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# CRS Report for Congress

## A Predatory Lending Primer: The Home Ownership and Equity Protection Act

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# A Predatory Lending Primer: The Home Ownership and Equity Protection Act

## Summary

The subprime mortgage market began to flourish in the 1990s. As subprime mortgage lending increased, predatory lending did as well. Congress responded to this influx of predatory lending practices by passing the Home Ownership and Equity Protection Act (HOEPA, P.L. 103-325), which proscribes some common abusive tactics. Drawing the line between valid subprime lending and predatory lending has proven to be a difficult task. Some have argued that while HOEPA has helped curb some predatory lending practices, it does not go far enough. Others believe that HOEPA has gone too far, arguing that it has reduced competition and dried up credit to risky borrowers, as some lenders as a matter of policy stopped extending HOEPA-covered loans.

At least 30 states and the District of Columbia have enacted a wide array of legislation seeking to improve upon HOEPA. Some are only minimally different from HOEPA, while others are far more comprehensive. The differences among them reflect the difficulty in striking the appropriate balance between discouraging predatory terms and conditions without also unreasonably restricting lending to borrowers with less-than-perfect credit.

Even with their differences, federal and state predatory lending statutes tend to confront a combination of 11 basic issues:

(1) covered loans;
(2) asset-based lending;
(3) prepayment penalties;
(4) balloon payments;
(5) negative amortization;
(6) loan flipping;
(7) credit counseling;
(8) mandatory arbitration clauses;
(9) loan packing;
(10) no call acceleration provisions; and
(11) financing of points and fees.

This report provides an overview of these 11 common aspects of predatory lending legislation, starting with a general description of the practice followed by how each is addressed in HOEPA and its regulatory counterpart, Subpart E of Regulation Z (Reg Z).

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# A Predatory Lending Primer: The Home Ownership and Equity Protection Act

## Introduction and Background

The mortgage lending market is separated into two sectors: prime and subprime. Predatory lending, for reasons discussed below, is almost entirely a problem in the subprime market.[1] Prime borrowers generally have higher incomes and stronger credit ratings than their subprime counterparts. Additionally, mortgage lenders often try to fit prime loans into the industry standard debt-to-income ratios (DTI) and loan-to-value ratios (LTV) set by secondary mortgage market entities like Fannie Mae and Freddie Mac, so that those organizations are able to purchase the loans in the secondary market.[2]

Subprime borrowers, on the other hand, tend to be of lower income, have lower credit scores, and generally have little besides their home equity to put up as collateral for loans.[3] Subprime borrowers, for these reasons, are considered riskier customers by lenders. Because of this increased risk, subprime loans are less likely to meet Fannie Mae and Freddie Mac standards, and subprime lenders generally seek higher interest rates and other fees on the loans, in part to offset the danger of default.

The subprime mortgage market began to flourish in the 1990s. Prior to this time, many borrowers with less-than-perfect credit profiles were not extended credit. The expansion of the subprime market improved access to credit for these borrowers. As such, the subprime mortgage market has likely played a large role in the increase of homeownership in the country.[4] As subprime mortgage lending increased, predatory lending did as well. Commentators have had a difficult time coming up with an

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[1] It should be made clear that predatory lending is not confined exclusively to the subprime lending market. However, the majority of predatory loans are also subprime. *See* National Predatory Lending Task Force, *Curbing Predatory Home Mortgage Lending: A Joint Report*, by the United States Department of Housing and Urban Development and the United States Department of the Treasury, 17 (June 2000) (hereinafter "Joint Report"); available at [http://www.huduser.org/Publications/pdf/treasrpt.pdf] (last visited October 30, 2007).

[2] *Id.* For more information about securitization, *see* CRS Report RS22722, *Securitization and Federal Regulation of Mortgages for Safety and Soundness*, by Edward Vincent Murphy.

[3] For more information regarding the subprime mortgage market, *see* CRS Report RL33930, *Subprime Mortgages: Primer on Current Lending and Foreclosure Issues*, by Edward Vincent Murphy.

