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The impact of local predatory lending laws on the flow of subprime credit ☆

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Abstract

Local authorities in North Carolina, and subsequently in at least 23 other states, have enacted laws intending to reduce predatory and abusive lending. While there is substantial variation in the laws, they typically extend the coverage of the Federal Home Ownership and Equity Protection Act (HOEPA) by including home purchase and open-end mortgage credit, by lowering annual percentage rate (APR) and fees and points triggers, and by prohibiting or restricting the use of balloon payments and prepayment penalties. Empirical results show that the typical local predatory lending law tends to reduce rejections, while having little impact on the flow (application and origination) of credit. However, the strength of the law, measured by the extent of market coverage and the extent of prohibitions, can have strong impacts on both the flow of credit and rejections.

JEL classification: G21; C25

Keywords: Mortgages; Predatory; Laws; Subprime

1. Introduction

The current mortgage market consists primarily of two segments—the prime market and the subprime market. The prime market extends credit to the majority of households. The subprime market provides more expensive credit to households who do not qualify for a prime mortgage.

☆ The views expressed in this research are those of the individual author and do not necessarily reflect the official positions of the Federal Reserve Bank of St. Louis, the Federal Reserve System, and the Board of Governors.

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These households tend to be less financially secure and located in low-income areas and areas with a concentration of minorities. The combination of higher borrower costs and higher rates of delinquency and foreclosure have led to public policy concerns over fairness and accessibility of credit.

Subprime lending represents an opportunity for the mortgage market to extend the possibility of home ownership beyond traditional barriers. These barriers have existed because the prime segment of the mortgage market uses lending standards (credit scores, documented employment history, income, and wealth, among other factors) to accept or reject loan applicants. Applicants that are rejected or expect to be rejected can look to the more expensive subprime market. In this fashion the subprime market completes the mortgage market and can be welfare enhancing (Chinloy and MacDonald [4]) because it provides the opportunity of home ownership to a larger portion of the population.

Over the past ten years subprime lending has grown rapidly—from $65 billion to $332 billion of originations from 1995 through 2003 (Inside Mortgage Finance [16]).[1] According to the Mortgage Bankers Association of America, the rate that loans were in foreclosure from the first quarter of 1998 to the third quarter of 2004 rose by more than 400 percent for subprime loans while declining by approximately 25 percent for prime loans. In addition, during the same time period anecdotal evidence of predatory lending in the subprime market was gaining more public and regulatory attention.[2] Therefore, the welfare benefit associated with increased access to credit is believed to have been reduced by some unscrupulous lending in the subprime mortgage market.

In response to public concerns of predation in the subprime mortgage market, federal regulations generated under the Home Ownership and Equity Protection Act (HOEPA) restrict some types of high-cost lending. Many states, cities, and counties have used HOEPA as a template and have extended the restrictions on credit to an even broader class of mortgages. These restrictions include limits on allowable prepayment penalties and balloon payments, prohibitions of joint financing of various insurance products (credit, life, unemployment, etc.), and requirements that borrowers participate in loan counseling.

By introducing geographically defined predatory lending laws, policymakers have conducted a natural experiment with well defined control and treatment groups. Since state boundaries reflect political and not economic regions, we can compare mortgage market conditions in states with a law in effect[3] (the treatment group) to those in neighboring states currently without a predatory lending law (the control group). However, instead of examining whole states we focus on households that are geographically close to each other (border counties) and as a result are in similar labor and housing markets.

Data at the individual loan level are used to identify the impact of local predatory lending laws on subprime applications, originations, and rejections. We create an index that measures the strength of the local laws. This index measures the increase in market coverage and the extent that certain lending practices and mortgage types are restricted. We find that the strength of the law can have strong impacts on both the flow of credit and rejections. In fact, variation in the

[1] These numbers are derived from type B&C loans. B&C loans are loans with less than an A (or prime) rating. See the Mortgage Markets Statistics Annual published by Inside Mortgage Finance for more details on loan classification schemes.

[2] See HUD-Treasury report (HUD-Treasury [15]) and Federal Reserve HOEPA Final Rule (Federal Reserve [8]).

[3] Laws are first enacted by the local legislature and become effective typically at a later date. It is not until the law becomes in effect that lenders are required to follow the new rules and restrictions.