COMMUNITY REINVESTMENT
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Who Has the Authority to Regulate Predatory Lending?

Reports of fraudulent lending practices have proliferated in recent years, along with testimonies of its destructive effects on many low- and moderate-income neighborhoods. Although predatory lending is a thorny issue—complicated by the absence of a consistent, shared definition—it is generally agreed that the term refers to abusive or deceptive mortgage lending practices, which may result in homeowners losing their homes in foreclosure.[1]

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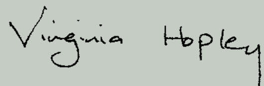
EDITOR'S NOTE

This issue of *CR Forum* investigates who has the authority to address predatory lending in the Fourth Federal Reserve District. Regulatory agencies, including the Federal Reserve, are concerned about abusive lending practices that may be corroding some of the positive impacts of CRA-related lending in low- and moderate-income neighborhoods over the last decade.

Many financial institutions, government, private, and nonprofit players that cross local, state, and federal jurisdictions are dedicated to ameliorating the problem—a testament to its severity and complexity, its cost to society, and the extent to which it has captured the attention of community economic development practitioners. But to many, the regulatory landscape is becoming more ambiguous as new laws are enacted and others are preempted. A better understanding of each Fourth District state's current legal and regulatory framework may clarify how to address the problem without adversely impacting legitmate subprime lending.

In My Opinion, penned by Kathleen Engel from Cleveland State University's Cleveland-Marshall School of Law, discusses how financial institutions can help solve the problem, and 4th District Profile highlights grassroots efforts to combat predatory lending across the Fourth District. Compliance Corner details recent amendments to the federal Home Ownership Equity and Protection Act that became effective this fall.

A number of individuals have helped our Community Affairs staff to understand the scope and impact of predatory lending in the Fourth District, and we thank them for their expertise and insight. We welcome your comments on this edition of *CR Forum*; please e-mail them to *virginia.l.hopley@clev.frb.org*



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Although it is difficult to measure the size or impact of the problem without a precise definition, according to one estimate, U.S. borrowers lose $9.1 billion annually to predatory lending.[2] It is a market failure that cannot be ignored.

What is driving the surge in unethical lending practices? Many attribute it to the growth of subprime lending, which extends legitimate credit to borrowers with less-than-perfect credit histories. The subprime lending market—which ballooned from virtually nothing in 1994 to $500 billion in 1999—has, in fact, provided greater access to credit to those who otherwise might not qualify.[3] But questionable lenders are also most likely to flourish in this market: It is subject to fewer regulatory controls, less information is available to consumers, and most borrowers use the collateral in their homes to consolidate debt, make home improvements, or satisfy other credit needs.

Subprime lending tends to correlate with low- and moderate-income individuals who cannot qualify for conventional loans and may not understand the complex documentation involved in mortgage lending. When credit is not available for home improvements, home equity can be used to finance everything—often, much more than the owner intends or can repay. Chances are, this is exactly the reason predatory lenders target these individuals.

Unscrupulous loans can be found in the prime mortgage market, though the greater competition among lenders and greater standardization in loan terms—both of which are lacking in predatory loan schemes—make it unlikely. Furthermore, most prime lenders are commercial banks, savings institutions, and credit unions, all of which are tightly regulated at the federal and state levels.[4] Although unregulated nonbank lenders, such as mortgage brokers and lenders, finance companies, and home improvement contractors, may originate loans once licensed, they are not subject to the same scrutiny, and there may be pressure to complete as many transactions as possible, with little concern for their appropriateness. Because these loans are bundled, securitized, and sold on the secondary market, the loan originators can relinquish their responsibility for the integrity of the loans.

As Federal Reserve Board Governor Edward Gramlich has observed, "attempts to deal with predatory lending are hampered by two broad phenomena:

- Predatory lending often involves the abuse of credit promises that can be of value to many borrowers.
- Predatory lending seems to occur most commonly in the unregulated sector of the loan market by lending institutions that are not forced to undergo periodic compliance exams."[5]

The growth in subprime lending is, of course, not the only cause behind the rise of deceptive lending practices. Our investigation here seeks a better understanding of who has the authority to address such practices in the Fourth Federal Reserve District, and where consumers may turn when saddled with a bad loan.

How Are the States Addressing Fraudulent Lending Practices?

Over the last decade, the states of the Fourth Federal Reserve District—Ohio, Kentucky, Pennsylvania, and West Virginia—have acknowledged the rise of questionable lending practices and their potentially ruinous consequences on residents and neighborhoods.

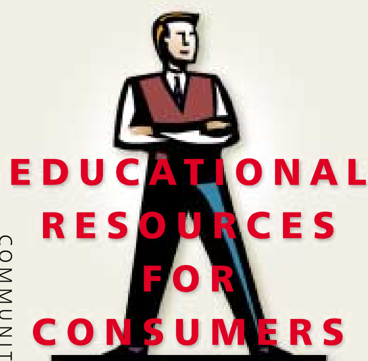
Across the Fourth District, a host of players are actively pursuing remedies to protect consumers and drive out the bad actors. At the state level, some agencies have authority and enforcement powers to address the problem from various angles. Often, a state's ability to protect citizens from unethical lenders rests in the attorney general's office and the state banking department. Typically, the attorney general's office protects consumers from dishonest or fraudulent business transactions, while the banking department regulates financial institutions and mortgage credit providers. In cases where discrimination or targeting can be proven, state human or civil rights commissions also may be called to task.