[4] *Id.*

explicit definition of "predatory lending." The Joint Report offered this definition: "In a predatory lending situation, the party that initiates the loan often provides misinformation, manipulates the borrower through aggressive sales tactics, and/or takes unfair advantage of the borrower's lack of information about the loan terms and their consequences. The results are loans with onerous terms and conditions that the borrower often cannot repay, leading to foreclosure or bankruptcy."[5]

Obtaining a mortgage can be an intimidating and confusing process. To negotiate the attendant maze of loan terms, fees, and financing documents, borrowers frequently place trust in the lenders providing them the loan. This creates the potential for abuse by unscrupulous lenders,[6] who can take advantage of borrowers by adding terms and fees to loan agreements that, while potentially profitable for lenders, may not be in the best interest of borrowers. If loan terms are too burdensome, then borrowers may default on their contractual obligations, which increases the likelihood that lenders will foreclose on mortgages and force borrowers out of their homes.

Drawing the line between valid subprime lending and predatory lending has proven to be a difficult task.[7] Determining at what point higher rates and fees and more onerous loan terms become predatory is a fundamental factor in adopting appropriate legislation to curb these practices. If restrictions on lending practices go too far, the availability of credit for those with damaged credit profiles could dry up, leaving them without the option of homeownership. On the other hand, if the restrictions are too loose, then borrowers may be stripped of the equity in their homes by unscrupulous lending practices. The unnecessary loss of equity caused by points, fees, or rates that make a loan more expensive than what a borrower should qualify for considering the borrower's financial and other relevant characteristics is detrimental to borrowers. It can be especially harmful to low-income, subprime borrowers who have few savings other than the equity in their home.

The 103rd Congress responded to the influx of predatory lending practices by passing the Home Ownership and Equity Protection Act (HOEPA),[8] which proscribes some common abusive tactics. Some have argued that while HOEPA has helped curb

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[5] Joint report, at 17. A number of legislative proposals have been introduced in the 110th Congress that are directed at the subprime mortgage market, including at least four bills seeking to amend § 1322 of Chapter 13 of the Bankruptcy Code. For more information about these bills and how mortgages are dealt with in bankruptcy, *see* CRS Report RL34301, *The Primary Residence Exception: Legislative Proposals in the 110th Congress to Amend Section 1322(b)(2) of the Bankruptcy Code*, by David H. Carpenter.

[6] For simplicity, the term "lender" is used in this report to describe a party engaged in the practice of brokering, originating, or underwriting loans.

[7] Joint Report, at 17.

[8] Subtitle B of Title I of the Riegle Community Development and Regulatory Improvement Act, P.L. 103-325 (1994). HOEPA is codified as part of the Truth in Lending Act (TILA) at 15 U.S.C. § 1601 et seq.

some predatory lending practices, it does not go far enough.[9] Others believe that HOEPA has gone too far, arguing that it has reduced competition and dried up credit to risky borrowers, as some lenders as a matter of policy stopped extending HOEPA-covered loans.[10] For these reasons, some in Congress are seeking to amend HOEPA.[11] Additionally, at least 30 states and the District of Columbia have already enacted a wide array of legislation seeking to improve upon HOEPA. Some are only minimally different from HOEPA,[12] while others are far more comprehensive.[13]

The differences among them reflect the difficulty in striking the appropriate balance between discouraging predatory terms and conditions without also unreasonably restricting lending to borrowers with less-than-perfect credit. These differences have come under increasing scrutiny since the Office of the Comptroller of the Currency (OCC) concluded that HOEPA and its regulations preempt the application of state predatory lending statutes to nationally chartered banks[14] and their subsidiaries.[15] This view has received at least partial support from the U.S. Supreme Court.[16] Generally speaking, this means that nationally chartered banks and their

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[9] *See, e.g.,* Margot Saunders, *The Increase in Predatory Lending and Appropriate Remedial Actions*, 6 N.C. Banking Inst. 111, 112-113 (2002).

[10] *See* Fed. Res. Press Release and Notice, Doc. No. R-1090, [http://www.federalreserve.gov/boarddocs/press/boardacts/2001/200112142/attachment.pdf].

