

1-2010

# Regulation of Subprime and Predatory Lending (forthcoming)

David Reiss

Follow this and additional works at: <https://brooklynworks.brooklaw.edu/faculty>



Part of the [Law Commons](#)

---

## Recommended Citation

The International Encyclopedia of Housing and Home. Elsevier Ltd, 2010.

This Book is brought to you for free and open access by BrooklynWorks. It has been accepted for inclusion in Faculty Scholarship by an authorized administrator of BrooklynWorks.



**From the SelectedWorks of David J Reiss**

---

January 2010

## Regulation of Subprime and Predatory Lending (forthcoming)

Contact  
Author

Start Your Own  
SelectedWorks

Notify Me  
of New Work

---

Available at: [http://works.bepress.com/david\\_reiss/28](http://works.bepress.com/david_reiss/28)

To understand the regulation of subprime and predatory lending, one must first understand the rapid growth and subsequent implosion of the subprime mortgage market.

### **1. The Subprime Mortgage Market**

The development of the subprime mortgage market in the 1990s coincided with a dramatic departure from the typical process of obtaining a mortgage prior to that time. Previously, Americans who wanted to purchase a home would often walk into a local savings bank and speak to an officer who would evaluate their application. Depending on income, wealth and ties to the community, the loan officer might approve a loan. Typically only those with a healthy, or “prime,” profile were approved. This profile usually reflected a steady work history, a large down-payment and no problems with credit.

Thrifts, including savings banks, savings and loans and mutual savings banks, were not only the dominant type of lender, but they also vertically dominated the residential mortgage market. They serviced the mortgages that they originated and typically held them until they were paid off by the borrowers. Now, technological, financial and legal innovations allow global finance companies to offer a range of mortgage products to a broad array of potential residential borrowers. These same innovations have also led to increased specialization.

As a result, there has been a fracturing of the mortgage industry. Since the 1990s, it is common for a given mortgage to be originated by a mortgage broker contacted by telephone; serviced by a mortgage banker; insured by a mortgage insurance company; legally owned by a trust; and beneficially owned by an institutional investor.

“Subprime” lending became a very significant portion of this type of mortgage activity. Subprime lending is the extension of credit to those with lower incomes, less wealth and riskier credit profiles than traditional, “prime,” borrowers. Subprime lending extended credit to people who not have received it in the past. A negative consequence of the change in the residential mortgage industry away from dominance by thrifts and toward relatively unregulated specialty firms has resulted in a variety of abuses in the subprime market.

Subprime lenders typically offered two types of products to borrowers. First, they offer refinance and purchase mortgages to borrowers with poor credit histories. In many cases, borrowers refinance mortgages for an amount greater than the balance of the original mortgage, thereby taking “cash out” of their homes. Second, they offer “Alt-A” mortgages to borrowers with FICO scores similar to those found in the prime market. Alt-A mortgages are typically made to borrowers who cannot document all of the information in their loan application (“low doc” or “no-doc” loans, some of which are referred to as “liar loans” or “no income no asset loans”). Alt-A mortgages can be used either for purchases or refinances. Subprime loans have higher interest rates than prime loans, a fact that lenders ascribe to the subprime borrowers’ greater risk of default although this is not always the case as many prime borrowers had been steered into subprime mortgages.

Most subprime loans were originated by mortgage and consumer finance companies, with a smaller amount issued by banks and thrifts. And most of them are used for the refinancing of existing mortgages. The growth of subprime lending had been utterly explosive. The secondary market provides much of the liquidity and capacity for

this extraordinary growth for the subprime market. From making up a tiny portion of new mortgage originations in the early 1990s, subprime mortgages made up 40 percent of newly originated securitized mortgages in 2006. Beginning in 2006, mortgage default and delinquency rates began to rise. Nonetheless, subprime lenders kept lending. Lenders made loans on very easy terms, at least for initial teaser periods, to borrowers with poor credit, low income and low assets. By 2007, the subprime market began to look disastrous as a wave of foreclosures quickly built and swept across the nation. The subprime boom had gone bust, taking the rest of the credit markets with it.

