreclosure rates. Unfortunately, foreclosure is the ultimate consequence of abuses such as equity stripping and steering. In its recently released study, the GAO noted that foreclosure patterns are an indicator of the prevalence of predatory lending.[20] Harvard's Joint Center for Housing Studies recently reviewed and summarized this body of research:

> To date there have been over ten studies of foreclosure activity in individual metropolitan areas. Though economic factors obviously play a role, these studies paint **a remarkably consistent picture of the rising incidence of foreclosure in a period of strong economic growth, led in large measure by the relatively high incidence of foreclosure among subprime loans in lower-income and minority neighborhoods**. [21]

The increase in subprime foreclosures, the so-called "smoking gun of predatory lending,"[22] could hardly be more clearly established.

---

[19] "Credit, Capital and Communities: The Implications of the Changing Mortgage Banking Industry for Community Based Organizations," Joint Center for Housing Studies, Harvard University (March 9, 2004), p.33 &44 (citation omitted).
[20] "Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending," overnment Accounting Office (GAO-04-280) (January 2004).
[21] "Credit, Counseling and Communities" at p. 67.
[22] See Bunce, Harold et. al., *Subprime Foreclosures the Smoking Gun of Predatory Lending*? U.S. Department of Housing and Urban Development (Feb. 2001). Available at: http://www.huduser.org:80/publications/pdf/brd/12Bunce.pdf

A very recent study of the relationship between subprime lending and foreclosure rates—a study that controls for variables that have frequently been blamed for the increase in foreclosures--further drives home the dangers of assuming that more loans are always better than fewer loans. Dan Immergluck, of Grand Valley State University, and Geoff Smith, of Woodstock Institute, recently found that **"after controlling for neighborhood demographics and economic conditions, subprime loans lead to foreclosures at twenty or more times the rate that prime loans do."[23]** In fact, an increase in prime loans may actually decrease foreclosures by crowding out more problematic subprime loans.[24] The differential impact of subprime and prime loans is true for purchase, home improvement, and refinance loans. Clearly, lending practices are at least partially responsible for the number of families that are losing homes to foreclosure.

A recent study of foreclosure records in one Kentucky county directly links foreclosure to predatory loan terms. In a study conducted for the Louisville Urban League, court documents were examined for more than 1,500 mortgage foreclosures that resulted in court-ordered auctions between January 2000 and December 2002. This examination resulted in the conclusion that "About one-third of those foreclosures appeared to involve loans with predatory characteristics. This suggests that predatory lending probably accounts for a significant part of the growing foreclosure rate in Jefferson County." [25] Of the loans with predatory terms, 73 percent had prepayment penalties combined with high interest rates (defined as at least 4 points higher than the 30-year Treasury rate) and 29 percent had balloon payments.[26]

---

[23] Immergluck and Smith, Risky Business -- An Econometric Analysis of the Relationship Between Subprime Lending and Neighborhood Foreclosures, Woodstock Institute, March 2004.
[24] Immergluck and Smith at p.22 i.
[25] Steve C. Bourassa, "Predatory Lending in Jefferson County: A Report to the Louisville Urban League," 2 (Urban Studies Institute, University of Louisville Dec. 2003).
[26] Id.

As many others have pointed out, the cost of foreclosures is not borne only by the families who lose their homes. Rather,"[f]oreclosed homes are often a primary source of neighborhood instability in terms of depressed property values and increased crime." [27] One estimate of direct costs is $37,000 in expenses to the city and neighborhood per foreclosure.[28] Whole communities are affected. Trust in our financial system is eroded, and belief in social mobility is strained.

III. The North Carolina anti-predatory lending law successfully set standards that encouraged responsible lending and drove out bad loans.

A. <u>The North Carolina law has decreased the incidence of equity-stripping loan terms.</u>

When Self-Help helped champion a state anti-predatory lending law in 1999, we pushed for provisions that would encourage lenders to limit fees and reflect credit risk accurately in interest rates. When the cost of credit is reflected in rates rather than fees, shopping is much easier for homeowners—and homeowners can also rectify mistakes through refinancing. The North Carolina law—passed virtually unanimously with the support of industry, consumer groups, and civil rights organizations--prohibits or discourages unfair and abusive fees and prohibits the flipping of loans solely for fee generation purposes. Because of the law, in North Carolina today, the best defenders of borrowers from excessive interest rates are responsible lenders eager to refinance them to an appropriate rate.