Several municipalities have also proposed or enacted local ordinances against predatory lending practices. Grassroots and nonprofit organizations are aggressively lobbying to protect their constituents and offering credit counseling and financial literacy education (see 4th District Profile, page 12). Legal aid societies and attorneys are representing victims and co-counseling with private attorneys to provide adequate representation and legal expertise. And law enforcement agencies are realizing they can play a proactive role in preventing such criminal activity. There are also many federal-level laws and regulatory agencies that have authority to curb fraudulent lending.

Ohio

Ohio's Division of Financial Institutions, housed in the state's Department of Commerce, regulates state-chartered banks and oversees consumer finance licensees, including mortgage brokers.[6] State-chartered banks must comply with state and federal statutes and regulations governing their operations and those of their subsidiaries.

Two laws took effect in Ohio in 2002, giving the state's Department of Commerce additional authority to halt predatory lending. In May, the Ohio General Assembly passed Senate Bill 76—an amendment to the Mortgage Broker Law—to strengthen the regulation of the mortgage broker industry. The bill's provisions require loan officers working for mortgage brokers to be licensed by the Department's Division of Financial Institutions and subject to criminal background checks, and loan officers must pass a knowledge test within 90 days of becoming licensed.[7]



Ohio

Department of Commerce
Borrow Smart Campaign
"Predatory Lending: Tricks of the Trade and How to Recognize Them"
"Don't Become a Victim: A Guide to Predatory Lending"

Attorney General's Office
"Tips to Avoid Predatory Practices"

Pennsylvania

Office of the Attorney General
"Loan Smarts: What Every Borrower Should Know"

West Virginia

Office of the Attorney General
"Not in My House! Help 'Judge' McGraw Stop Predatory Lenders from Stealing the American Dream"

Division of Banking
"Know Your Mortgage"

Kentucky

Office of the Attorney General
"Home Repairs and Improvement"

Department of Financial Institutions
"Don't Fall Prey to Predatory Lending"

If licensing requirement laws have been violated, the office may initiate enforcement action on behalf of the consumer and refer criminal cases to the police and county prosecutors. In cases in which the county prosecutor chooses not to pursue the defendant, the Department of Commerce may refer the case to the attorney general for prosecution.

A second statute, House Bill 386, resembles HOEPA and preempts local ordinances.[8] The legislation created within the Department of Commerce a new Office of Consumer Affairs, which serves as an ombudsman for consumers who believe they have been victimized by abusive lenders.[9] Consumers may file a complaint by calling a centralized telephone number and mailing a form. The office will examine each complaint and refer borrowers to credit counseling organizations that can assist them. In cases where it has regulatory authority, the Office of Consumer Affairs tries to act as a mediator between the consumer and lender, with the intent of avoiding legal action unless necessary. The office may refer matters to the superintendent of the Department of Financial Institutions, which has the discretion to investigate and impose fines.

H.B. 386 contains no provision for an individual's private cause of action. Under the current statute, private citizens cannot ask a court to find a broker (or other lender) in violation of the law—only the Department of Commerce can pursue this avenue of action. Some consider such a provision critical for consumer protection, and advocates hope the Predatory Lending Study Committee (another outcome of the bill) will recommend such action to the legislature in 2003.

Although Ohio's consumer protection laws are designed to prohibit deceptive, unfair, and unconscionable sales practices, the Ohio Attorney General's Office plays a limited role in mitigating allegations of predatory lending.[10] The state's Consumer Sales Practices Act regulates unfair and deceptive acts and practices, but it exempts transactions made by financial institutions as a "dealer of intangibles," thus excluding most mortgage lending.[11] Ohio is one of the few states where financial institutions are exempt from this law.

The attorney general may get involved with cases of abusive lending that are referred to that office for prosecution from the Department of Commerce's Office of Consumer Affairs. The same is true when outright fraud and forgery are alleged, although a pattern of such practice must first be established, which is cumbersome and time consuming. In cases where individuals can demonstrate they have been the target of discrimination, the attorney general may file a charge with the Ohio Civil Rights Commission for further investigation.

Kentucky

Homeownership rates in Kentucky are higher than the national average, and many residents own homes that have been in their family for generations—often, the property is the family's only asset.[12] Coupled with the fact that many borrowers are underemployed, undereducated, and have low incomes, unscrupulous lenders have plenty of fodder for equity stripping and asset-based lending schemes. Although predatory lending is most often considered a problem in urban and high-density areas, rural and suburban areas with a prevalence of homeownership are just as prone to such activity.

In Kentucky, fraudulent lending is not yet well policed, and few laws regulate the mortgage industry. The Department of Financial Institutions is responsible for chartering, licensing, and registering

financial institutions, securities firms, and professionals operating in the state, including mortgage loan companies and brokers.[13] Kentucky has tried to pass a licensure law that would register and regulate the state's mortgage brokers, but legislative attempts to do so have been unsuccessful. It is anticipated that licensure efforts will continue in 2003 as problematic loans increase in severity.

Potentially predatory lenders are identified primarily by state regulators during exams that take place every 18 months. If abusive practices are found, examinations of that lender are scheduled more frequently. When egregious practices are identified, the Department of Financial Institutions may file an administrative complaint, to which the licensee has 20 days to respond with a request for a hearing. If there is no response, fines may be imposed and licenses revoked. At that point, licensees' appeals are referred to the circuit court system.

