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**Federal Regulation of Consumer Credit:  
The Cause or the Cure for Predatory Lending?**

**Margot Saunders and Alys Cohen**

**BABC 04-21**

**March 2004**

Graduate School  
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H A R V A R D   U N I V E R S I T Y

**Joint Center for Housing Studies**

**Harvard University**

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The Cause or the Cure for Predatory Lending?**

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## Summary of Paper

Federal law has long been a primary source of important individual rights, from voting and other civil rights to workplace safety. State law, however, has traditionally provided most protections for consumers in the marketplace. Instead of leading the way on consumer protections, federal law – with the important exception of the Consumer Credit Protection Act<sup>1</sup> – has unfortunately degraded the traditional protection of consumers through state law and has created and supported the advance of predatory lending in this nation. These changes can be laid on the doorstep of federal preemption of state consumer credit laws, the expansion of federal banking agency powers, and congressional changes to the tax code.

Since the 1980's, these developments on the federal level have been sending two erroneous messages: 1) that deregulation of consumer credit is the optimal policy; and 2) that sound personal financial planning requires the use of home equity to secure consumer credit. In fact, both of these messages are wrong, and have been a significant – if not the primary – cause for the escalation of the predatory lending problem which is steam rolling through communities across America. While abusive and fraudulent credit scams have always been a problem in a commercially oriented culture, the problems in the past 15 years caused by the explosion of predatory lending are new in the history of personal credit.

Consumers are weighed down with too much debt, and the wrong kind of debt, in the forms of unsecured credit cards, high-cost auto loans, payday lending, rent-to-own transactions, and – the most expensive and damaging variation on dangerous credit – predatory mortgage lending. The continued escalation of bankruptcy filings,<sup>2</sup> and the continued depletion of savings and increase in personal debt are indicative of a credit system gone awry.

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<sup>1</sup> The Federal Consumer Protection Act include *inter alia*:

1) The Truth in Lending Act, 15 U.S.C. § 1601, et seq., simply mandating a uniform method of disclosing the costs and terms of consumer credit transactions, passed in 1968.

2) The Equal Credit Opportunity Act, 15 U.S.C. § 1691, et seq., prohibiting discrimination in the granting of credit, passed in 1974.

3) The Electronic Fund Transfer Act, 15 U.S.C. § 1693, et seq., providing a structure for electronic transfers of consumer funds, and providing some consumer protections against loss, passed in 1978.

4) The Fair Debt Collection Practices Act, 15 U.S.C. § 1692, establishing consumer protections against over-aggressive debt collectors, passed in 1978.

5) The Fair Credit Reporting Act, 15 U.S.C. § 1681, establishing some standards protecting consumers in the gathering, compiling and delivery of personal information, the first version of which was passed in 1979.

6) The Home Ownership and Equity Protection Act, 15 U.S.C. § 1602(aa) and § 1639, providing some special protections for consumers in high cost mortgages, passed in 1994.

<sup>2</sup> For example, in 2002, a record was set with more than 1.5 million bankruptcy filings during the 12-month period ending June 30<sup>th</sup>, including \$1.47 million personal bankruptcies. Reuters, *U.S. Sees Record Number of*

Credit is no longer considered an important but dangerous tool to be applied carefully to appropriate situations, but is now akin to a necessity. Deregulation has been pursued in order to protect the perceived need for unrestricted credit access, no matter how great the cost. As a result, the rate of increase in foreclosures continues to rise annually, the depletion of home equity continues and the American dream of homeownership – and all of the security, family and community stability that flows from it – is lost forever for millions of American families.

### **States Have Traditionally Provided Consumer Protections**

The states have always been the main source of consumer protections, as well as a laboratory for devising new approaches to such laws.<sup>3</sup> Except for a limited number of important, but non-traditional, consumer protections mostly passed in the 1970s and '80s by the U.S. Congress, the states have traditionally provided all of the safeguards for consumer credit.

It has been recognized for centuries that borrowers and lenders often do not enter credit contracts on equal footing. The absence of equal bargaining power may manifest itself in different ways. Most obviously, a debtor who, for example, has lost his job and has defaulted on his mortgage may agree to almost any terms to obtain new credit and to avoid losing his home. Usury statutes have traditionally been justified as attempts to prevent the exploitation of such a needy borrower by limiting the price that she may be asked to pay for the loan.<sup>4</sup> Yet, modern credit laws often address more subtle effects of unequal borrowing power as well as flagrant

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*Bankruptcies*, Aug. 14, 2002. Unfortunately, even this record does not begin to tell the full story. Household debt is at a record high relative to disposable income. American Bankruptcy Institute, <http://www.abiworld.org/stats/newstatsfront.html>. Moreover, many families are too poor to declare bankruptcy because they are flat broke.