Empirical research shows that North Carolina's approach has led to a drop in abusive refinance loans. After analyzing the effects of North Carolina's law on the home mortgage market, researchers from the University of North Carolina concluded, **"although the total volume of subprime originations in North Carolina declined, the number of home purchase**

[27] HUD/Treasury Report at p.51.
[28] Moreno, The Cost-Effectiveness of Mortgage Foreclosure Prevention, Minneapolis: Family Housing Fund, 1995.

loans was unaffected by the law. While refinance originations did fall, about ninety percent of the decline was in predatory loans."[29] More specifically, the UNC study noted a decline in the incidence of subprime home refinance loans containing prepayment penalty terms that exceed three years. In fact, there was a 75 percent decline in North Carolina, compared with a 30 percent increase nationally in extended prepayment penalty loans. In addition, the authors found a decline in subprime balloon payments and loan-to-value ratios of 110 percent or more. The study appropriately viewed such loans as of little or no benefit to the borrower and therefore as a subset of flipping.

CRL estimates that the new law saved consumers at least $100 million—in its first year—by preventing predatory loan terms that would have been expected to occur in the law's absence.[30]

B. The North Carolina law has improved the operation of risk-based pricing in the prime market.

The UNC study also found that, after the law was fully implemented, North Carolina's mean origination interest rates were consistent with corresponding national rates and actually increased slightly less than the national average increase. One would have expected that rates would rise more than elsewhere since the intention of the law was to clamp down on fees and shift lender compensation to rate. This result suggests that the fees being charged before the law's implementation were not genuinely priced to account for the risk of default, but rather function as a vulnerability tax on North Carolina families.

In a separate finding, the UNC researchers noted that subprime loans to borrowers with credit scores above 660—those who could more easily qualify for low-cost conventional loans—

[29] R. Quercia, M. Stegman, & W. Davis, "An Assessment of the Impacts of North Carolina's Predatory Lending Law" (forthcoming Fannie Mae Foundation Housing Policy Debate), p.26. See "STUDY: NC Predatory Lending Law Cuts Abuses, Does Not Dry Up Credit for Borrowers", Center for Community Capitalism June 25, 2003 press release (available at http://www.kenan-flagler.unc.edu/News/DetailsNewsPage.cfm?id=466&menu=ki).

declined by 28 percent. According to HMDA data, overall loans by primarily prime lenders increased by 40 percent in the state from 2000 to 2001. This finding suggests a reduction in "steering" of borrowers to loans with a higher price than that justified by their credit history.

C. Although research has not yet been conducted, we would expect foreclosure rates to fall in North Carolina in concert with the reduced incidence of predatory loan terms.

As I mentioned, a loan-level study from Kentucky found that particular combinations of predatory loan features appear to contribute to foreclosure rates. In particular, the Kentucky study looked at prepayment penalties (when coupled with high interest rates), balloon payments, and high loan-to-value ratios. In North Carolina, we have decreased the incidence of all three of these features. Although I do not believe that anyone has conducted a formal study of foreclosures in North Carolina, it is clear to me that our tremendous drop in loans containing these features will result in a substantial decrease in foreclosures than would have happened without the law.

D. North Carolina's law has allowed for the continued widespread availability of credit.

It is important to note that a finding of a reduced number of subprime refinance loans after a law has been passed is only the start of an honest inquiry, since part of the purpose of the law was to accomplish exactly that, by eliminating predatory lending. First, when the prevalence of equity-stripping loans that do not benefit the borrower is reduced, subprime lending volume falls but the state is better off. The loan to Mrs. V. that I described earlier, for example, never should have been made. The Associates settled a predatory lending case for $215 million dollars with the Federal Trade Commission, while Household Finance settled with state Attorneys

[30] Ernst, Keith, John Farris, and Eric Stein, "North Carolina's Subprime Home Loan Market After Predatory

General for $484 million. Had North Carolina's law been in place to keep these loans from being made in the first place, we would have been much better off. In fact, UNC found that 90 percent of the reduction in refinance lending after the law was implemented was in loans with predatory, equity-stripping features. Second, when borrowers with prime-eligible credit receive a conventional loan instead of a subprime one, that also is a result to be celebrated. As mentioned, subprime loans to borrowers with credit scores over 660 fell by 28 percent after the law; since conventional lending increased by 40 percent, we can conclude that steering fell in the state, to its benefit.