[11] *See*, *e.g.*, H.R. 3915, 110th Congress, the Mortgage Reform and Anti-Predatory Lending Act of 2007, and S. 2452, 110th Congress, the Homeownership Preservation and Protection Act of 2007. These two bills would, among other things, broaden the definition of HOEPA loans and place additional restrictions and protections on these loans. For more information on these bills and others that would amend HOEPA, *see* the "Required Disclosures" section of CRS Report RL33879, *Housing Issues in the 110th Congress*, by Libby Perl, *et al*.

[12] *See*, *e.g.*, Fla. Stat. Ann. §§ 494.0078-0097 and Me. Rev. Stat. Ann. tit. 9-A, § 8.

[13] *See*, *e.g.*, Ga. Code Ann. § 7-6A and N.C. Gen. Stat. § 24-1.1E.

[14] The United States has a dual banking system. Banks chartered by the states are regulated by state law, while nationally chartered banks are regulated by federal law.

[15] On August 5, 2003, the OCC issued a Preemption Determination and Order (OCC Docket No. 03-17, 68 Fed. Reg. 46,264) preempting the Georgia Fair Lending Act regarding real estate lending in Georgia by national banks and their Georgia subsidiaries. The OCC subsequently issued more detailed regulations that appear to generally preempt state predatory lending laws with respect to national banks and their subsidiaries (69 Fed. Reg. 1904 (amending 12 C.F.R. Parts 7 and 34)). *See* CRS Report RS22057, *Preemption of State Law for National Banks and Their Subsidiaries by the Office of the Comptroller of the Currency: A Sketch*, by M. Maureen Murphy; *see also* C. Bailey King, Jr., *Preemption and the North Carolina Predatory Lending Law*, 8 N.C. Banking Inst. 377 (2004).

[16] Watters v. Wachovia Bank, N.A., (No. 05-1342) 550 U.S. __ (2007) (where the Court, in a 5-3 decision, ruled that Michigan mortgage lending requirements do not apply to a state-chartered operating subsidiary of a national bank). Although all state laws regulating the terms and conditions of loans were not before the Court, OCC regulations are broadly written to preempt state laws on virtually every aspect of the core banking business. Moreover, there are regulations extending the preemptive effect to national bank operating subsidiaries and covering all state laws that "obstruct, impair, or condition a national bank's

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subsidiaries are not subject to state lending laws, whereas many subprime lenders must adhere to both state and federal lending laws, where the federal laws serve as the baseline.

Even with their differences, federal and state predatory lending statutes tend to confront a combination of 11 basic issues:

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(11) financing of points and fees.[17]

This report provides an overview of these 11 common aspects of predatory lending legislation, starting with a general description of the practice followed by how each is addressed in HOEPA and its regulatory counterpart, Subpart E of Regulation Z (Reg Z).[18]

## Eleven Common Aspects of State and Federal Predatory Lending Laws

It should first be noted that each of the 11 common aspects of predatory lending statutes that are discussed in this report can be beneficial to borrowers in certain circumstances. For instance, a refinance just two months after a borrower acquired a loan could be in the borrower's best interest if, at that time, she unexpectedly earned a job promotion that increased her credit rating, thus qualifying her for a less-expensive loan. Another example would be a borrower agreeing to a six-year prepayment penalty in exchange for other, more favorable terms if that borrower is reasonably confident that she will remain in the same home for at least six years. Critics, consequently, would argue that by proscribing prepayment penalties after the first five years of the loan, barring refinances within three months of acquiring the underlying loan, or otherwise limiting the availability of loan terms, predatory lending statutes are actually harming borrowers, rather than attaining the policy goal of helping them.

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[16] (...continued)
ability to fully exercise its powers to conduct activities under Federal law." 12 C.F.R. § 7.4006. For further discussion on the *Watters* decision and its possible implications, *see* CRS Report RS22485, *Watters v. Wachovia Bank, N.A.*, by M. Maureen Murphy.

[17] For a more detailed discussion of these issues, *see generally* Joint Report.

[18] 12 C.F.R. §§ 226.31-35.