<sup>3</sup> Other than the Federal Consumer Credit Protection Act, only the following federal laws were passed to provide consumers protection:

- 1) The FTC Act, 15 U.S.C. § 45(n), prohibiting unfair or deceptive practices, but with no private enforcement, passed in 1938
- 2) The Magnuson Moss Warranty Act, 15 U.S.C. § 2301 *et seq.*, providing federal protections for consumers in certain warranty situations, passed in 1975.
- 3) The Real Estate Settlement Procedures Act, 12 U.S.C. § 2601 *et seq.*, providing for disclosures and some substantive protections for consumers in home mortgages, passed in 1974.

<sup>4</sup>*See, e.g., Ghirardo v. Antonioli*, 883 P.2d 960 (Cal.1994)(purpose of usury law is “to protect the necessitous, impecunious borrower who is unable to acquire credit from the usual sources and is forced by his economic circumstances to resort to excessively costly funds to meet his financial needs.”); *Jersey Palm-Gross, Inc. v. Paper*, 658 So.2d 531, 534 (Fla.1995)(purpose of usury laws is to “protect borrowers from paying unfair and excessive interest to overreaching creditors”; and “to bind the power of creditors over necessitous debtors and prevent them from extorting harsh and undue terms in the making of loans”); *Trapp v. Hancuh*, 530 N.W.2d 879 (Minn.Ct.App.1995)(purpose of usury laws is “to protect the weak and necessitous from being taken advantage of

exploitation. It is a fact of the modern consumer credit market that creditors, not borrowers, draft loan documents, and that the terms of credit contracts offered to consumers are basically non-negotiable. A potential borrower can “take it or leave it” and go elsewhere, though sometimes the “elsewhere” is not so easy to find. Moreover, the increased complexity of credit makes it difficult for consumers to do any meaningful comparison shopping to determine whether it is best to “leave it” or not. The ubiquity of adhesive credit contracts, combined with the ignorance of almost all consumers about the fine print contained in these contracts, leads to opportunities for the exploitation of borrowers that are just as great as those presented by the classic desperate borrower.

### **Purpose of Usury Laws and Their Progeny**

The lending of money or commodities such as grain in return for interest has been documented as early as 3000 B.C. and, undoubtedly, predates that. From its inception, the practice seems to have caused controversy in many societies. In part, the charging of interest was condemned on moral and religious grounds; it was considered ungodly and uncharitable for one person to profit from the need of another. Yet there were also many concrete grounds for opposing money lending. In hard times, a borrower could lose all his property and be sold into slavery to pay his debts. The evils caused by usury were very real, and moneylending was at times banned outright. In England, it was not until 1545 that Parliament legalized charging interest in the modern sense.<sup>5</sup>

English usury statutes, particularly the Statute of Anne, were adopted by the American colonies prior to independence. Variations on these statutes remain in effect to this day in many states, and are commonly referred to as “general ”usury laws because they purport to set a ceiling for all loans of money or forbearance of debt in a jurisdiction, not just for particular types of lenders or credit transactions. With very few exceptions, general usury laws were the only statutes regulating credit costs in the United States prior to the twentieth century.

Until the latter part of the twentieth century all states had general usury laws prohibiting the lending of money at interest rates greater than a certain number. This changed as the structure

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by lender who can unilaterally establish the terms of the loan transaction ”; distinguishing position of corporations, presumed to be in an equal bargaining position).

<sup>5</sup>37 Hen.8,C.9 See also *Commonwealth v. Donoghue*, 63 S.W.2d 3 (Ky.App. 1933)(discussing the development of English usury law).

of credit statutes became more specific to different purposes, differentiating first between individual and business credit, then based on the purpose for the credit, and finally by the characteristics of the lender providing the consumer credit.<sup>6</sup>

In an effort to limit the reach of loan sharks and to include individual borrowers in a more regulated credit environment, states in the early 20th century created exceptions to the general usury ceilings for small, unsecured loans. These “small loan laws” created a category of regulated personal lending that soon exploded into a host of exceptions to the general usury laws, including the creation of credit unions, industrial banks and mortgage lenders. States also began to regulate previously unrecognized forms of credit, such as installment loans for financing purchases of consumer goods. Although these changes allowed lenders to exceed previous usury ceilings for many types of transactions, they also brought individual borrowers – and their creditors – into the regulated credit market.

