

Policy Comment

A “Flip” Look at Predatory Lending: Will the Fed’s Revised Regulation Z End Abusive Refinancing Practices?

The regulation of predatory loans can be a tedious business. The whole topic redounds of such yawn-inducing terms as “single-premium credit insurance” and “negative amortization.” Yet the human costs of predatory lending are no less real for all the financial jargon that masks them. Thousands of Americans, especially minorities and the elderly, have lost their homes due to sharp lending practices. The effective regulation of such abusive lending, while not a very sexy endeavor, could markedly improve the quality of life for some of the nation’s most vulnerable people. This reality has led thirteen states and several major cities to undertake statutory and regulatory reform efforts in the past three years. The Federal Reserve Board (Fed), too, has attempted to rein in predatory lending through the recent promulgation of its revised standards under Regulation Z.

This Comment will attempt to analyze the potential efficacy of the Fed’s effort by examining a specific portion of the revised Regulation Z, namely, its prohibition of so-called loan “flipping.”¹ This rule forbids the refinancing of any “high-cost loan”² within one year of its initiation, unless that refinancing is “in the borrower’s interest.”³ The prosecutorial discretion

1. Loan flipping will be defined in more detail later in this Comment. *See infra* text accompanying note 19. In essence, “flipping” is the early or frequent refinancing of a loan in order to extract greater points and fees from a borrower.

2. Again, the term “high-cost loan” will be defined more fully later in this Comment. *See infra* text accompanying note 14. For now it will suffice to say that a high-cost loan is a loan subject to the substantive requirements of the Fed’s predatory lending rules due to high interest rates or fees.

3. 12 C.F.R. § 226.34(a)(3) (2002). I have chosen to analyze this provision for two reasons. First, it is emblematic of the current crop of predatory lending reforms in its greater emphasis on prosecutorial discretion; it can thus serve as a specific vehicle through which to explore the more general strengths and weaknesses of the recent reform measures. Second, it covers all fifty states

embedded within the new federal antiflipping provision represents a potential improvement over the previous generation of predatory lending regulations. This is because a discretionary standard better enables regulators and judges to end illegitimate mortgage refinancings, while still permitting others to go forward when warranted by individual circumstances. Such a result can improve both the justice and efficiency of the regulatory regime. Even so, like all other regulatory systems relying on prosecutorial discretion, also present is the opportunity for over- and underenforcement. In the case of the antiflipping provision, most of the worry has been that the standard will be overenforced and cause the market for legitimate subprime⁴ loans to dry up. This Comment argues that this fear is overstated and that the real worry is underenforcement.

I

Predatory lending is a long-standing social problem. But its salience was never greater than in the 1990s, when the market for subprime loans exploded.⁵ The upside of this boom was that more low-income and high-risk borrowers were able to gain access to the credit markets than ever before—these borrowers helped fuel the expansion in personal spending at the heart of the Clinton-era economy. The downside was a dramatic increase in home foreclosures. During the eight years from 1993 to 2000, overall foreclosures skyrocketed by sixty-eight percent;⁶ in some urban areas, such as Chicago, they as much as doubled.⁷ Although there is little empirical evidence indicating how many of these subprime foreclosures were due directly to predatory lending, anecdotal evidence suggests that

and appears to be a far harder rule than those enacted at the state and local levels, which are currently the targets of a federal preemption statute. Michele Heller, *Federal Anti-Predator Bill Ready for Introduction*, AM. BANKER, Feb. 13, 2003, at 3 (“Rep. Bob Ney plans today to introduce a bill that would . . . preempt the city and state laws that lenders oppose.”).

4. The term “subprime” is used to denote loans that carry higher interest rates or fees than are typically found in “prime” market loans. There is nothing per se wrong with subprime loans costing more. If lenders could not charge more to their riskier customers, then they would simply fail to offer loans to low-income or high-risk borrowers at all. But while the economic rationale for differentiating subprime from prime borrowers is sound, the potential for lenders to abuse these borrowers is real. It is for this reason that predatory lending protections exist.