The Department of Financial Institutions has recently begun working closely with two agencies that have some jurisdiction over dishonest lenders: the Real Estate Appraisers Board and the FBI. Unethical mortgage brokers may work in collusion with appraisers to inflate property values and/or alter loan documents. When appraisers are identified as being involved with a deceptive lending scheme, their license may be revoked. The FBI has become involved with predatory lending efforts in parts of Kentucky, especially with loans that involve falsified information, fraud, and conspiracy. When cases involve criminal activity and felony indictments, they are often too big for the state to address single-handedly, and federal enforcement becomes necessary.

Kentucky's attorney general may bring cases against questionable lending practices when fraud is involved and when a pattern of behavior can be demonstrated. But because it has no direct regulatory authority over many of the businesses and contractors involved in originating unconscionable loans, the attorney general frequently attempts to mediate rather than pursue legal action. These cases are handled under the Consumer Protection Division, which enforces the Consumer Protection Act and holds businesses accountable for unfair and deceptive acts and practices. However, without some evidence of a pattern of misconduct, the attorney general's office cannot issue subpoenas to investigate brokers.

Two initiatives are under way to address predatory lending in Kentucky. The Department of Financial Institutions began an aggressive financial literacy campaign targeting high schools, and the state enacted a "no-call law" in July 2002 to limit the number of telemarketing phone calls residents receive at home, unless there is an existing business relationship (more than 700,000 have signed up to date). This law indirectly deters predatory lenders, many of whom use aggressive telemarketing to target borrowers.

Pennsylvania

Pennsylvania's Mortgage Bankers and Brokers and Consumer Equity Protection Act—also known as the Predatory Lending Law—closely resembles HOEPA and preempts local municipalities from regulating lending.[14] The law requires lenders to assess consumers' ability to repay loans before closing, thus averting the consequences of asset-based lending. Mortgage brokers are subject to additional disclosures and specific monetary civil penalties for violating the law, in addition to suspension of licenses and other measures designed to discourage predatory lending.

Pennsylvania's authority to regulate fraudulent lenders resides in the Department of Banking and the Office of the Attorney General. The Department of Banking regulates state-chartered institutions and many nondepository financial institutions and licensees, including first-mortgage bankers and brokers, secondary-mortgage lenders, and brokers and

brokers' agents.[14] Consumer complaints are addressed by the department's Consumer Services Division, which uses information obtained from the borrower to resolve complaints and to determine legal or regulatory violations. Violations may result in the revocation of licenses and/or fines. The Division also attempts to mediate between the consumer and the institution/licensee, and prospective borrowers are referred to consumer advice organizations through the Pennsylvania Housing Finance Agency.

The attorney general's Public Protection Division works to uphold the rights of consumers in business and service transactions and to protect citizens' civil rights.[16] Within this division, the Bureau of Consumer Protection enforces the Unfair Trade Practices and Consumer Protection Law and "investigate[s] fraud and deception in the sale, servicing and furnishing of goods and products, and strives to eliminate such illegal actions." It may take formal legal action against persons and organizations engaging in unfair and deceptive conduct in the sale of goods or services within the state. Because of the volume of complaints filed each year, the bureau's statewide mediation program seeks restitution, refund, or other relief.

In cases of alleged discrimination, the Civil Rights Enforcement Section of the Attorney General's Office may investigate complaints, possibly resulting in formal legal action or referral to the Pennsylvania Human Relations Commission (or other government agency), which has some authority to enforce civil rights laws. Like Kentucky, Pennsylvania's attorney general has launched a statewide "do not call" program that allows consumers to reduce unsolicited and unwanted telemarketing calls.

West Virginia

As in Kentucky, homeownership rates in West Virginia are high, with the added demographic of a large elderly population. The elderly often are targeted by predatory lenders because they have high medical bills, need home repairs, and have fixed incomes. Home equity is one way for elderly residents to pay for such expenses.

Although West Virginia is a small state, government officials are keenly aware of the increasing scale of unethical lending in the state, and, since 2000, the

What Characterizes a Predatory Loan?

Organizations, trade associations, and government agencies have varying definitions and perspectives on what constitutes predatory lending, and they do not necessarily agree with one another. Here we cite a sample of organizations and the lending practices they consider predatory.

MORTGAGE BANKERS ASSOCIATION OF AMERICA

The **Mortgage Bankers Association of America** believes that significant steps can be taken to combat abusive lending practices. Prohibited practices should include:

- Steering borrowers to high-rate loans and lenders
- Intentionally structuring high-cost loans with payments the borrower cannot afford
- Falsifying loan documents
- Making loans to mentally incapacitated home owners
- Forging signatures on loan documents
- Changing the loan terms at closing
- Requiring credit insurance
- Falsely identifying loans as lines of credit or open-end mortgages
- Increasing interest charges when loan payments are late
- Charging excessive prepayment penalties
- Failing to report good payment on borrowers' credit reports
- Failing to provide accurate loan balance and payoff amount.[1]

FANNIE MAE FOUNDATION

According to a recent report by the **Fannie Mae Foundation**, "Generally speaking, three features—alone or in combination—define predatory lending practices. Those features include targeted marketing to households on the basis of their race, ethnicity, age or gender or other personal characteristics unrelated to creditworthiness; unreasonable and unjustifiable loan terms; and outright fraudulent behavior. . ."[2]

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT AND THE DEPARTMENT OF THE TREASURY

A joint report issued by the **U.S. Department of Housing and Urban Development and the Department of the Treasury** identifies four categories of predatory abuses:

- Loan flipping
- Excessive fees and packing
- Lending without regard to the borrower's ability to repay
- Outright fraud.[3]

legislature has enacted legislation to outlaw dishonest lenders. For example, all mortgage lenders and brokers doing business in West Virginia must be licensed and registered with the state (unless otherwise exempt). The initial licensing of loan originators took effect in July 2002 and includes seven hours of continuing education every year, as well as regular examinations.