Throughout the 20<sup>th</sup> century, state consumer protection statutes adopted several tactics to combat the vulnerability of borrowers in everyday transactions. Many of these laws are unrelated to direct limitations on the interest rate or other charges which a creditor may assess. For example, state credit statutes frequently render unenforceable some particularly one-sided contract clauses such as waivers of a borrower’s legal rights. Disclosure statutes, as another example, attempt to inform consumers about the charges contained in a contract without placing legal limits on what those charges may be. State statutes also play a role in protecting borrowers in everyday credit transactions. Either expressly in special usury statutes or through the judicial interpretation of general usury statutes, there may be limitations on attorneys’ fees, credit insurance premiums, “service charges,” appraisal fees, commitment fees and other charges for services, real or imagined, that a creditor may impose. The most obvious purpose of these limitations on the particular kinds of charges that a creditor may assess is to define what the “interest” charges are that are subject to usury rate ceilings.<sup>7</sup>

While one could describe this scheme as “piecemeal,” it led to relatively comprehensive protection for consumers. For example, states passed laws regarding open-end or “revolving” credit requiring purveyors of credit cards to disclose detailed information to borrowers, such as

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<sup>6</sup>Another factor that led individuals to borrow from loan sharks was the fact that the credit market was generally focused on commercial lending. Personal borrowing was a minor part of the lending industry prior to the 20th century.

transaction histories and finance charges, and limiting interest rates and fees such as late charges and membership costs. In response to expanded use of second mortgages, some states set interest rate ceilings and regulated closing costs, including points and appraisal fees.<sup>8</sup>

Often statutes regulating credit were the result of a dissatisfaction among creditors with the charges allowed by previous judicial decisions or with the uncertainties of the whole judicial process.<sup>9</sup> Another motive for regulating particular credit fees exists in at least some special usury laws;<sup>10</sup> these regulations may attempt to prevent consumers from being nickel-and-dimed to death by miscellaneous fees which, realistically, they are powerless to dispute. This goal is somewhat akin to the purposes of disclosure statutes which force creditors to include various “fees” in the calculation of a disclosed interest rate, except that it is a substantive limitation rather than merely a disclosure. A final purpose of at least some usury statutes is to make consumer debt more easily repayable. For example, a special usury law which granted licensed creditors the right to collect a high interest rate might require that the interest rate be fixed and that it be repayable in equal monthly installments. Such conditions are common in small loan acts, installment loan laws, and retail installment sales acts. State and federal mortgage regulations often required similar repayment terms until mortgage laws were “deregulated” in the early 1980s.

Overall, state regulation took on the difficult task of mediating the everyday issues that arise for consumers in obtaining new credit.<sup>11</sup> Many of these protections, however, have been relegated to the annals of history by federal preemption of state law--and consumers are (literally) paying the price.

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<sup>7</sup>For a full history of the development of consumer credit regulation, see Kathleen E. Keest & Elizabeth Renuart, *The Cost of Credit*, Chapter 2 (2d ed. 2000).

<sup>8</sup>Of course, in ancient times, state protection of borrowers was at its maximum because the charging of interest itself was disfavored. See, e.g., *Exodus* 22:25. This approach, however, may have led to the same kinds of loan sharking that flourished in the less regulated environment of pre-20th century United States.

<sup>9</sup>The influence of the credit industry on the drafting of consumer credit legislation is hard to understate. The industry exerts constant pressure on Congress and state legislatures to loosen or remove whatever restrictions have been placed upon it, either legislatively or judicially. Due to a lack of consumer opposition and the limited understanding that many legislators have of credit legislation, this pressure often bears fruit, and credit regulations are gradually weakened, until some particularly egregious abuse draws public attention and restrictions are reimposed. This cycle of loosening and tightening of consumer credit regulation has been evident through much of the twentieth century; the past twenty years have been only the latest and most costly example for consumers.

<sup>10</sup>A good example is small loan laws, which were traditionally more strict with the purported non-interest charges that a creditor may impose.

<sup>11</sup>States passed laws outlawing unfair and deceptive acts and practices and regulating the foreclosure process, in addition to laws specific to certain types of transactions. For a comprehensive discussion of the regulation of consumer credit, Kathleen E. Keest & Elizabeth Renuart, *The Cost of Credit*, Chapter 2 (2d ed. 2000).

## Federal Laws Removed Essential State Protections

Federal deregulation of consumer credit protection began with the passage of the Depository Institution Deregulation and Monetary Control Act ("DIDMCA")<sup>12</sup> in 1980 and the Alternative Mortgage Transaction Parity Act ("AMTPA")<sup>13</sup> in 1982.<sup>14</sup> DIDMCA specifically removed the usury caps on state interest ceilings for loans secured by first mortgages on homes and preempted state limitations on a lender's ability to assess "points," finance charges, or "other charges."<sup>15</sup> AMTPA removed states' abilities to limit terms on "alternative" mortgages, thus deregulating mortgage terms that had long been seen as dangerous and potentially exploitive of consumers. Negative amortization clauses, variable rate loans (even those that only go up, and never go down), balloon payment provisions, and (until June, 2003) prepayment penalties all could be included in mortgages regardless of state law restrictions, even if they were not explicitly bargained for and provided in exchange for lower interest rates.<sup>16</sup>

Both of these federal laws were passed at a time of record-high interest rates, when lenders were often unable to make market-rate loans because of state usury laws.<sup>17</sup> While the intent of both of these laws was to loosen the effects of state limits on interest rates and loan terms that were temporarily strangling access to credit necessary to achieve homeownership, their effect was far more pervasive. The direct effect of these laws was to preempt state consumer credit protection laws applicable to mortgages, unless states acted within a short time frame to preserve the ability to govern the interest rates for first mortgage loans and the terms for

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<sup>12</sup>Pub. L. No. 960221, 94 Stat. 161 (1980), codified throughout Title 12 of the U.S. Code.