5. See Dennis Hevesi, *New Curbs on Predatory Loans*, N.Y. TIMES, Nov. 10, 2002, § 11, at 1 (“[I]n 1993 there were 6.9 million loans originated in the entire mortgage market, of which 126,000 were subprime. By 2000, when a total of 7.8 million loans were made, 1.1 million were subprime. The prime market had no growth, while the subprime market increased by a magnitude of 7” (internal quotation marks omitted)).

6. See *id.*

7. See Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 580 (2002).

loan predation was at least a contributing factor in a disturbingly high percentage.⁸

Such foreclosures impose huge personal and social costs on those whom they affect, even indirectly. There are, first, the immediate personal consequences for an individual involved in a foreclosure proceeding. That person loses what is almost undoubtedly her most valuable economic asset, in addition to giving up the simple security and stability of having somewhere to call home. Substantial dignitary costs are also at stake. This is especially true in a society like ours, where home ownership is emphasized as a central pillar of the American Dream. Yet individuals do not alone bear the costs of foreclosures; entire communities can feel the consequences as well. Chicago's mayor, Richard Daley, described the way that the effects of foreclosures have rippled through some neighborhoods in his city:

We are seeing a pattern in the city and in the suburbs It's the same story: A family has suddenly abandoned their home. In many cases, it is elderly people who have lived there for many years Once abandoned, these homes have been taken over by gangs and drug people, and they become breeding places for crime.⁹

The costs of predatory lending, then, are distressingly large—and not only do they leave individual lives in shambles, but neighborhoods too.

Bad as this may seem, the situation is even more upsetting because it is primarily the nation's minority and elderly communities upon whom such lenders prey. Black Americans, for example, are five times more likely than whites to refinance their homes in the subprime market. This remains true even among affluent blacks, who are twice as likely to refinance their homes in the subprime market as *low-income* whites.¹⁰ Elderly homeowners are also the frequent targets of subprime lenders.¹¹ The elderly are particularly inviting to these lenders because they often need quick cash for home repairs or retirement and already have significant equity in their homes.¹² What these demographics demonstrate is that the burdens of

8. See Hevesi, *supra* note 5; see also Sarah E. Lockyer, *Fed Official Hints Predator Rules Need Fine-Tuning*, AM. BANKER, Nov. 1, 2002, at 11 (“The predatory lending story is one of anecdotes; it is very hard to get data,” [Fed Governor Edward] Gramlich said.”).

9. James T. Berger, *Subprime Lending Produces Dangerous Side-Effects*, CHI. SUN-TIMES, June 9, 2000, at 16N.

10. See Eggert, *supra* note 7, at 574.

11. The ideal customer for a subprime lender has been described as “an uneducated widow who is on a fixed income . . . who has her house paid off, is living off of credit cards, but having a difficult time keeping up with her payments.” *Predatory Lending Practices: Hearing Before the U.S. Senate Special Comm. on Aging*, 105th Cong. 31 (1998) (statement of “Jim Dough,” anonymous representative of the financial services industry).

12. More equity up-front increases the collateral that a lender can collect in the event of a foreclosure.

subprime lending—especially the increased risks of loan predation and foreclosure—fall heavily upon groups that, like minorities, still have difficulty gaining access to prime credit markets or else, like the elderly, tend to live on fixed incomes and be acutely vulnerable to the financial stresses of a serious illness or other personal calamity.

Taken together, the consequences of predatory lending sound a call for regulatory action. The next Part will offer a brief history of federal efforts to rein in predatory lending—including an analysis of the shortcomings in the regulatory framework of the mid-1990s that led the Fed to promulgate new standards under the revised version of Regulation Z.