The best that can be said for the subprime boom is that it allowed many people to access the equity in their homes who would not have otherwise been able to do so. This greater access to credit in the subprime market came at the cost of significantly higher fees and interest rates than a prime borrower would face. It also came at the cost of significantly higher fees and interest rates for minority borrowers as compared to white borrowers, and these higher costs were not efficiently related to the comparative credit risk of white and minority borrowers. In other words, the subprime market in the aggregate appeared to discriminate to some extent against communities of color. And it also came at the cost of enticing many borrowers to take out loans that were extraordinarily inappropriate for them, given the low likelihood that they would be able to repay them.

The subprime market is far less regulated and standardized than the prime market. As such, it presents an opportunity for those seeking to separate financially unsophisticated borrowers from the equity that they have built up in their homes. That is, it presents an opportunity to engage in predatory lending. Most predatory behavior takes

place between a mortgage broker or mortgage banker on the one hand and the borrower on the other. But such thinly funded entities could not exist without funding from secondary market investors.

Predatory lending is far more common in the “refinance” or “home equity” market than in the home purchase market because home equity borrowers have much more equity in their home than purchasers: the existing home equity gives predatory lenders a greater opportunity to pack a refinanced loan with excessive fees that might not be readily identifiable by the borrower.

While there is no generally accepted comprehensive definition of predatory lending, the U.S. General Accounting Office (GAO) has cobbled together a good working description: predatory lending is “an umbrella term that is generally used to describe cases in which a broker or originating lender takes unfair advantage of a borrower, often through deception, fraud, or manipulation, to make a loan that contains terms that are disadvantageous to the borrower.” Accordingly, the GAO has defined predatory lending to include the following abusive practices and loan terms: (1) excessive fees; (2) excessive interest rates; (3) single-premium credit insurance; (4) lending without regard to ability to repay (also known as equity-based lending, where a lender should know that a borrower is unlikely to be able to keep up with the monthly payments); (5) loan flipping (repeated, costly refinancing in a short period of time without any economic gain for the borrower); (6) fraud and deception; (7) prepayment penalties (fees or finance charges that become payable when consumers repay principal faster than scheduled); and (8) balloon payments (large payments of principal due at the end of a loan term).

Predatory practices are not typically present in the prime market. And not all subprime loans are predatory. But predatory practices were found throughout the subprime market, where low- and moderate-income borrowers are concentrated. They are used to prey on unsophisticated homeowners, typically those who are not integrated in the sphere of mainstream financial institutions such as banks and credit unions.

The holder in due course doctrine severely limits the remedies available to victims of predatory lending. This is because the holder in due course doctrine protects the ultimate funders of predatory practices, secondary market investors who purchase mortgage notes. The holder in due course doctrine immunizes them, as good faith purchasers, from liability for many types of fraud perpetrated by the originator of a loan. The net result of the application of the doctrine is that a borrower who has been the victim of a fraud not only cannot be compensated for the harm caused by the fraud, but even more, cannot assert the existence of the fraud as a defense against payment on the mortgage note nor as a defense in a foreclosure proceeding.

Consider the following example: a borrower receives a predatory home equity loan from a mortgage broker who then immediately sells the loan to an investor on the secondary market. If that investor can be shown to be a holder in due course (and the loan is not covered by the Home Ownership and Equity Protection Act of 1994 nor certain state statutes, as discussed below), then the borrower will not be able to hold anyone other than the originator responsible for many abusive practices. And because the originator is likely to be an undercapitalized mortgage broker or banker, the borrower is left with no real remedy at all.

## **2. Potential Remedies**

All that protects homeowners from abusive lenders and unreasonable terms are market forces and a skimpy patchwork of legislation and regulation. This regulatory environment has provided insufficient protection to homeowners, a fact made all too clear by the foreclosure crisis that commenced in 2007.

Most federal legislation, relying on the expectation that markets will self-correct with time, has done little more than require additional disclosures to be made by the lender for most subprime loans. Academic research has, however, challenged disclosure as an effective intervention for consumers operating in the complex and ever-changing world of mortgage lending.