<sup>13</sup>12 U.S.C. §3801.

<sup>14</sup>The National Bank Act, passed in 1864, began the federal regulation of interest rates, setting a ceiling on rates charged by federally chartered banks based on the higher of 1) the interest rate allowed lenders in the state where the bank is located or 2) 1% above the discount rate on 90-day commercial paper in effect at the Federal Reserve Bank in the district where the bank is located. 12 U.S.C. § 85. As discussed below, later interpretations of this statute have resulted in additional deregulation of interest rates. The Home Owners' Loan Act ("HOLA"), a depression-era statute intended to bolster the home loan market during a period of great distress, provides a similar ceiling for savings and loans. 12 U.S.C. § 1463(g).

<sup>15</sup>DIDMCA also extends certain protections of federally chartered banks under the National Bank Act to any federally insured commercial bank, savings and loan, or credit union.

<sup>16</sup>Indeed, the laws of 35 states and the District of Columbia limiting or prohibiting the charging of prepayment penalties on mortgages were preempted explicitly by a 1996 OTS regulation pursuant to AMTPA, 12 C.F.R. § 560.34, for loans made by finance companies and other state housing creditors. After advocates convinced OTS that this regulation was facilitating predatory lending and the bleeding of home equity, OTS rescinded the rule, effective June 2003. 67 Fed. Reg. 60542 (Sept. 26, 2002). See also *National Home Equity Mortgage Association v. Office of Thrift Supervision*, 271 F.Supp.2d 264 (D.D.C. 2003).

<sup>17</sup>The legislative history makes clear that Congress was concerned about the solvency of the savings and loan industry, although concerns about the viability of consumer lending in such an interest rate environment also seem

alternative credit products. Only a small minority of states acted quickly enough to maintain this prerogative.<sup>18</sup> As a result, a panoply of state protections was lost.

Beyond their explicit preemptive effect on state consumer credit law, DIDMCA and AMTPA served as the vehicle for a strong signal from the federal government that deregulation of consumer credit was both necessary and appropriate. The same federal government that had mandated huge changes applicable to all credit-related transactions for the *protection* of consumers under the Consumer Credit Protection Act – as well as the array of other protections for individual rights in the areas of civil rights, health care, access to basic housing and subsistence income – was now saying that the best way to ensure ready access to credit while protecting consumers is to allow market forces to work unencumbered by regulation.

### **The States and Court Joined the Deregulation Bandwagon**

This message provided powerful motivation to state legislatures to cede to the demands of the credit industry's ever-expanding wish list of deregulation. At the time, most states had legal schemes that included both general usury ceilings and special laws focusing on specific types of credit. While most states resisted total deregulation of consumer credit, many did deregulate to a certain extent. Most states raised the interest rate caps so they would not interfere with market-rate lending. Some states adopted usury ceilings that were calibrated with published market rates. A significant number of states, however, repealed their general usury ceilings. This left consumers whose transactions were not covered by one of the specific laws exposed to raw market forces; only contract law served as a protection. The driving force for this deregulation often was competition for jobs in the credit industry with neighboring states who had already deregulated. Thus, states moved from their role as guardians of consumer financial rights to bidders for jobs in the financial services sector.

Moreover, even where a state has retained a usury ceiling, lenders have circumvented that limit by relying on the more lenient approach in their home state. Contemporary interpretations of the National Bank Act, a civil war era statute intended to protect banks from potentially

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to have played a role. See Cathy L. Mansfield, *The Road to Subprime "Hel" was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C.L. Rev. 473, 495 (2000).

<sup>18</sup>The following fourteen states preserved their ability to regulate interest rates for first mortgage loans: Colorado, Georgia, Hawaii, Idaho, Iowa, Kansas, Maine, Massachusetts, Minnesota, Nebraska, Nevada, North Carolina, South Carolina, and Wisconsin. Only six states preserved their ability to regulate alternative mortgage transactions: Arizona, Maine, Massachusetts, New York, South Carolina, and Wisconsin.

onerous state legislation,<sup>19</sup> have allowed national banks and other lenders to export their interest rates between states. This change began in 1978, with the U.S. Supreme Court's decision in *Marquette National Bank of Minneapolis v. First of Omaha Service Corp.*,<sup>20</sup> which gave national banks the right to use their "most favored lender" status from their home state and export it across state lines, preempting the law of the borrower's home state.