Currently, mortgage brokers and lenders are supervised by the West Virginia Division of Banking.[17] According to state statute, a violation of federal law is tantamount to a violation of state law; exams for mortgage companies thus incorporate federal and state regulations.

The Division of Banking works directly with consumers, maintaining a consumer complaint process to mediate between borrowers and companies under its regulatory authority. If mediation is successful, consumers may see any number of remedies, including refunds of overcharges, account adjustments, or a payment plan. If there is no response from the company, the division may open an investigation, and licenses may be revoked by the state, among other injunctions.

West Virginia's Office of the Attorney General, too, is concerned about unscrupulous lending practices in the state. Its Consumer Protection Division enforces the Consumer Credit and Protection Act, which guards residents against fraud.[18] The attorney general may pursue cases on behalf of consumers, and it investigates companies suspected of engaging in deceptive tactics to the extent its resources permit.

Like Kentucky, West Virginia has no local ordinances, and there is no preemptive language to prevent such ordinances from being proposed and passed. The AARP, various housing counseling agencies, and Mountain State Justice (a legal services organization) are dedicated to remediating predatory lending, but also face resource constraints. Private attorneys, too, may represent clients with allegations of fraudulent loans—this is probably where most litigation is occurring, though it is costly and unaffordable to those most likely to be targeted by unconscionable lenders. The complexities of the cases do not lend themselves to simplified legal procedures.

FREDDIE MAC

Freddie Mac's *Don't Borrow Trouble Campaign* cites the following abusive lending practices:

- Repeatedly refinancing a loan within a short period of time and charging high points and fees with each refinance
- "Packing" a loan with single-premium credit insurance products, such as credit life insurance, and not adequately disclosing the inclusion, cost, or additional fees
- Charging excessive rates and fees to a borrower who qualifies for lower rates and/or fees offered by the lender.[4]

AMERICAN BANKERS ASSOCIATION

The **American Bankers Association** does not "condone any practices that deceive, defraud or otherwise take unfair advantage of consumers." It follows the distinctions that regulators make between subprime and predatory loans:

- Making unaffordable loans based on the borrower's assets
- Inducing a borrower to repeatedly refinance a loan
- Engaging in fraud or deception.[5]

ASSOCIATION OF COMMUNITY ORGANIZATIONS FOR REFORM NOW

The **Association of Community Organizations for Reform Now** (ACORN) identifies the following predatory lending practices:

- Excessive fees
- Higher interest rates than are warranted by the borrower's credit
- Disregard for the borrower's ability to pay (known as "asset-based lending")
- Prepayment penalties
- Greater than 100 percent loan-to-value ratio
- Home-improvement scams
- Single-premium credit insurance financed into the home loan
- Balloon payments
- Negative amortization
- Loan flipping—successive, repeated refinancing of loan that incurs high-cost fees
- Property flipping
- Aggressive and deceptive marketing
- Yield-spread premiums—compensation paid to mortgage brokers for coercing borrowers to accept higher interest rates
- Falsified loan applications, including inflated incomes and forgeries
- Inflated appraisals
- Mandatory arbitration clauses.[6]

NOTES

1. See *www.mbaa.org/resources/predlend/*.
2. James H. Carr and Lopa Kolluri, "Predatory Lending: An Overview," Fannie Mae Foundation, 2001.
3. HUD/Treasury Task Force, "Curbing Predatory Home Mortgage Lending," June 2000.
4. See *www.dontborrowtrouble.com/dontborrow/anti_predatory.html*.
5. See *www.aba.com/industry+issues/predatorylendingmenu.htm*.
6. Excerpted from *www.acorn.org/acorn10/predatorylending/practices.htm*.

WHERE CONSUMERS CAN TURN FOR HELP

Ohio

Department of Commerce, Office of Consumer Affairs
866/278-0003
www.com.state.oh.us/ODOC/dfi/consumeraffairs.htm

Attorney General's Office Consumer Protection
800/282-0515
www.ag.state.oh.us

Pennsylvania

Department of Banking
800/PA BANKS
(for consumer complaints and inquiries)
www.banking.state.pa.us

Office of the Attorney General Consumer Protection Hotline
800/441-2555
www.attorneygeneral.gov

West Virginia

Division of Banking
800/642-9056
www.wvdob.org/general/index.html

Office of the Attorney General Consumer Hotline
800/368-8808
www.state.wv.us/wvag

Kentucky

Department of Financial Institutions
800/223-2579
www.dfi.state.ky.us

Office of the Attorney General Consumer Protection Division
888/432-9257
www.law.state.ky.us

As in the other Fourth District states and across the country, most consumers do not turn anywhere for help and go unrepresented when faced with a questionable mortgage lender. Many victims of abusive lending terms end up in bankruptcy court or in foreclosure, only to damage their credit and lose their homes.

What More Can Be Done?

This examination of the legal and regulatory structure in Fourth District states illustrates that fraudulent lending practices are not being addressed or enforced systematically at the state or federal level, allowing some unregulated (and regulated) players to operate unchecked. In fact, much of what is considered "predatory lending" is actually permitted by law unless there is evidence of fraud or nondisclosure.

