

Remarks by Governor Edward M. Gramlich

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Subprime Lending, Predatory Lending

I am pleased to participate in today's conference. Activities such as this series of meetings that the Philadelphia Federal Reserve and the Reinvestment Fund have sponsored provide the opportunity to share information and learn more about the very complex issues that surround predatory lending. Among these concerns is the over-generalization that sometimes occurs when the terms "subprime lending" and "predatory lending" are equated. As the Federal Reserve has begun studying these mortgage market developments intensively, we have been made all the more aware of the vast difference between the two. It is important that the distinction between the generally beneficial subprime market and destructive predatory lending be kept clear.

One of the welcome developments in recent years is the expansion of the home mortgage market to all socioeconomic classes. Studies of data submitted under the Home Mortgage Disclosure Act (HMDA) have shown that lower-income and minority consumers, who have traditionally had difficulty in getting mortgage credit, have been granted loans at record levels. Specifically, conventional home purchase mortgage lending to low-income borrowers increased nearly 75 percent between 1993 and 1998, compared with a 52 percent rise for upper-income borrowers. Also during this time, conventional mortgages to African-Americans increased 95 percent over this period, and Hispanics 78 percent, compared with a 40 percent increase in all conventional borrowing.

Much of this increased lending can be attributed to the development of the subprime mortgage market. The Department of Housing and Urban Development (HUD) reports that the number of subprime home equity loans has gone from 80,000 in 1993 to 790,000 in 1998, an 880 percent increase. This rapid growth has given access to credit to consumers who have difficulty in meeting the underwriting criteria of "prime" lenders because of blemished credit histories or other aspects of their profile. This access gives people from all walks of life a shot at the American dream--owning a home and getting capital gains.

But along with this positive development have come increasing reports of abusive lending practices, targeted particularly at female, elderly, and minority borrowers. These practices, many of which can result in consumers losing much of their equity in their home, or even the home itself, are commonly referred to as "predatory lending." Predatory lending destroys people and communities and is a clear blight in this otherwise attractive picture.

The term "predatory lending", much like the terms "safety and soundness" or "unfair and deceptive practices," is far-reaching and covers a potentially broad range of behavior. As such, it does not lend itself to a concise or a comprehensive definition. But typically

predatory lending involves at least one, and perhaps all three, of the following elements:

- making unaffordable loans based on the assets of the borrower rather than on the borrower's ability to repay an obligation
- inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced ("loan flipping")
- engaging in fraud or deception to conceal the true nature of the loan obligation from an unsuspecting or unsophisticated borrower.

Some of these practices are clearly illegal and can be combatted with legal enforcement measures. But some are more subtle, involving misuse of practices that can improve credit market efficiency most of the time. For example, the freedom for loan rates to rise above former usury law ceilings is mostly desirable, in matching relatively risky borrowers with appropriate lenders. But sometimes the payments implicit in very high interest rates can spell financial ruin for borrowers. Most of the time balloon payments make it possible for young homeowners to buy their first house and match payments with their rising income stream. But sometimes balloon payments can ruin borrowers who do not have a rising income stream and are unduly influenced by the up-front money. Most of the time the ability to refinance mortgages permits borrowers to take advantage of lower mortgage rates, but sometimes easy refinancing means high loan fees and unnecessary credit costs. Often mortgage credit insurance is desirable, but sometimes the insurance is unnecessary, and sometimes borrowers pay hefty premiums up-front and often as their loans are flipped.

Generally advertising enhances information, but sometimes it is deceptive. Most of the time disclosure of mortgage terms is desirable, but sometimes key points are hidden in the fine print. Apart from outright fraud, predatory lending often entails the abuse of complex mortgage provisions that are generally desirable and advantageous to a borrower, but only when they are fully understood by the borrower.

The Congress has passed a number of statutes in this area. One important statute is the Home Ownership and Equity Protection Act (HOEPA) of 1994. Among other things, this act requires that the Board periodically conduct public hearings to gather information about trends within the home equity market. This summer we held a second round of HOEPA hearings in Charlotte, Boston, Chicago, and San Francisco. Earlier hearings had been held in 1997 and led to a joint report to the Congress from the Board and HUD. We are still sorting through the material from our 2000 hearings.

The basic approach of HOEPA is to shine a bright spotlight on high-cost mortgage loans. For these high-cost loans, certain practices--balloon payments in the first five years and prepayment penalties--are banned. In addition, for HOEPA-covered loans, creditors must provide a short disclosure to borrowers three days before the loan is closed, in addition to the normal three-day rescission period for other mortgage loans. HOEPA is not a usury law, since high-cost loans can still be made, but borrowers' protections are significantly greater than for other subprime mortgage loans.