The fact that these lending practices can be legitimate in some circumstances while predatory in others can make regulating them quite difficult. It is important to weigh these counterbalancing factors when devising a predatory lending statute.

**Covered Loans.** One of the most important features of a predatory lending statute is the determination of which loans fall under the umbrella of its protections and restrictions. Many statutes exempt certain types of mortgages from their definition of covered loans. Predatory lending statutes also generally set thresholds that nonexempt mortgages must meet before their protections are triggered. Most commonly, the thresholds are based on the loan's annual percentage rate (APR) and/or the total points and fees paid by the borrower in connection with the loan.[19]

HOEPA applies to mortgages that are secured by a borrower's *primary* residence, but exempts from coverage residential mortgage transactions,[20] reverse mortgage transactions,[21] and open end credit plans.[22] The most significant of these exemptions is residential mortgage transactions, which are basically loans provided for the purchase or initial construction of the homes securing the loans.[23] HOEPA's regulations apply where (1) the nonexempt loan's "APR exceeds by more than 10 percentage points the yield on Treasury securities with comparable periods ... of maturity ... "; or (2) "the total points and fees payable by [a borrower] at or before

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[19] Definitions of "points and fees" also differ among the statutes. *See, e.g.,* 12 C.F.R. § 226.32(b)(1) (which includes finance charges, compensation paid to mortgage brokers, premiums or other charges for credit insurance, application fees, late payment/default charges, overdraft charges, credit plan fees, seller's points, interest forfeited due to legally required interest reduction on a time deposit used to secure the loan, and real estate related fees, such as title examination, preparation of documents, notary, etc.).

[20] Defined at 15 U.S.C. § 1602(w) ("The term 'residential mortgage transaction' means a transaction in which a mortgage, deed of trust, purchase money security interest arising under and installment sales contract, or equivalent consensual security interest is created or retained against the consumer's dwelling to finance the acquisition or initial construction of such dwelling.").

[21] Defined at 15 U.S.C. § 1602(bb) ("The term 'reverse mortgage transaction' means a nonrecourse transaction in which a mortgage, deed of trust, or equivalent consensual security interest is created against the consumer's principal dwelling securing one or more advances; and with respect to which the payment of any principal, interest, and shared appreciation or equity is due and payable (other than in the case of default) only after the transfer of the dwelling; the consumer ceases to occupy the dwelling as a principal dweller; or the death of the consumer.").

[22] Defined at 15 U.S.C. §1602(i) ("The term 'open end credit plan' means a plan under which the creditor reasonably contemplates repeated transactions, and which provides for a finance charge which may be computed from time to time on the outstanding unpaid balance. A credit plan which is an open end credit plan within the meaning of the preceding sentence is an open end credit plan even if credit information is verified from time to time.").

[23] These types of loans usually are covered by state predatory lending statutes. They also are often referred to as purchase money mortgages. Because of the exemption of "residential mortgage transactions," HOEPA's coverage is basically limited to certain secondary mortgages and refinances.

closing exceed the greater of 8 percent of the total [nonexempt] loan amount" or $561.[24]

**Asset-Based Lending.** Most creditors extend mortgages with the expectation that the borrower will be able to meet the scheduled payments. Some predatory lenders, however, make loans based on the value of the security interest (e.g., the home) without considering the borrowers' financial characteristics. This practice is already discouraged by federal banking regulators because it is considered speculative and unsound.[25] It is also alleged that some lenders make loans knowing that borrowers will be unable to repay, thereby allowing the lenders to refinance the loans while adding additional up-front fees or to obtain borrowers' houses through foreclosure.[26] State statutes often combat these practices by requiring lenders to consider the borrower's financial characteristics, such as their debt-to-income ratios (DTI) and loan-to-value ratios (LTV).[27]

HOEPA prohibits lenders from "engag[ing] in a pattern or practice" of providing covered loans based on the value of the collateral without regard to the borrower's ability to repay.[28] A lender is presumed to have violated this provision if the lender engages in a pattern or practice of extending covered loans without "verifying and documenting consumers' repayment ability."[29] Proving a lender has engaged in a "pattern or practice" requires evidence of more than just a single violative act.[30]