II

This basic structure of federal predatory lending regulation is set out in a 1994 statute, the Home Ownership and Equity Protection Act (HOEPA).¹³ HOEPA creates a framework for the protection of borrowers taking out certain subprime mortgages, the precise details of which are then filled in and enforced by the Fed through Regulation Z. HOEPA's safeguards cover home equity mortgages deemed to be "high cost," which Regulation Z defines as a home equity mortgage meeting one of two threshold conditions known respectively as the rate trigger and the fee trigger.¹⁴ Once one of these triggers is satisfied, the HOEPA-Regulation Z regime mandates that the lender give the borrower a set of basic disclosures three business days before the loan is closed.¹⁵ These disclosures are on top of the regular Truth in Lending Act (TILA) requirements and, when combined with TILA's three-day right to rescission, provide the consumer with at least six days to reflect on the appropriateness of a particular loan.¹⁶

Besides these disclosures and the cooling-off period, HOEPA-Regulation Z loans are barred from incorporating certain terms, including: (1) balloon payments in loans with a term of less than five years, (2) payment schedules that are negatively amortized and thereby allow the balance owed on a loan to increase rather than decrease, (3) increased interest rates in the event of default, (4) certain prepayment penalties, and (5) requirements that payments be bundled and paid in advance.¹⁷ These

13. Home Ownership and Equity and Protection Act of 1994, Pub. L. No. 103-325, 108 Stat. 2190 (codified as amended in scattered sections of 15 U.S.C.).

14. Prior to the recent revisions of Regulation Z, the rate trigger was met when the annual percentage rate of the loan was more than ten percent greater than the yield on a Treasury security with a maturity date comparable to the loan. The fee trigger was met when the total of all the loan's points and fees payable at or before closing exceeded the greater of either \$400 annually adjusted for inflation, or eight percent of the total loan amount. *See* 15 U.S.C. § 1602(aa)(1)(A)-(B) (2000).

15. *See id.* § 1639(a)-(b).

16. *See* Eggert, *supra* note 7, at 586.

17. *See* 15 U.S.C. § 1639(c)-(g).

terms have been deemed per se impermissible because they have long been associated with predatory practices, and it is thought that there is little or no legitimate reason for such terms to be included in a high-cost loan.

Viewed as a whole, the HOEPA-Regulation Z regime represents an effort to provide protections and disclosures to borrowers of high-cost loans, without unduly limiting the ability of these same low-income and high-risk borrowers to obtain credit on the subprime markets. These are precisely the right policy goals. They recognize that legitimate subprime loans increase social welfare by helping borrowers gain access to loans that they would not otherwise be able to obtain; they also recognize that borrowers are infrequent players in the credit markets and consequently need some protections to level the playing field in negotiations with repeat-playing lenders. Yet just because these are the right aims does not mean that they are easy to realize in practice. They are, in fact, extraordinarily difficult to achieve.

Indeed, the initial HOEPA-Regulation Z standards did little to protect at-risk borrowers. There are a couple of reasons why they fell short. First, the rate and fee triggers were too easy to evade, especially for lenders willing to charge interest rates and fees only slightly below the triggers provided in the regulatory scheme. Evidence indicates that exactly the types of unscrupulous lending practices the regulatory structure had been designed to root out were proliferating in loans just beneath the triggers for high-cost loan status.¹⁸ Second, and more relevant for our purposes, lenders were able to obtain higher profits by more rapidly “flipping” the loan. Loan flipping is defined as the “early or frequent refinancing of a loan, normally with each new set of loan fees financed by the loan, so that the loan amount continually rises, even while the homeowner makes her payments.”¹⁹ For example, since fees on an initial loan would not have applied to the determination of whether a pair of refinancings of that loan are high-cost mortgages, a lender could have charged a 7.5% fee three separate times in rapid succession for three different loans, collecting fees totaling well over 20% of the loan amount, but without ever exceeding the 8% fee trigger. Flipping became so common in the subprime industry that “[s]ometimes borrowers [would] have loans flipped four, five times and . . . [be] left with

18. One lender, for example, revealed how near its fees were to the fee trigger when it estimated that ninety percent of its loans would be covered by HOEPA if only the fee trigger were to include the cost of single-premium credit insurance. See Sandra Fleishman, *Fed Favors Tougher Loan Rules*, WASH. POST, Dec. 14, 2000, at E1; see also Carol Hazard, *Predatory Loans Often Set Up Borrowers for Failure and Can Cost Them Their Biggest Investment: Their Homes*, RICH. TIMES-DISPATCH, Oct. 9, 2000, at A1 (stating that Fed members heard “reports of lenders skating just below the HOEPA requirements and still engaging in egregious practices”).