Even The Home Ownership and Equity Protection Act of 1994, the most aggressive of the federal statutes, has offered little protection as subprime lenders can easily avoid its reach. And when states sought to increase consumer protections for their residents, the Bush Administration preempted many of them, leaving homeowners to rely upon federal disclosure requirements and a few other modest protections. Beginning in 2008, the Federal Government has signaled that it is more open to increasing consumer protection in the residential mortgage industry.

Opponents of increased consumer protection regulation argue that such regulation is paternalistic and that the market will correct itself. The power of such arguments waxes and wanes with the fortunes of the housing market; the housing bust has led to a severe decline in their influence.

### **3. Federal Legislation**

As noted above, federal law does not provide much in the way of protection for mortgage borrowers. The Truth in Lending Act requires certain material lender disclosures to a borrower in connection with the origination of a home loan. The Real Estate Settlement Procedures Act was enacted to protect consumers from unnecessarily high settlement charges and certain other abusive practices that had developed in the residential real estate industry. The Home Ownership and Equity Protection Act, an amendment to TILA, places direct limits on certain practices if made in connection with “high cost loans.” Unfortunately, none of these statutes present much of an impediment to abusive lenders.

Congress enacted the Truth in Lending Act (TILA) in 1968 as an effort to guarantee the accurate and meaningful disclosure of the costs of consumer credit and thereby enable consumers to make informed choices in the credit marketplace. Aimed at giving consumers a way to understand how much their loans would really cost, the act is primarily a disclosure statute compelling creditors who extend credit to consumers to disclose costs using a standardized format and terminology. TILA requires that before a loan can be originated the lender must provide the borrower with loan terms such as the Annual Percentage Rate (or APR, a standardized measurement of a lender’s rate of return based on the finance charges such as interest rate, points and fees relating to the loan). TILA also includes some other forms of consumer protection, most notably a three-day period to rescind or cancel all transactions in which a creditor receives a security interest in the borrower’s home, the so-called “cooling off” period. In a limited number of circumstances, TILA abrogates the holder in due course doctrine.

The Real Estate Settlement Procedures Act (RESPA) of 1974 prescribes how settlement services for residential real estate loan transactions are provided and compensated. RESPA also requires disclosure of settlement costs before the home loan agreement is signed, ideally enabling the borrower to make an informed decision as to whether the terms are acceptable and reasonable.

The Home Ownership and Equity Protection Act of 1994 (HOEPA) was enacted as an amendment to TILA and appears, at first glance, to provide more significant protection to homeowners than TILA and RESPA. HOEPA applies to closed-end loans (one-time, large financings, such as purchase money mortgages that have repayment plans fixed in both amount and number of payments) that exceed either a (i) high APR or (ii) points and fees trigger designated by the act. These loans are referred to as “HOEPA loans.” HOEPA only protects home equity or refinancing loans and does not cover purchase-money loans or loans to finance the construction of a home. Once triggered, HOEPA requires additional disclosures; limits certain contract terms; prohibits potentially abusive acts and practices; and prescribes tough civil remedies for violation of the act.

HOEPA’s APR trigger is determined by comparing the interest rate for the loan with the interest rates on treasury securities with comparable maturities. If the interest rate of a loan exceeds by more than eight percentage points comparable securities, then HOEPA is triggered. For example, if the comparable treasury securities are at 5% and the interest rate of a closed-end home equity loan entered is higher than 13%, then that loan would be a HOEPA loan, subject to the additional consumer protections of HOEPA.

Similarly, HOEPA regulates loans with excessive fees and points. If a lender

charges points and fees in excess of eight percentage points (with a minimum of \$400) of the total loan amount, then a closed-end home equity loan will be regulated by HOEPA. This means, for example, that a mortgage with a total loan amount of \$100,000 must have fees of \$8,000 or less to avoid being regulated by HOEPA.

HOEPA loans require greater disclosure and are subject to certain prohibitions designed to prevent some predatory lending practices targeted at vulnerable consumers. At least three business days before the loan closing, the borrower of a HOEPA loan should receive a statement disclosing the APR and the monthly payment, as well as warnings about the risks of entering into a high cost home equity loan. The disclosure may also contain additional information, depending on the type of loan.