**Prepayment Penalties.** Prepayment of loans often takes place as a result of relocation or refinancing. Some lenders, particularly those in the subprime market, charge fees for prepayment that are intended to cover the lender for lost interest payments incurred due to such early payment. Prepayment penalties can hinder a borrower's ability to refinance, thus locking the borrower into the existing loan, which could be more expensive than a loan for which the borrower currently

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[24] 15 U.S.C. § 1602(aa). The Board of Governors of the Federal Reserve System (the Board) has the authority to adjust the percentage thresholds, within a specified floor and ceiling where such an adjustment is "consistent with the consumer protections against abusive lending" and "warranted by the need for credit." *Id*. Additionally, HOEPA set a $400 figure that is to be adjusted each year based on the Consumer Price Index. For 2008, the adjusted amount is $561.

[25] *See*, *e.g.*, Expanded Guidance for Subprime Lending Programs, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Thrift Supervisor (February 2, 2001), at 10-11 [http://www.ots.treas.gov/docs/2/25137.pdf].

[26] *See* Joint Report, at 76-77.

[27] *See*, *e.g.*, Cal. Fin. Code § 4973(f).

[28] 15 U.S.C. § 1639(h).

[29] 12 C.F.R. § 226.35(a)(4).

[30] *See* Williams v. G.M. Mortgage Corp., 2004 U.S. Dist. LEXIS 29365, at 31-32 (E.D. Mich. 2004) and Newton v. United Cos. Fin. Corp., 24 F.Supp. 2d 444, 456 (1998).

qualifies.[31] Consequently, predatory lending statutes typically place limitations on prepayment penalty terms.[32]

HOEPA prohibits prepayment penalties after the first five years of the covered loan where the borrower has a total monthly indebtedness (including monthly payments under the proposed mortgage) greater than half the borrower's monthly income. This prohibition does not apply to funds obtained from refinancing the mortgage with the same lender or one of its affiliates.[33]

**Balloon Payments.** Balloon payments, which are larger than the average of previous payments, generally occur at the end of the loan term to fully amortize the principal. Balloon payments tied to high-cost loans with short terms can be particularly difficult for low-income, subprime borrowers to make, thus encouraging them to refinance (sometimes repeatedly) with new high-cost loans.[34] Many statutes prohibit payments that are more than double the average of earlier payments.[35]

HOEPA-covered loans "of less than five years may not include terms under which the aggregate amount of the regular periodic payments would not fully amortize the outstanding principal balance."[36] This basically bars balloon payments in covered loans that last less than five years.

**Negative Amortization.** Negative amortization refers to payment terms that do not entirely cover the loan's interest, thus leading to an increase in the loan's principal. This may be beneficial to a borrower who has low cash-on-hand at the time of closing, but whose income is likely to increase in the near future (e.g., a recent graduate with a good job lined up). However, borrowers lose equity under such a payment scheme,[37] which is why predatory lending laws often prohibit these terms in covered loans.[38]

HOEPA bars the inclusion of terms in a covered loan that would allow the principal to increase due to the fact that regular payments do not fully cover the loan's interest.[39]

**Loan Flipping.** Loan flipping is the practice of refinancing a loan frequently over a short time while charging the borrower fees for each transaction. The borrower may get an individual benefit for the refinance, such as a lower interest rate, but the

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[31] *See* Joint Report, at 93-94.

[32] *See*, *e.g.*, Colo. Rev. Stat. § 5-3.5-102(1)(g).

[33] 15 U.S.C. § 1639(c).

[34] *See* Joint Report, at 96.

[35] *See*, *e.g.*, Conn. Gen. Stat. § 36a-746c(1).

[36] 15 U.S.C. § 1639(e).

[37] *See* Joint Report, at 91.

[38] *See*, *e.g.*, 815 Ill. Comp. Stat. 137/65.