The very nature of predatory lending makes it difficult—if not impossible—to regulate comprehensively: Many individuals and organizations—often linked by schemes—may be involved in booking unethical loans. Interjurisdictional and interagency cooperation and responsibility have become convoluted, legal authority is scattered, and desperate consumers don't know where to turn; it is then too late to save their homes.

Dishonest lenders often can find more loopholes through which to escape victims' legal recourse. This is a result of the current regulatory framework: Many agencies have some authority over certain players and practices involved in deceptive lending practices; in turn, the lending and financial services industries are changing so quickly that laws cannot be enacted in time to adequately regulate the number of individuals and players involved. Often, it is within these gaps that criminal and unconscionable actions take place.

Although predatory lending is a fairly recent phenomenon and our understanding of it is incomplete, a range of solutions to mitigate its severity have been offered by government officials, community-based organizations, and trade associations that we interviewed. Some of these include:

- While only a few "bad apples" account for the bulk of abusive loans, all of the individuals, institutions, and organizations involved in the mortgage lending process—lenders, mortgage brokers, real estate appraisers, loan originators, holders of loans, banks, and nondepository institutions—need to be examined and regulated for the suitability and soundness of their home equity and mortgage loans.
- Mortgage lenders and brokers must assume a legal responsibility to refrain from making unsuitable loans (that is, asset-based lending).
- Holders and assignees of mortgages must be held liable for fraud, deception, and illegal conduct in the origination of loans; lenders must recognize and take responsibility for the conduct of the brokers they deal with. Secondary-market participants must guard against purchasing loans containing questionable business practices.
- Mandatory predispute arbitration clauses that are included in loan documentation, which prevent enforcement of the law, should be prohibited.
- More training should be made available to attorneys (private, pro bono, and legal aid societies) to tackle fraudulent lending cases.
- Financial institutions should consider creative refinancing for predatory lending victims, which could prove to be profitable for the institution.
- All states should create a statewide clearinghouse—such as the Ohio Department of Commerce's Office of Consumer Affairs—to streamline the treatment

of alleged mortgage or home equity fraud cases. This office would diagnose the problem and direct victims to mediation or legal recourse. For consumers considering mortgages or home equity loans, this office could recommend certified housing counselors and educate borrowers about the documentation they will be signing and their obligations. This office could also support research, advocacy, and policy to better regulate unethical lending practices.

- Congress and the states need strong, uniform laws to redress predatory lending and to prevent such lenders from slipping through the cracks of the myriad federal, state, and local laws. With stricter laws, municipalities will not need to enact their own legislation. This would avoid the current complex patchwork of federal, state, and local laws, which are difficult for multistate lending agencies (and attorneys) to navigate. If penalties are stiff, deceptive lenders and brokers will be pushed out—or have enough disincentives to stay out—of the legitimate subprime market.

- Consumer education is critical to prevent unscrupulous lending. As Governor Gramlich states, "Educated borrowers who understand their rights under lending contracts and who know how to exercise those rights put up the best defense against predatory lenders."[19] Educational campaigns have been designed for home buyers and financial institutions by Freddie Mac, The Neighborhood Reinvestment Corporation, and the American Bankers Association, to name a few.

Solutions cannot be made hastily, as legitimate lenders may pull back mortgage credit if regulations become too cumbersome. A balance must be struck between assuring access to mortgage credit and covering the cost of that credit risk to lenders. Expectations of state and federal regulatory powers should be realistic, balancing the resources that legislatures and agencies can dedicate to deter abusive lending practices among the many other demands they face in a tight budgetary climate.

It is in everyone's best interest that unethical and dishonest lending does not continue unabated, and the Fourth District states are increasing their awareness of the problem and its harmful outcomes. An effective network must participate in its prevention, regulation, and correction. Initiatives to develop education, advocacy, and enforcement are all steps in the right direction.

NOTES

1. Here we discuss predatory lending as it pertains to mortgage credit only; other areas of concern include check-cashing establishments and payday lenders, among others.
2. See Eric Stein, *Quantifying the Economic Cost of Predatory Lending*, Coalition for Responsible Lending, July 25, 2001.
3. See Anna Beth Ferguson, "Predatory Lending: Practices, Remedies and Lack of Adequate Protection for Ohio Consumers," *Cleveland State Law Review*, 2000.
4. See Center for Community Change, "Working to Curb Predatory Mortgage Lending," available at *www.communitychange.org/NRP/predlending.asp.* An exception to this generalization may be unregulated affiliates of these institutions.
5. Testimony of Governor Edward M. Gramlich, May 24, 2000, *www.federalreserve.gov/boarddocs/testimony/2000/20000524.htm*.
6. Please refer to *www.com.state.oh.us/odoc/dfi/default.htm* for more information.
7. See Ohio Department of Commerce, "Regulation of Ohio's Mortgage Broker Industry Strengthened," press release, May 1, 2002.
8. Two major local ordinances have passed in Ohio. In Cleveland, an ordinance prohibits lenders from making predatory loans, prohibits certain loan terms for high-cost loans, and requires new disclosures for home improvement loans. Dayton also passed a predatory lending ordinance restricting the origination of "high-cost loans," with an exemption for banking and financial organizations with satisfactory or higher ratings on Federal Reserve Board examinations. The Dayton ordinance also prohibits specific unfair trade practices. The City of Dayton sued the State of Ohio, claiming the preemption provisions in H.B. 386 are unconstitutional.
9. See *www.com.state.oh.us/odoc/dfi/consumeraffairs.htm.*
10. See *www.ag.state.oh.us/agpubs/conslaws.htm* for more information.
11. However, home improvement loans and contractors may be covered by the Consumer Sales Protection Act, depending on whether they offer financing. For example, they may offer a retail installment sale, which is not considered a loan, and thus subject to the Act's protections.
12. According to the Census Bureau, in 2000, Ohio's homeownership rate was 69.1 percent, Kentucky's, 70.8 percent, West Virginia's 75.2 percent, and Pennsylvania's, 71.3 percent. The national average was 66.2 percent.
13. See *www.dfi.state.ky.us* for more information.
14. Philadelphia passed an ordinance that was preempted by this statute. The Philadelphia City Council legislation was similar to Cleveland's legislation.
15. See *www.banking.state.pa.us/mission.htm* for more information.
16. See *www.attorneygeneral.gov/ppd/bcp/index.cfm.*
17. See *www.wvdob.org/general/index.html* for more information.
18. See *www.state.wv.us/wvag* for more information.
19. Remarks by Governor Edward M. Gramlich, January 18, 2002, *www.federalreserve.gov/boarddocs/speeches/2002/20020118/default.htm*.