Following *Marquette*, there was a string of hotly-contested litigation exploring what constitutes an "interest rate" that can be exported, and what types of lenders can claim this privilege. As a result, loan terms that are regulated only by a lender's home state include late charges, cash advance fees, methods of computing interest, lender commissions or bonuses, closing costs and credit card over-the-limit fees.<sup>21</sup> Although the National Bank Act's provisions explicitly address only national banks (and were drafted in a time of no interstate banking), lenders that can claim the privilege of exporting "interest" from their home state include federally-related lenders that are state-chartered.<sup>22</sup> Federal savings and loans institutions also can export interest rates.<sup>23</sup> The development of this doctrine has allowed lenders to establish themselves in home states with the most lenient consumer credit protections (such as Delaware and South Dakota) and consumers have become subject to loan terms, including those from the exploding credit card industry, from which *their* home state intended to protect them.

### **Deregulation Has Spawned New Forms of Usury and Abusive Lending**

While changes to consumer credit laws began as a response to the inflationary interest rates of the early 1980s, deregulation has developed a following of its own. The ability to extend credit without state interest rate caps or state limits on terms proved immensely profitable for the credit industry, especially once the industry figured out that large segments of the consumer market were not good shoppers. Initially this was discovered after consumers continued borrowing on credit cards at the previously high interest rate levels even after the cost of money

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<sup>19</sup>12 U.S.C. § 85. See footnote 14 for a description of the Act's key provisions.

<sup>20</sup>439 U.S. 299 (1978).

<sup>21</sup>See *Smiley v. Citibank (South Dakota) N.A.*, 517 U.S. 735 (1996); see generally Kathleen E. Keest & Elizabeth Renuart, *The Cost of Credit*, § 3.4.5.2. (2d ed. 2000).

<sup>22</sup>*Greenwood Trust v. Massachusetts*, 971 F.2d 818 (1st Cir. 1992) *cert. denied*, 506 U.S. 1052 (1993) (allowing a Delaware-chartered state bank to export high late charges on its Discover card to Massachusetts, where such fees otherwise would not have been allowed). For a more detailed discussion of this critical issue, see Keest and Renuart, *The Cost of Credit*, §§ 3.4 & 3.5.

<sup>23</sup>*Gavey Properties/762 v. First Fin. Sav. & Loan Ass'n.*, 845 F.2d 519 (5<sup>th</sup> Cir. 1988); *Cappalli v. Nordstrom FSB*, 155 F. Supp. 2d 339 (E.D. Pa. 2001) (applying *Smiley* principles in the HOLA context).

plummeted. Imaginative – and usurious – new types of consumer credit continued to yield huge profits when marketed to the least sophisticated and most desperate borrowers. Deregulation was promoted as appropriate because the disclosures required for consumer credit by the Truth in Lending Act, it was argued, would ensure fair negotiation between the parties. Many state legislatures were persuaded to authorize various exorbitantly-priced credit schemes, starting with rent-to-own transactions and then moving to payday loans and auto pawn transactions, all of which carry effective annual interest rates of several hundred to over one thousand percent.<sup>24</sup>

One of deregulation's most punishing results has been the growth in the 1990's of predatory mortgage lending by the subprime industry. This growth was hastened by an influx of capital from Wall Street. Subprime mortgage-backed securities grew from over \$18 billion issued in 1995 to more than \$134 billion issued in 2002.<sup>25</sup> As with other transactions that comprise the "new usury," federal law – DIDMCA and AMTPA in the case of mortgage lending – has been the precipitating factor in the industry's ability to market exorbitantly priced credit to consumers. The refinancing of low-rate purchase money mortgages with high-rate first mortgage loans has become a serious problem in low- and middle-income communities. Vulnerable homeowners who believe they cannot access mainstream forms of credit have generally been the target of these practices.<sup>26</sup> The terms of these high cost loans are not necessary to protect the lenders against loss; indeed the terms are generally so onerous that they precipitate default and, in many cases, foreclosure.