19. See Eggert, *supra* note 7, at 515.

no equity as points and fees strip[ped] out the value of their homes.”²⁰ Homes were essentially stolen from low-income Americans, and the laws of the time could do nothing to stop it.

III

Recognizing the initial HOEPA-Regulation Z standards’ shortcomings, the Fed worked to tighten the restrictions on predatory lenders in a revised version of its regulation. These amendments, effective December 20, 2001, with compliance mandatory by October 1, 2002, seek to beef up the HOEPA-Regulation Z regime through the following steps. First, they reduce the rate trigger for first-lien mortgage loans from ten percentage points to eight percentage points.²¹ Second, while keeping the fee trigger at the same percentage level, they change the relevant definition of fee to include optional insurance, such as credit life, health, accident, or loss of income insurance, as well as other debt-protection products financed by the loan.²² These two revisions should help to solve the first major shortcoming outlined above by making more subprime loans subject to HOEPA-Regulation Z protections.

Third, the amendments to Regulation Z also take dead aim at ending “flipping” by prohibiting a lender from refinancing one high-cost loan into another within twelve months of the first loan’s origination, unless that refinancing is “in the borrower’s interest.”²³ The definition of “in the borrower’s interest” is left intentionally vague and does not offer a laundry list of terms deemed to be per se impermissible in a loan refinancing.²⁴ It instead places discretion in the hands of regulators and judges to determine on a case-by-case basis whether the refinancing practices of a particular subprime lender are so beyond the pale as to constitute predatory lending.

This emphasis on prosecutorial and judicial discretion through the flexible standard of “in the borrower’s interest” represents a potential welfare improvement over the approach found in the previous generation of

20. See Hevesi, *supra* note 5 (quoting Sarah Ludwig, Executive Director of the Neighborhood Economic Development Advocacy Project).

21. 12 C.F.R. § 226.32(a)(1)(i) (2002).

22. *Id.* § 226.32(a)(1)(ii), (b)(1)(iv).

23. *Id.* § 226.34(a)(3).

24. According to the Fed:

[P]recisely defining circumstances that are “in the borrower’s interest” is not necessary, given the nature of the loan flipping prohibition. . . . The Board recognizes that this approach places the primary burden on the creditor, in light of the totality of the circumstances, to weigh whether the loan is in the borrower’s interest. The standard is intended to give legitimate creditors some flexibility for extenuating circumstances, while creditors that rely on the exception routinely to “flip” HOEPA loans bear the risk that a court will find that they violated HOEPA.

Prohibited Acts or Practices in Connection with Credit Secured by a Consumer’s Dwelling, 66 Fed. Reg. 65,612, 65,613 (Dec. 20, 2001).

predatory lending standards. Both rounds of regulation have held the same pair of difficult-to-reconcile goals—reining in abusive lending practices, while also permitting the extension of legitimate subprime loans. The earlier effort attempted to accomplish these ends through a small number of hard-and-fast rules. The problem was that predatory lenders proved too nimble and exploited the regulatory gaps left to accommodate legitimate subprime lenders. The Fed's new antiflipping provision works to fill in one of these gaps and leaves the accommodation of legitimate subprime lenders to the discretion of regulators and judges. Greater discretion is potentially welfare-improving because it enables better filtering between permissible and impermissible subprime loans. It thus still permits the gains of legitimate subprime loans to accrue to lenders and borrowers, while more ably limiting the personal and social drains associated with predatory loans.