HOEPA also restricts certain loan terms, such as prepayment penalties; interest rate increases upon default; balloon payments; negative amortization (resulting from scheduled payments that are insufficient to cover interest due on the loan); and prepaid payments (withheld from the loan proceeds at closing). HOEPA also limits a lender's ability to originate loans underwritten without regard to the borrower's ability to pay. The holder in due course doctrine is abrogated for HOEPA loans.

HOEPA did not successfully address abusive lending in the subprime sector because its coverage is limited to a small portion of residential mortgages and lenders can continue to originate extremely abusive loans without triggering HOEPA protections. Indeed, it has been estimated that as few as 1-5% of loans originated since HOEPA's enactment have fallen under its protection. HOEPA's protections can most easily be circumvented by either converting products from closed-end to open-end (revolving credit in which debtor and creditor expect multiple transactions and possible adjustments

of fees and charges) or by adjusting their rates and fees just enough to avoid HOEPA's reach (for example, fees of 7.99%). Many of the more aggressive state predatory lending statutes build on the framework of HOEPA but set lower triggers in order to regulate a greater proportion of mortgages.

A few other federal statutes have some impact, but even less than the three discussed above, on subprime and predatory lending. Some mortgage borrowers may have remedies pursuant to the Fair Housing Act of 1968 and/or the Equal Credit Opportunity Act of 1976. The Fair Housing Act prohibits intentional discrimination against protected classes in connection with the renting or selling of residential real estate. Similarly, the Equal Credit Opportunity Act prohibits discrimination against protected classes in credit transactions, including mortgage transactions. Because of the difficulty proving discrimination claims and the statutes' limited damage remedies, they have not had much of an impact.

#### 4. **Federal Regulatory Responses**

Federal regulators have limited jurisdiction over the subprime market. The Department of Housing and Urban Development (a Cabinet-level agency) enforces the Fair Housing Act and RESPA, but has not actively sought to enforce these laws against subprime lenders. The Federal Trade Commission (or FTC, an independent agency established in part to enforce consumer protection laws) brought a number of actions against subprime lenders alleging unfair and deceptive trade practices pursuant the Federal Trade Commission Act. While not insignificant, these cases did not lead to any fundamental changes in the subprime market. The FTC has also exercised its authority to abrogate the holder in due course doctrine for some home improvement loans which were

made or originated by home improvement contractors. While this has been a relatively small sector of the subprime market, it has also been one that is rife with abusive practices.

The Office of the Comptroller of Currency (a bureau of the Department of the Treasury that charters, regulates and supervises national banks); the Office of Thrift Supervision (a bureau of the Department of the Treasury that is the primary regulator of all federal and many state-chartered thrift institutions); the National Credit Union Association (the independent federal agency that charters and supervises federal credit unions); and the Federal Deposit Insurance Corporation (the independent agency that regulates and insures deposits of certain banks and thrifts) have all alerted the institutions that they regulate of the problems in the subprime sector. These agencies have not, however, had much impact on that sector because so many subprime mortgages were originated by lenders that were not supervised by any of those federal regulators.

Moreover, during the subprime boom of the 2000s, the Bush Administration and the regulators it appointed actively opposed increased consumer protection regulation of lenders and moved to preempt attempts by the states to implement such regulation as well. For instance, the OCC actively sought to preempt attempts by states to increase consumer protection regulation. In Watters v. Wachovia, 550 U.S. 1 (2007), the Supreme Court adopted the OCC's position that state banking officials could not regulate operating subsidiaries of national banks that would have otherwise been subject to such regulation.

Nor did the Federal Reserve Board, which Congress had charged with implementing HOEPA, make a significant dent in abusive lending in the subprime sector. Indeed, Alan Greenspan, the Chairman of the Board during the subprime boom, made it

clear that the Board would not pursue a meaningful consumer protection agenda during his tenure as it would be inconsistent with his broader deregulatory agenda. Under Chairman Benjamin Bernanke, the Board has issued final regulations (revising Regulation Z, which implements TILA) adopted pursuant to HOEPA that are intended to increase borrower protections from abusive lending practices. The new regulations limit various acts and practices in mortgage loans with APRs exceeding a new, lower trigger. The new interest rate trigger is anything higher than one and one half percentage points more than the average prime offer rate established by the Board for a first lien loan and three and a half percentage points for a subordinate lien loan. The new regulations, among other things, limit for loans meeting these lower triggers (i) lending without considering borrower's ability to pay and (ii) prepayment penalties. These new regulations will take effect on Oct. 1, 2009.