The present legislative trigger for HOEPA is the Treasury rate on comparable maturity loans plus 10 percentage points. There is also a test for points and fees. The Board has the authority to alter the HOEPA threshold trigger rate to between 8 and 12 percentage points and to alter the points and fees included in that test. Data on this segment of the mortgage market are sparse. A study by the Office of Thrift Supervision (OTS) estimates that the

share of subprime mortgage loans falling under HOEPA is about 1 percent now and would rise to about 5 percent were we to use our full authority. But these percentages are based on rates alone, and many subprime lenders feel that HOEPA coverage is much broader than this when the points and the fee test is factored in (more on this below).

One week ago the Board solicited comments on proposed revisions to our Regulation C, which implements HMDA. HMDA requires depository and certain for-profit, nondepository institutions to collect, report, and disclose data about applications, originations, and purchases of home mortgage and home improvement loans. Data now reported include the type, purpose, and amount of the loan; the race or national origin, gender, and income of the loan applicant; and the location of the property. The purposes of HMDA include helping determine whether financial institutions are serving the housing needs of their communities and assisting in fair lending enforcement.

The Board's proposal incorporates suggestions received in response to an Advance Notice of Proposed Rulemaking published in 1998, as well as from discussions with a wide range of interested parties, including industry and consumer representatives and officials of financial regulatory and fair lending enforcement agencies.

In evaluating potential changes to the HMDA reporting requirements, the Board considered whether the changes would improve the quality and utility of the resulting data. The Board took into account changes in the home mortgage market, including growth in areas such as home equity lines of credit and subprime lending. The objective of the proposed changes is to enhance the public's and agencies' understanding of the home mortgage market generally, and the subprime market in particular. HMDA data are also critical in fair lending analysis.

At the same time, the Board has attempted to minimize the increase in the data collection costs and reporting burden by limiting proposed changes to those likely to have significant benefits. As we have done earlier, we will make available software to help reduce the reporting burden for financial institutions.

The three fundamental changes offered in the proposal would

- increase the number of nondepository lenders required to submit data
- clarify and expand the types of reportable transactions
- specify new loan elements to be included in the data.

First, with respect to the coverage of nondepository lenders, the Board's proposed changes would alter definitions to require all nondepository lenders whose annual home purchase and refinancing activity comprises at least 10 percent of the dollar value of all of their loan originations (mortgage and nonmortgage related), or \$50 million, to report HMDA data. The new element is the \$50 million reporting floor, which seems necessary in any reasonable test of determining whether a lender is "engaged in the business of mortgage lending" (a direct quote from the statutory language).

Second, the expansion of the types of transactions covered is intended to improve the integrity of the data by establishing consistency in reporting requirements. Right now, loan data on refinancings and home improvement loans are unclear, and quite likely incomplete, because the regulation provides lenders a great deal of flexibility in determining which loans to report. For example, lenders may avoid reporting closed-end home improvement loans by

not classifying them as such in their records. Lenders also may choose not to report open-end home equity lines of credit, even if used for home improvement purposes. The proposal would tighten up these definitions so that the resulting data would be more complete and more consistent from one lender to the next. This change too seems certainly consistent with the spirit of HMDA.

Third, the proposal specifies that three new items be reported from a consumer loan or application: the annual percentage rate (APR), whether the loan is subject to HOEPA, and whether the loan involves a manufactured home. Having APR and HOEPA information will assist in the identification of subprime loans, enabling better analysis of this market. Among other things, we will be able to ascertain with much more precision the extent of present HOEPA coverage and the way that coverage might change were the Board to use its HOEPA authority.

The collection of data on mobile or manufactured home loans will provide for an improved understanding of this type of lending, which employs different underwriting criteria from those used for loans secured by conventional homes. Because manufactured home loans have much higher denial rates than other mortgage loans, such data would also permit us to better understand denial patterns.

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Other steps may need to be taken, and may be taken, to deal with predatory lending. But we should be able to agree that more information is an important prerequisite to sensible policies in this area. At this point we have plenty of anecdotes about predatory lending but not much hard information. Increased HMDA data collection is the first step in gaining broader understanding of the business practices of subprime lenders and in helping us distinguish appropriate from inappropriate lending practices.

Beyond this, we should all recognize that the best defense against predatory lending is a thorough knowledge on the part of consumers of their credit options and resources. Educated borrowers who understand their rights under lending contracts and know how to exercise those rights can thwart predatory lenders. As the knowledge base of consumers grows, the market for credit-at-any-cost diminishes. Unfortunately, as is usually the case, the best solutions are often the most difficult to implement. A massive educational campaign is needed to bring about this expanded consumer knowledge.

But the Federal Reserve will continue to do its part through its consumer and industry education efforts. Both the Board and our twelve Reserve Banks will continue to promote our many programs designed to improve consumer financial education and literacy. We are very interested in your perspective on ways to effect change through education as you discuss in this afternoon's panel the promise and success of many of these programs. Again, thank you for this opportunity to be a part of this valuable information exchange.

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