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Predatory Lending: Legitimate Lenders Can Be a Part of the Solution

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Predatory lenders target people who are disconnected from credit markets and strike when they are most vulnerable. For example, abusive lenders identify areas where there is limited legitimate mortgage lending and approach homeowners who have been cited for housing code violations. These naive borrowers, who believe they are ineligible for credit and are desperate to repair their homes, perceive the predatory lenders as their rescuers.

Predatory lenders, in turn, take advantage of the borrowers' lack of sophistication by suggesting that their opportunity to borrow is fleeting and that they must commit quickly. The lenders then write loans that contain padded fees, unnecessary insurance, loan terms that are not based on the risk the borrowers present, and many other exploitative provisions.

Legitimate lenders, by failing to market their products to the most inexperienced borrowers, enable predatory

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lenders to dominate the market for unsophisticated borrowers. If legitimate lenders reached out to these borrowers, they could create competition both in terms of attracting borrowers and loan terms. This competition would have the desirable effect of driving out predatory lenders.

> **"Legitimate lenders, by failing to market their products to the most inexperienced borrowers, enable predatory lenders to dominate the market for unsophisticated borrowers."**

Some lenders may argue that these borrowers are eligible only for subprime loans and that they are reluctant to make such loans because of safety and soundness issues, and lack of experience in collecting on subprime loans. These concerns are overstated: Fannie Mae has estimated that up to 50 percent of all borrowers with subprime loans actually qualify for prime loans. Thus, if lenders limited their lending activity to prime-eligible borrowers, they would not generate any safety and soundness red flags, nor would they need to develop expertise in subprime loan collections. It is conceivable that their mere presence in the market would help to stimulate other legitimate lenders to come in to meet the needs of higher-risk borrowers who otherwise would obtain predatory loans.

A more difficult issue is the cost of marketing loans to prime-eligible borrowers who are isolated from the legitimate credit system. Lenders' current marketing strategies rely on the Internet, in-office advertising, and mass media. To the extent that borrowers are convinced they are ineligible for credit, this type of marketing is ineffective.

Lenders need to develop innovative marketing strategies to reach these customers. For example, lenders could set up small storefront offices in neighborhoods and grocery stores. They could work with local churches and community centers to develop educational information. They could ask municipalities to create lists of certified lenders that do not engage in predatory lending. The municipalities could then provide the names of these certified lenders to homeowners with housing code violations.

These strategies would require significant expenditures of money; however, it is possible—and maybe even probable—that the return would be worth the investment. Lenders could increase their prime lending and, in the process, generate more clients for banking services such as checking accounts and auto loans. They could refer higher-risk borrowers to their affiliates that make legitimate subprime loans.

Predatory lending is a community issue, and legitimate lenders have an interest in sustaining communities. They can and should be part of the solution, and it is time for them to act.

4th district prof

Local Programs Work on

Many local and grassroots efforts are under way in the Fourth District to guard residents against predatory lenders. Here, we highlight just a few of these innovative programs.

Serving the Underserved

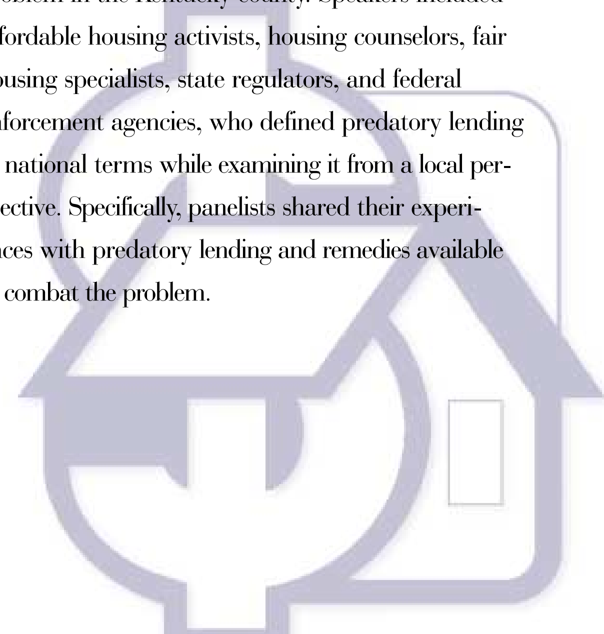
Based in Wheeling, West Virginia, the Community Homebuyer Investment Program (CHIP) promotes home ownership through outreach and education geared toward low- and moderate-income individuals and families in the northern panhandle of West Virginia and eastern Ohio.