Although the new antiflipping measure represents a potential welfare improvement, it also carries with it a risk of over- or underenforcement, just like any other regulatory regime relying on prosecutorial discretion. Fear of overenforcement led banking lobbyists to oppose the antiflipping standard vigorously in the lead-up to its adoption.²⁵ They argued that uncertainty over its meaning and the consequent likelihood of producing overzealous enforcement would lead to a chilling of the market for legitimate subprime loans. This, in turn, would destroy efficiency by denying loans to would-be borrowers unable to obtain credit elsewhere. These fears have found little support in the evidence, however. A nationwide survey of subprime lenders conducted in the summer of 2002 by Morgan Stanley found that the volume of subprime loans was expected to increase thirty-five percent over the previous year.²⁶ Such quick growth in the face of stronger regulation seems a strong rebuttal to the overenforcement critique of the Fed's anti-loan-flipping rule. This is doubly so since the market grew in the first year of the new restriction, when uncertainty over the regulation and its potential chilling effect should have been greatest.

The real worry, rather, is underenforcement. The evidence on the continued growth of the market for subprime loans is consistent with two separate hypotheses: that the new regulation is achieving the welfare gains described above, or that it is being underenforced. Although the evidence is as yet indeterminate, there are strong reasons for fearing the latter.

Legal efforts to enforce Regulation Z generally come from one of two sources—enforcement actions undertaken by the Fed, or private actions undertaken by the individual victims of a predatory lender. Neither of these

25. See *id.* at 65,612 (“[C]reditors believed that the standard’s lack of certainty would subject them to litigation risk.”); Rob Blackwell, *Industry Opposes Fed’s Anti-Predator Proposal*, AM. BANKER, Mar. 23, 2001, at 3 (“[I]ndustry representatives countered that the [antiflipping proposal] would set a dangerous precedent.”).

26. Hevesi, *supra* note 5.

loci of enforcement, unfortunately, may be especially well placed to end the loan-flipping abuses of subprime predators. First, those directly harmed by predatory lending seem an especially unlikely group to look to for regulatory enforcement. Such individuals are, almost without exception, lacking the financial resources necessary to mount an effective legal campaign against sophisticated and well-funded financial institutions—and, perversely, their dearth of resources has been at least exacerbated through interactions with the very institutions they would look to sue.

This suggests that the Fed should enforce Regulation Z with heightened vigor. Yet it has not been an especially zealous advocate on the predatory lending front. For example, the Fed was slow in responding to the surge in foreclosures during the mid-1990s; it took the Fed several years to begin to formulate potential reforms to Regulation Z, even after it had become apparent that its existing rules were not succeeding.²⁷ This reveals a more fundamental point about the Fed as a predatory lending regulator—since its primary mission is the safety and soundness of the banking system, not consumer protection, it tends to be more sympathetic to the concerns of those in the banking industry than those who worry about the abuses of that industry. Furthermore, even given its relative insulation from the political process, the recent shift in congressional power could reinforce the Fed's inclination toward foot dragging on consumer protection measures, such as the loan-flipping prohibition discussed here.²⁸ Empirical evidence is beginning to back these claims. Although the antiflipping provision has been fully mandatory since October 1, 2002, the Fed has initiated no enforcement actions for violations of this provision of Regulation Z.²⁹

IV

The Fed's antiflipping provision may lead to gains in social welfare, but only if the subprime market is actively policed for the kinds of abuses that history shows predatory lenders are willing to inflict. As I have argued, there are strong reasons to suspect that such "active policing" may fail to occur, in which case policymakers will have to think carefully about the next steps in the predatory lending battle. In the meantime, we can only hope that the Fed embraces its prosecutorial grant and protects the interests of those dependent on the HOEPA-Regulation Z safeguards.

—Michael J. Pyle

27. See Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1341 (2002).

28. Telephone Interview with Patricia A. McCoy, Visiting Professor of Law, University of Connecticut School of Law (Nov. 26, 2002).

29. Telephone Interview with David Stein, Attorney, Federal Reserve Board of Governors (Mar. 6, 2003).