The North Carolina successfully addressed practices that strip homeowners' equity, steer homeowners into unnecessarily expensive loans, and contribute to foreclosure rates, and simultaneously has allowed the subprime lending market to thrive. Our own analysis of home loans reported to federal regulators as originated under the Home Mortgage Disclosure Act (HMDA) shows that North Carolina was still the sixth most active state for subprime lending in 2000, with North Carolina borrowers 20 percent more likely to receive a subprime loan than borrowers in the rest of the nation. One in every three loans to low-income North Carolina families (annual incomes of $25,000 or less) was subprime, the highest such proportion in the country. [31]

Still, the UNC study found that home purchase loans to borrowers with credit scores below 580, those whose only option is subprime, more than doubled after the law was fully implemented, compared with an increase of 62 percent nationally. While refinance loans to borrowers to higher credit score borrowers fell, a consequence of reduced steering, such loans to borrowers with credit scores below 580 increased by 18.5 percent in NC after the law. While

---

Lending Reform", Center for Responsible Lending (August 2002) (available at http://www.responsiblelending.org).

this increase was at a lower rate than the country as a whole -- since abusive loans were not made in the state -- it demonstrates that the market continues to be available to those who need it most.

In other words, as UNC Professor Michael Stegman reported, "[t]he North Carolina predatory lending law is doing what it was intended to do: purge the market of abusive loans without restricting the supply of subprime mortgage capital accessible to North Carolina borrowers with blemished credit records."[32]

While the most rigorous examination of North Carolina's subprime market, the UNC study does not stand alone. A leading industry trade journal, *Inside B & C Lending*, reported that top North Carolina subprime lenders "continue to offer a full array of products for borrowers in North Carolina—with little or no variation in rate" compared to other states.[33] A recent Morgan Stanley & Co. survey of 280 subprime branch managers and brokers found that tougher state laws, including North Carolina's, have not reduced subprime residential lending volumes.[34] In fact, 84 percent of the managers thought changed practices are having neutral to positive impact on volume because they make customers feel more comfortable and "lower points and less onerous prepayment penalties make the economic terms more attractive."

What the academic studies show is simply what lenders like us who operate in this state every day experience -- there is no shortage of credit available to borrowers across the state.

---

[31] Ernst, Keith, John Farris, and Eric Stein, "North Carolina's Subprime Home Loan Market After Predatory Lending Reform", Center for Responsible Lending (August 2002) (available at http://www.responsiblelending.org).

[32] Quercia at p.1. Although an industry-sponsored Credit Research Center (CRC) study claimed that the North Carolina law led to a decrease in access to credit for low-income borrowers, that conclusion should be viewed with suspicion. The CRC study contradicts other industry reports and the weight of available evidence. The CRC study relies upon a limited data set from nine anonymous lenders that has not been made available for independent verification. The CRC study examines data from a period ending June 30, 2000, the day before most of the North Carolina law's provisions took effect. Moreover, the data omits all open-end home loans from those lenders. Finally, the CRC study ignores the problem of "flipping" (refinancing loans with no benefit to the borrowers) and "steering" (providing subprime loans to prime-eligible borrowers) and consequently assumes that any reduction in subprime originations is evidence of harm. However, any successful anti-predatory lending law would curb both practices and thus would tend to reduce the number of subprime refinance originations.

[33] Inside B&C Lending. Lenders Will Try to Pin Down Effects of NC Mortgage Law. March 5, 2001.

[34] Morgan Stanley. 2002. Channel Check: Surprisingly Strong Subprime Growth. Diversified Financials. August 1.

Joseph Smith, North Carolina's Commissioner of Banks, has commented that "[d]uring the last twelve months, over seventy-five percent of formal complaints to [his office] … have involved mortgage lending activities [but] …. [n]ot one of these complaints has involved the inability of a North Carolina citizen to obtain residential mortgage credit."[35]

Conclusion

While the North Carolina anti-predatory lending law certainly has not eliminated predatory lending from our state, mounting evidence suggests that it and similar state laws are effective because they set clear and meaningful standards that drive out unscrupulous actors and allow responsible lenders to flourish. Carefully crafted reforms are needed to change the incentives for lending practices and to make market participants compete on the basis of what they can offer homeowners rather than how much they can strip away.

State anti-predatory lending laws have by in large been carefully designed to correct specific market failures identified in each state. North Carolina and a number of other states have taken the lead in addressing the inequities of the subprime market. We have limited the financing of fees, created disincentives for packing high fees into loans, and prohibited the flipping of loans when only the broker or lender benefits. We have taken steps to put unscrupulous brokers out of business and to create pressure on lenders to decrease side-payments to brokers for steering people into unnecessarily costly loans. We have limited prepayment penalties that strip equity from homeowners on the "back end" of their loans. These steps serve as important protections against rising rates of foreclosure and ensure that we continue to build wealth in all of our communities.

[35] North Carolina Office of the Commissioner of Banks, Joseph A. Smith, Jr. letter to Comptroller John D. Hawke, Jr. (October 2, 2003) (available at http://www.banking.state.nc.us/reports/Hawke.pdf).