



**SHADOW
FINANCIAL
REGULATORY
COMMITTEE**

COMMITTEE MEMBERS

GEORGE G. KAUFMAN
Co-Chair
Loyola University Chicago

ROBERT E. LITAN
Co-Chair
Brookings Institution

GEORGE J. BENSTON
Emory University

CHARLES W. CALOMIRIS
Columbia University

FRANKLIN R. EDWARDS
Columbia University

SCOTT E. HARRINGTON
University of South Carolina

RICHARD J. HERRING
University of Pennsylvania

PAUL M. HORVITZ
University of Houston

ROBERTA ROMANO
Yale Law School

HAL S. SCOTT
Harvard Law School

KENNETH E. SCOTT
Stanford University

PETER J. WALLISON
American Enterprise Institute

Administrative Office
c/o Professor George Kaufman
Loyola University Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
Tel: (312) 915-7075
Fax: (312) 915-8508
E-mail: gkaufma@luc.edu

Statement No. 173

For information contact:

Charles W. Calomiris
212-854-8748
Robert E. Litan
202-797-6120

Statement of the Shadow Financial Regulatory Committee

On

Predatory Lending

December 3, 2001

The Federal Reserve is in the process of drafting detailed regulations dealing with alleged problems of so-called "predatory lending" in the subprime mortgage market, and the Congress is considering actions to curb various alleged abuses in this type of lending.

Predatory practices include a broad range of activities in the marketplace for credit. The common denominator of the prospective Fed rules and various Congressional proposals is the desire to protect "vulnerable" borrowers from being tricked into paying exorbitant costs or inadvertently incurring large probabilities of losing their homes. In particular, the desire to prevent "flipping" (deceptive sales practices that entice borrowers to refinance mortgages on unfavorable terms) has been emphasized as a primary motivation for new Fed rules. Another set of criticisms has revolved around single-premium credit life insurance. Critics argue that borrowers are tricked into believing that this type of insurance is cheaper than alternative monthly insurance through deceptive explanations of the amortization of the cost of the insurance.

Because much of what is classified as predatory lending involves loans to low-income, minority, and higher-risk borrowers, a central principle that should guide legislation and regulation in this area is the desirability of preserving access to subprime mortgage credit for such borrowers, who are most at risk of losing access to this market in the wake of misguided and punitive regulations. The democratization of consumer finance that has occurred over the past decade has created new opportunities for low-income consumers. This is now threatened by

An independent committee
sponsored by the
American Enterprise Institute

<http://www.aei.org>

chilling effects that inappropriate regulations and laws might have on the supply of subprime credit to these consumers. If this source of financing is denied to them when legitimate lenders leave the market, low-income consumers will be forced either to pay higher prices for goods they buy on time, borrow at more onerous terms and under harsh collection conditions from illegal lenders, or do without.

Subprime credit to low-income consumers necessarily entails higher interest rates. As recent evidence of increasing loan defaults demonstrates, this line of business is risky, and institutions will only be willing to provide such credit if interest rates are sufficiently high relative to risks and other costs of servicing consumers. One of the risks that must be borne by intermediaries is regulatory risk. Laws or regulations that place lenders at greater risk of legal liability for having entered into a loan agreement (for example, state and municipal statutes that penalize refinancings that could be deemed contrary to the interests of the borrower) generally will reduce the supply of beneficial lending as well as predatory lending. Illegal lending, however, would not be reduced; indeed, it would be encouraged.

As the Fed contemplates new rules to limit flipping and other abuses it should be careful to minimize the chilling effects on loan supply. This is difficult to do because mortgage contracts are complex and borrowers' loan needs vary. Mortgage loan contracts have multiple dimensions: the interest rate, maturity, loan amount, points, prepayment penalties, and monthly payments are the most important characteristics of the mortgage contract. Different borrowers prefer different combinations of these elements, and a change in terms that would be favorable for borrowers on some dimensions and unfavorable on other dimensions will be preferred by some and not by others. For example, a borrower expecting to pay off a loan quickly would be less willing to choose higher points or greater prepayment penalties, and would be willing to pay a higher interest rate to avoid those contractual features. The optimal combination of contractual terms is a matter of subjective preference for each borrower.

The Fed's proposed flipping rule would hold lenders liable if a refinancing is judged as not having been in the interest of the borrower. Some refinancings can be judged to be clearly in the interest of borrowers (for example, a reduction in rate, lengthening of maturity, increase in loan amount and reduction of prepayment penalties would be an unambiguous improvement for the borrower), but many desirable refinancings entail tradeoffs where some elements improve but others worsen. It is impossible to establish an objective standard that could rank these "mixed" refinancings and determine when a refinancing worsens or improves borrower welfare.

The Committee believes that existing laws against unfair trade practices and fraud, if effectively enforced, are sufficient to deal with the problem of flipping and other predatory practices. The worst way to combat flipping would be the enactment of a vague regulation requiring refinancings to improve borrower welfare without specifying criteria for measuring borrower welfare. That approach would create new regulatory risk for lenders, which would make them less willing to engage in all "mixed" refinancings.

If the Fed is going to regulate refinancings, it should minimize the chilling effect of regulation by prescribing specific limitations. That is, the Fed should clearly state objective criteria that would give "safe harbor" to lenders against future claims of flipping. Such

clear criteria would allow financial institutions to identify clearly the conditions under which they should deny loans to customers, and thus avoid cutting off other loan refinancings as the result of the regulatory risk produced by vague regulatory requirements that lenders act in the borrower's interest.

A similar argument about preserving valuable options for borrowers can be made in the case of single-premium credit life insurance. Some (including sponsors of a Senate bill on predatory lending last year) have called for the abolition of single-premium insurance. It is alleged that borrowers do not understand the true cost of this product because of deceptive comparisons of the monthly costs of single-premium and monthly-premium products. This criticism may have merit, but the answer is not to prohibit single-premium insurance. Credit life insurance serves a valuable function for borrowers. Critics of single-premium insurance argue that monthly insurance is cheaper and that therefore there is no reason to permit single-premium insurance to be offered. But this argument neglects an important consideration: under the structure of existing state laws that place a ceiling on the premia for both kinds of credit life insurance, lower-cost monthly insurance may not be an accessible substitute for borrowers because of inadequate supply. A better approach to dealing with specific objections to single-premium marketing practices, and with other predatory practices, would be a combination of disclosure requirements, subsidies for credit counseling, and narrowly targeted regulation. In the case of single-premium insurance, limits on the financing of single-premium payments (such as requiring amortization of the premium over the period during which the insurance is in force) would substantially mitigate potential confusion about the true cost of insurance.

George Kaufman has recused himself from this statement.