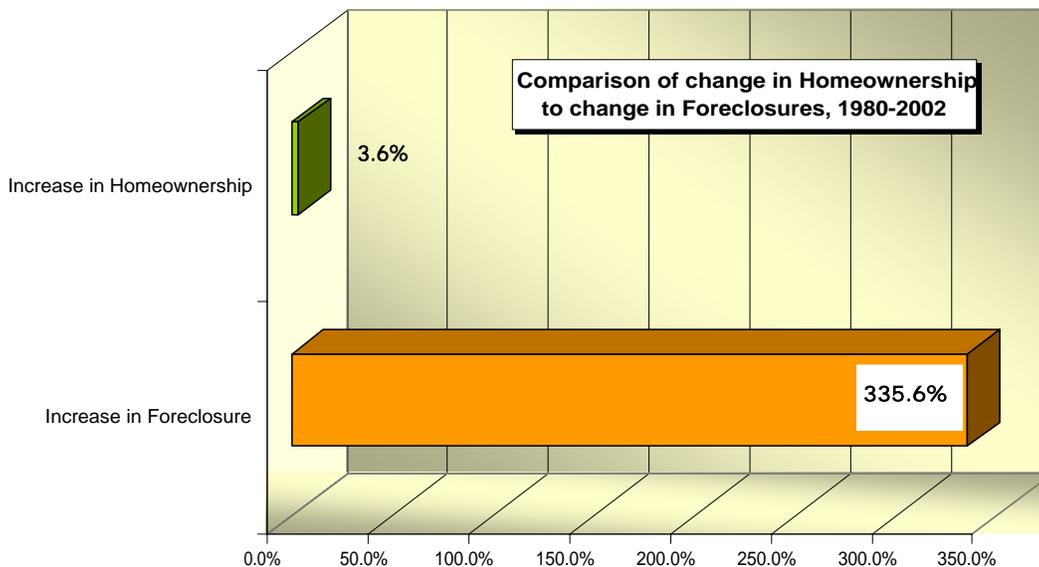
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<sup>24</sup>For the most comprehensive information about the growth and characteristics of this industry, see Lynn Drysdale & Kathleen E. Keest, *The Two-Tiered Consumer Financial Services Marketplace: The Fringe Banking System and its Challenge to Current Thinking About the Socio-Economic Role of Usury Law in Today's Society*, 51 S.C. L. Rev. 589 (2000). See also Jean Ann Fox & Edmund Mierzwinski, *Rent-a-Bank Payday Lending: How Banks Help Payday Lenders Evade State Consumer Protections*, Consumer Federation of America and U.S. PIRG (Nov. 2001); Edmund Mierzwinski & Jean Ann Fox, *Show Me the Money! A Survey of Payday Lenders and Review of Payday Lender Lobbying in State Legislatures*, U.S. PIRG and Consumer Federation of America (Feb. 2000); Jean Ann Fox, *The Growth of Legal Loan Sharking: A Report on the Payday Loan Industry*, Consumer Federation of America (Nov. 1998); Lisa Blaylock Moss, *Modern Day Loan Sharking: Deferred Presentment Transactions and the Need for Regulation*, 51 Ala. L. Rev. 1725 (Summer 2000); Deborah A. Schmedemann, *Time and Money: One State's Regulation of Check-Based Loans*, 27 Wm. Mitchell L. Rev. 973 (2000).

<sup>25</sup>Inside Mortgage Finance Publications, *The 2003 Mortgage Market Statistical Annual (2003)*. For a detailed discussion of loan securitization, see Kurt Eggert, *Held Up In Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 Creighton L. Rev. 503 (2002).

<sup>26</sup>See, e.g., Daniel Immergluck & Marti Wiles, *Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development*, Woodstock Institute (Nov. 1999). There are also concerns that such lending is discriminatory. See National Community Reinvestment Coalition, *The Broken Credit System* (2003), <http://www.ncrc.org/ncrcdiscrimstudy.pdf>.

In 1994, Congress addressed predatory mortgage lending by passing the Home Ownership and Equity Protection Act (“HOEPA”).<sup>27</sup> Unfortunately, HOEPA did not prohibit abusive high-rate mortgage lending. Instead, it singled out certain high-rate mortgage loans and prohibited the use of certain terms for those loans, including prepayment penalties, negative amortizations, and balloon payments on notes of less than five years. The law also restricts improvident lending, where the loan is made based on the availability of the asset rather than the ability of the borrower to repay the loan. Certain additional disclosures are required for high-rate loans. Regrettably, however, the explosion of high-cost credit, loss of equity and foreclosures have continued. HOEPA’s restrictions have not proven effective in addressing the problem of predatory mortgage lending.