Recognizing that its clients have been largely untouched by traditional lenders, realtors, and government programs, CHIP's outreach efforts are proactive. Many residents are intimidated by the home buying and home financing process. CHIP's free education program follows the Department of Housing and Urban Development model: It consists of approximately eight hours of instruction and covers budgeting, credit, home selection, home financing, home repair, and managing home ownership. Local housing and credit professionals serve as volunteer instructors.

CHIP was organized as a public–private partnership in 1994 in response to several Wheeling-area housing studies that evidenced a need for such services. Representatives of local lenders, realtors, municipalities, public housing authorities, and nonprofit organizations formed CHIP's board of directors and cooperatively developed its program. In 1995, CHIP conducted its first education program in Wheeling, and by 1998, the program—still based in Wheeling—expanded to serve the four counties of the northern panhandle of West Virginia and two bordering Ohio counties.

Don't Borrow Trouble

In early 2002, the Lexington–Fayette Urban County Human Rights Commission held a free community workshop to discuss the depth of the predatory lending problem in the Kentucky county. Speakers included affordable housing activists, housing counselors, fair housing specialists, state regulators, and federal enforcement agencies, who defined predatory lending in national terms while examining it from a local perspective. Specifically, panelists shared their experiences with predatory lending and remedies available to combat the problem.



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Predatory Lending from the Ground Up

The commission continues to be active in addressing predatory lending concerns. In June, Executive Director William Wharton testified before the Kentucky State Treasurer's Commission on Personal Savings and Investment. The public hearing aimed to assist in the study predatory lending practices in Kentucky and to strategize how to help lower-income families become more financially independent through existing savings programs.

Seeking Solutions for At-Risk Housing

In Ohio, the Predatory Lending Solutions project—the first of its kind in the nation—brings together the Miami Valley Fair Housing Center, Consumer Credit Counseling Service, and the Legal Aid Society of Dayton and Montgomery County to address predatory lending in Montgomery County. Since January 2001, cases handled by these agencies have identified more than $119.8 million in affordable housing that is currently at risk.

The project's aggressive strategy comprises four components:

- Community outreach and education, which involves a hotline for consumer inquiries, distribution of brochures and educational materials, and consumer education and outreach workshops.
- Intervention and rescue services, which have been provided to 1,703 clients since 2001.
- Local community impact research better informs the project's activities. A study released last year from the Center for Business and Economic Research closely examined the extent of predatory lending in Montgomery County.
- Legislative support, including participation in the Ohio Coalition for Responsible Lending, which advocates statewide comprehensive legislation to address predatory lending in Ohio.

Community response to the project has been overwhelming: Despite all of the planning that went into the project, the partners significantly underestimated the widespread need for the project's services. To date, the project has accepted and begun investigating 241 meritorious predatory lending complaints. In addition, staff have analyzed and addressed more than 970 complaints to secure relief or resolution for clients. The collaborative effort among the three agencies has assisted in handling the high number of open cases.

Community Homebuyer Investment Program
P.O. Box 162
Wheeling, West Virginia 26003
304/232-6733
www.chipeducation.org

Lexington–Fayette Urban County Human Rights Commission
162 East Main Street, Suite 226
Lexington, Kentucky 40507-1315
859/252-4931
www.lfuchrc.org

Predatory Lending Solutions Project
c/o Miami Valley
Fair Housing Center
21–23 East Babbitt Street
Dayton, Ohio 45405
937/223-6035
www.mvfairhousing.com

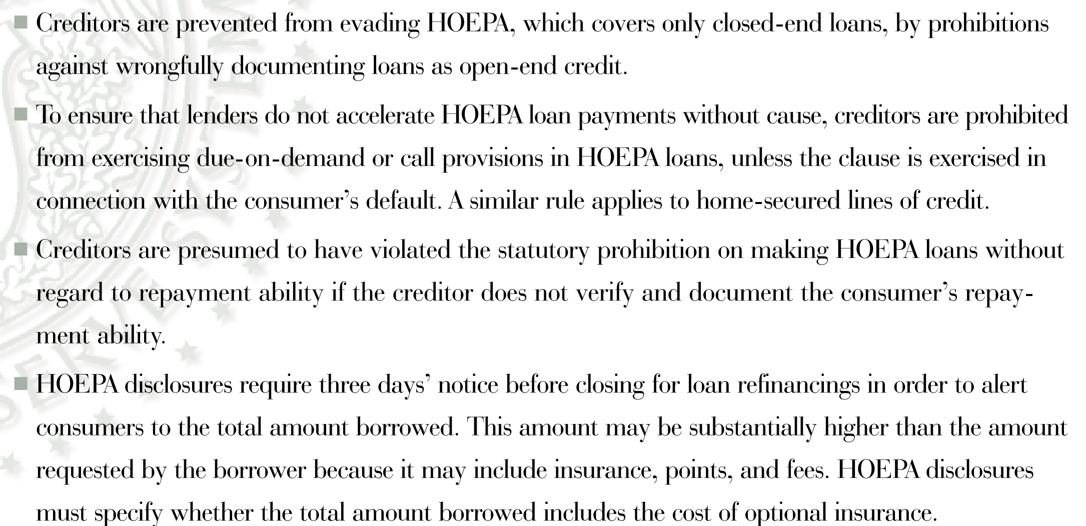
Changes to HOEPA Regulations Aim to Protect Consumers from Home Equity Fraud

Regulatory changes to the Home Ownership and Equity Protection Act have taken effect, giving consumers greater protection against home equity fraud and predatory lending practices.