[39] 15 U.S.C. § 1639(f).

overall effect may make such a transaction a bad option for the borrower.[40] Many state statutes restrict this practice in some way. Often, this is done by requiring lenders to ensure that an extended loan provides a net benefit to the borrower.[41]

Reg Z prohibits a lender from refinancing a covered loan within one year of originating the underlying covered loan "unless the refinancing is in the borrower's best interest."[42] Lenders are also barred from attempting to evade this regulation by, for instance, engaging in a "pattern or practice" of arranging with other creditors to refinance their own covered loans within the one-year period.[43]

**Credit Counseling.** Predatory lenders can take advantage of borrowers' unfamiliarity with loan practices and terms by adding points and fees to loans. Additionally, borrowers may not know that they qualify for less expensive loans than those offered by abusive lenders.[44] Recognizing the role that knowledge plays in curbing predatory lending, some statutes require borrowers to seek credit counseling before lenders may provide them a high-cost loan.[45]

HOEPA does not have a credit counseling requirement.

**Mandatory Arbitration Clauses.** Mandatory arbitration clauses require parties to a loan agreement to resolve their differences in arbitration, instead of in court. These clauses can be onerous to borrowers if they reduce the legal rights that borrowers would have in court, require borrowers to pay the costs of arbitration, force borrowers to travel far from home, or otherwise discourage borrowers from raising valid claims.[46] For these reasons, state predatory lending statutes often restrict the use of arbitration clauses in covered loans.[47]

HOEPA does not limit the use of arbitration clauses.

**Loan Packing.** There are several types of credit insurance that cover loan payments in case of the borrower's inability to pay, including credit life, credit accident, credit disability, credit unemployment, and credit property insurance. Frequently, the premiums for these products are folded into a single premium and financed into high-cost loans. These insurance products are not always in the best interest of the borrower, and because mortgage brokers are often compensated based

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[40] *See* Joint Report, at 73-74.

[41] *See*, *e.g.*, Ark. Code Ann. § 23-53-104(b).

[42] 12 C.F.R. § 226.35(a)(3). This provision also applies to assignees and servicers of covered loans. This provision does not prevent a borrower from refinancing a covered loan with a different lender.

[43] *Id.*

[44] *See* Joint Report, at 60-61.

[45] *See*, *e.g.*, Mass. Gen. Laws ch. 183C, § 3.

[46] *See* Joint Report, at 98-99.

[47] *See*, *e.g.*, N.M. Stat. Ann. § 58-21A-5(F).

on commissions, the broker may not have an incentive to find the products that will most benefit the borrower.[48] To combat this practice, many states prohibit the practice of financing (or "packing") single premium credit insurance into covered loans.

HOEPA does not restrict the practice of financing credit insurance.

**No Call Acceleration.** Some loans allow lenders to unilaterally accelerate loan payments and balances due. Such actions may be justified if initiated by borrowers' failure to abide by the terms of the loan agreements. However, they may also be predatory if done for reasons unrelated to borrowers' contractual obligations because they increase the chance of default. For this reason, some states' predatory lending statutes prohibit such practices.[49]

HOEPA does not address unilateral acceleration clauses.

**Financing of Points and Fees.** The practice of financing up-front points and fees into loans, while making the transaction cheaper in the front-end, forces borrowers to pay more in principal and interest over the course of their loans without increasing the amount of money received through the loans. Lenders receive this compensation up-front regardless of whether the points and fees are financed into the loan.[50] Similar to negative amortization terms, this practice can be beneficial to borrowers that have low cash-on-hand at closing but who are likely to have steady incomes over the coming months or years. However, predatory lenders could finance points and fees in an attempt to hide a loan's actual cost from the borrower. For this reason, many state predatory lending laws limit when and how lenders may finance points and fees.[51]

HOEPA does not place restrictions on the financing of points and fees.

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[48] *See* Joint Report, at 89-90.

[49] *See, e.g.*, N.C. Gen. Stat. § 24-1.1E(b)(1).

[50] *See* Joint Report, at 99-101; *see also* Margot Saunders, *The Increase in Predatory Lending and Appropriate Remedial Actions*, 6 N.C. Banking Inst. 111, 121-122 (2002).

[51] *See, e.g.*, S.C. Code Ann. § 37-23-40(3)(b).