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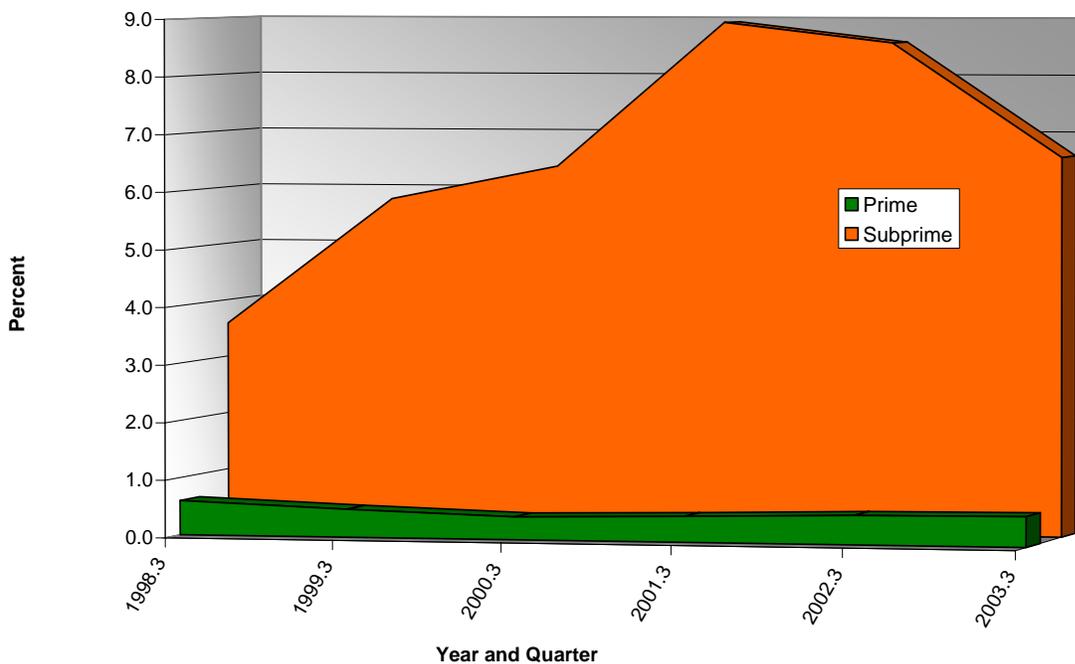
Sources:  
National Delinquency Survey, Mortgage Bankers Assoc. of America;  
and U.S. Census Bureau, Statistical Abstract of the US: 2003,  
Tables 953 & 1184; 2000 Statistical Abstract, Table 814.  
Increase in Foreclosures is per home-owned housing unit.

Foreclosures, a key indicator of the health of the home lending market, are skyrocketing, harming families and their communities. When compared to any other relevant measure –

<sup>27</sup>HOEPA was passed as part of the Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325, 108 Stat. 2160 (Sept. 23, 1994) and is part of the Truth in Lending Act. HOEPA regulations can be found at Reg. Z § 226.32.

increase in homeownership, increase in number of mortgage loans, even the ratio of foreclosures per mortgage – the rate and number of foreclosures is escalating at an alarming pace. As the chart above demonstrates, over the last two decades homeownership has increased by only 3.6%, but foreclosures per home have increased 335.6%. The blame for this dramatic increase in foreclosures can be traced directly to the subprime mortgage market. As of the third quarter of 2003, 6.6% of subprime mortgage loans—approximately one in every 15 loans—were in foreclosure. This stands in stark contrast to the rate for prime loans—.53% for the same period.<sup>28</sup> Indeed, a study of subprime lending in Chicago showed that for every 100 additional subprime loans made on owner-occupied properties in a typical neighborhood, the community suffers from nine additional foreclosures.<sup>29</sup>

**Comparison of Foreclosures in Prime and Subprime Loans**



Source:  
National Delinquency Survey, Mortgage Bankers Assoc. of America

<sup>28</sup>Mortgage Bankers Association, *National Delinquency Survey* (Third Quarter, 2003). Although subprime borrowers often have lower credit scores and thus are more likely to face foreclosure, this difference can not fully be explained by this factor. In fact, for at least some subprime borrowers, the reason they have lower credit scores is exactly because of the terms and conditions of their loans. That is, the loans themselves are the source of the problem.

<sup>29</sup>See *Risky Business—An Econometric Analysis of the Relationship Between Subprime Lending and Neighborhood Foreclosures*, Woodstock Institute, (Mar. 2004).

## **The States Sought to Recover Their Consumer Protection Role**

In the past decade, states have recognized that they are the last bastion of consumer protection for their citizens and have been fighting a desperate battle to preserve their ability both to pass laws governing credit transactions within the states, and to bring enforcement actions against violators of those laws. First, North Carolina faced down the trend of deregulation and passed significant legislation re-regulating mortgage credit.<sup>30</sup> Even the credit industry in that state was convinced that re-regulation was necessary to address the escalation of predatory mortgage lending, and the banking industry participated in the passage of the anti-predatory lending bill.

The North Carolina statute covers more loans than HOEPA and prohibits additional abusive loan terms, including the financing of points and fees and the financing of a prepayment penalty where a borrower is refinancing a loan held by the same lender or an affiliate of that lender. More and more states (including Georgia, New Jersey, California, Illinois, New York, and Kentucky) have since awakened and realized that state legislation was necessary to protect homes and equity. To date, a number of states have passed substantial laws seeking to stem the tide of predatory lending.<sup>31</sup>

Congress, however, continues to pass laws that erode this state authority, including the Reigle-Neal Interstate Banking and Branching Efficiency Act<sup>32</sup>; the Gramm-Leach-Bliley Act,<sup>33</sup> and the Fair and Accurate Credit Transactions Act.<sup>34</sup> Even as federal law continues to diminish state authority, with the exception of HOEPA Congress has not established any consumer credit protections to replace the state rules that are preempted.