Since October 2002, HOEPA regulations require lenders making first-lien mortgages with interest rates more than 8 percentage points above comparable Treasury securities to adhere to stricter consumer protections and disclose more information to borrowers. In response to consumer complaints, the Board of Governors of the Federal Reserve System also voted to prohibit the refinancing of high-cost loans within the loan's first year-known as "loan flipping"—unless it is in the borrower's best interest.

The Federal Reserve's final rule is similar to the initial proposed rule, with two exceptions. Based on staff recommendations, the Board did not lower the APR trigger for subordinate-lien mortgages, and it dropped a proposal to restrict refinancing of subsidized zero-interest-rate or low-interest-rate loans. The final rule implements the following changes:

- The APR trigger for first-lien mortgage loans decreases from 10 percentage points to 8 percentage points above the rate for Treasury securities with comparable maturities. The APR trigger for subordinate-lien loans remains at 10 percentage points. However, HOEPA does not cover first-lien loans when the borrower is making an initial purchase.
- The fee-based trigger has been adjusted to include amounts paid at closing for optional credit life, accident, health, or loss-of-income insurance and other credit-protection products.
- Creditors that make HOEPA loans to borrowers in the preceding 12 months are prohibited from refinancing another HOEPA loan to the same borrower. However, creditors will be permitted to make such a loan if it is in the borrower's interest. Assignees holding or servicing HOEPA loans are covered by this rule.



- Creditors are prevented from evading HOEPA, which covers only closed-end loans, by prohibitions against wrongfully documenting loans as open-end credit.
- To ensure that lenders do not accelerate HOEPA loan payments without cause, creditors are prohibited from exercising due-on-demand or call provisions in HOEPA loans, unless the clause is exercised in connection with the consumer's default. A similar rule applies to home-secured lines of credit.
- Creditors are presumed to have violated the statutory prohibition on making HOEPA loans without regard to repayment ability if the creditor does not verify and document the consumer's repayment ability.
- HOEPA disclosures require three days' notice before closing for loan refinancings in order to alert consumers to the total amount borrowed. This amount may be substantially higher than the amount requested by the borrower because it may include insurance, points, and fees. HOEPA disclosures must specify whether the total amount borrowed includes the cost of optional insurance.

The full text of the final HOEPA rule can be found at
www.federalreserve.gov/boarddocs/press/boardacts/2001/200112142/attachment.pdf.

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ACKNOWLEDGMENTS

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We welcome your comments and suggestions.

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# of interest

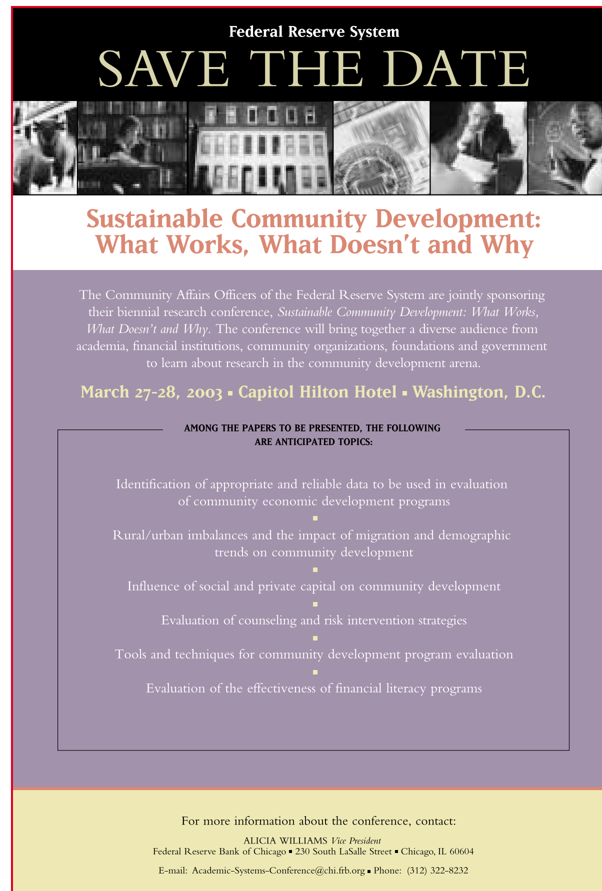
upcoming conferences

Microenterprise in Ohio: Where Do We Go from Here?

Microenterprise Organization of Ohio
February 27, 2003
Hyatt on Capital Square, Columbus, Ohio
Call 614/279-3323 for details and registration information.

Sustainable Community Development: What Works, What Doesn't, and Why

Federal Reserve System's Third Community Affairs Research Conference
March 27–28, 2003
The Capital Hilton, Washington, DC
312/322-8232



new publications coming this fall and winter

Perspectives on Credit Scoring and Fair Mortgage Lending

The Federal Reserve System's Credit Scoring Committee has produced a five-part series that presents a variety of perspectives on the credit scoring process and identifies areas where credit may create disparities in the home mortgage process. Available online at *www.clev.frb.org/CommAffairs/index.htm*.

CR Forum Special Report

Financial Literacy Programs in the Fourth Federal Reserve District: Results from the Federal Reserve Bank of Cleveland's Survey. The Community Affairs Office has surveyed financial literacy providers in the Fourth District. This report summerizes their curricula, impact, evaluation, and financial literacy subjects of greatest need.

To obtain a copy of this report, please contact Virginia Hopley at 216/579-2891 or *virginia.l.hopley@clev.frb.org*.