##### **5. State Legislative Responses**

Before the federal government made it clear that it would move to preempt them, many states enacted predatory lending legislation that sought to curb the worst excesses of the subprime sector. North Carolina enacted the first state predatory lending law on July 22, 1999, effective July 21, 2000. The North Carolina law is closely modeled on HOEPA, but with lower triggers and more stringent consumer protections.

Many other states enacted similar legislation over the following few years. They often set APR triggers in the 5%-6% range and lowered points and fees triggers. Some states also implemented various prohibitions for high cost loans such as no negative amortization; no balloon payments; no due on demand clauses; no prepaid payments; no default interest rates; no direct payments to home improvement contractors (a common

problem in the early 2000s in which borrowers were bypassed completely in the flow of funds from the lender to the contractor); and various additional mandatory disclosures relating to the terms of the loan and the mortgage origination process. State statutes also abrogated the holder in due course doctrine in certain circumstances for high cost loans.

The Watters v. Wachovia, 550 U.S. 1 (2007) decision took the steam out of the states' consumer protection movement as these predatory lending laws could be bypassed by operating subsidiaries of national banks that had been, pre-Watters, regulated by the states. Not only did the existing operating subsidiaries originate a sizable number of subprime loans, but now other state-regulated lenders would be incentivized to sell themselves to national banks in order to avoid the more stringent state regulation that was enacted throughout the early 2000s.

Like the FTC, various state Attorneys General brought some significant cases against abusive subprime lenders, some of which led to big settlements and major changes in the practices of the individual companies. But again like the FTC, these cases did not meaningfully resolve the pervasive abusive practices found throughout the subprime sector.

## **6. Conclusion**

The bust of the subprime market in the mid-2000s led to the global financial crisis of the late 2000s. This crisis has virtually ended subprime lending for the current credit cycle. Most subprime lenders have gone out of business or merged with other financial institutions. The remaining financial institutions have tightened their underwriting so that they no longer lend to those with subprime credit profiles. It is likely, however, that subprime lending will return in some form once the credit cycle turns. Other than the recent amendments to Regulation Z, the regulation of subprime and predatory lending has

not changed in any meaningful way since the peak of the subprime boom. For the cycle of abusive lending to be ameliorated once credit standards inevitably loosen, the federal government will need to further expand consumer protection regulation or allow the states to do so.

\* \* \*

*This entry is based in part on David Reiss, Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market, 33 FLORIDA STATE UNIVERSITY LAW REVIEW 985 (2006). Thanks to Mark John Costantino for his assistance in preparing this entry. For further reading, see*

- Baher Azmy, *Squaring the Predatory Lending Circle: A Case for States as Laboratories of Experimentation*, 57 FLORIDA LAW REVIEW 295 (2005)
- Kathleen Engel & Patricia McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEXAS LAW REVIEW 1255 (2002)
- US GAO, CONSUMER PROTECTION: FEDERAL AND STATE AGENCIES FACE CHALLENGES IN COMBATING PREDATORY LENDING (January 2004)
- Patricia McCoy & Elizabeth Renuart, *The Legal Infrastructure of Subprime and Nontraditional Mortgage Lending*, in BORROWING TO LIVE: CONSUMER AND MORTGAGE CREDIT REVISITED (Nicolas P. Retsinas & Eric S. Belsky eds., 2008)
- NATIONAL CONSUMER LAW CENTER, TRUTH IN LENDING, (6<sup>th</sup> Ed. 2007 & 2008 supp.)
- NATIONAL CONSUMER LAW CENTER, THE COST OF CREDIT: REGULATION, PREEMPTION AND INDUSTRY ABUSES (3d Ed. 2005 & 2008 supp.)
- Amanda E. Quester & Kathleen E. Keest, *Looking Ahead after Watters v. Wachovia Bank: Challenges for the Lower Courts, Congress, and the Comptroller of the Currency* 27 REVIEW OF BANKING AND FINANCIAL LAW 187 (2008)