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<sup>30</sup>N.C. Gen. Stat. S. 24.1-1E (1999).

<sup>31</sup>As is described by a recent article on state predatory legislation: “New Mexico, New Jersey, New York and North Carolina currently provide the greatest protections for their citizens. Georgia enacted an even stronger law last year, but by March 2003, the legislature had gutted some of its most significant protections after the governor, a strong proponent, lost his election in November. Arkansas, California, the District of Columbia, Illinois, Massachusetts, and Texas are other jurisdictions that regulate abusive mortgage loans, though not to the same degree. In contrast, new laws in Connecticut, Florida, Ohio and Pennsylvania are likely to have little real effect on predatory practices in those states.” Elizabeth Renuart, *Toward One Competitive and Fair Mortgage Market: Suggested Reforms in A Tale of Three Markets Point in the Right Direction*, 82 Tx. L. Rev. 421, 422 (Dec. 2003).

<sup>32</sup>12 U.S.C. § 1831 et seq. (passed in 1994; preempting state limitations on interstate banking and branching).

<sup>33</sup>Pub. L. No. 106-102 (1999), 15 U.S.C. § 6701 et seq. (prohibiting states from preventing or significantly interfering with the ability of an insured depository institution, or its subsidiary or affiliate, from engaging in any insurance sales, solicitations, or cross-marketing).

<sup>34</sup>Pub. L. No. 108-159 (2003) (continuing preemption of certain state laws concerning credit reporting under the Fair Credit Reporting Act and further preempting some state regulation of credit reporting and identity theft).

## Federal Bank Regulators Joined the Race to the Bottom

The resurgence of state consumer protection efforts has led in turn to the credit industry's call for a single, national standard that would provide a ceiling rather than a floor of credit regulation. States would be prohibited from passing legislation that provides more protection for its citizens. Some members of Congress are anxious to assist in a national standard that preempts state laws.<sup>35</sup> However, many lenders have found it unnecessary to wait for Congress to act. They have simply relied on the *protection from regulation* provided by their banking regulators: The Offices of Thrift Supervision<sup>36</sup> and Comptroller of the Currency, as well as the FDIC.

The latest incursion into the traditional regulation of credit and protection of consumers by the states is the present effort by the Office of the Comptroller of the Currency ("OCC") to preempt the application of almost all state credit laws to national banks and their operating subsidiaries.<sup>37</sup> On January 7, 2004, the OCC issued a final rule amending its regulations to do just that. Under the rule, states are preempted from regulating credit terms, interest rates, disclosures and advertising. This preemption would have the effect of disenfranchising the considered approaches to protect consumers adopted by the elected representatives to the legislatures of almost every state in the union.<sup>38</sup>

The OCC justifies the preemption of the particular laws passed by many states to combat predatory mortgage loans by stating that consumers suffer from those state laws because the state laws result in reduced availability of credit. While there is considerable dispute about that assertion, even assuming that it were true, it does not justify the preemption of those laws.

Access to credit is valuable, but it is not always positive. Too much credit, especially when it is of the wrong kind – because it is unaffordable, strips equity or savings, results in the loss of other, more beneficial credit, or leads to the loss of the home – is not good. State legislatures, in passing laws to combat predatory lending, have determined that some credit is not

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<sup>35</sup>See, e.g. HR 833, The Responsible Lending Act," introduced in February, 2003, by Congressman Robert Ney and a number of co-sponsors. This bill would preempt a broad swath of state consumer protections laws governing credit and foreclosures.

<sup>36</sup> The Office of Thrift Supervision issued a regulation in 1996 "occupying the field" of credit regulation and preempting almost all state laws. 12 C.F.R. § 560.1 *et seq.*

<sup>37</sup>The Office of the Comptroller of the Currency issued regulations preempting credit regulation and state enforcement of credit rules, 69 Fed. Reg. 1904 (Jan. 13, 2004)(regarding Bank Activities and Operations; Real Estate Lending and Appraisals), 12 C.F.R. Part 7 & 34 (Final Rule); and 69 Fed. Reg. 1895 (Jan. 13, 2004)(regarding Bank Activities & Operations),12 C.F.R. Part 7(Final Rule).

<sup>38</sup>Although the OCC rule technically applies only to national banks and their operating subsidiaries, historically state chartered banks have sought parity when such federal regulations have been promulgated.

welcome in their state. The assertion that preemption is needed because anti-predatory lending laws lead to the reduced availability of credit misses the point.<sup>39</sup>

### **Tax Code Changes Further Promote Home Equity Debt**

Changes to the federal tax code have exacerbated the problems caused by federal deregulation of consumer credit by shifting more consumers into home equity debt. In 1986, Congress changed the tax code to allow taxpayers to deduct interest for consumer loans only if the loan is secured by the home.<sup>40</sup> This sent a pervasive message to homeowners that borrowing against home equity is sensible economic planning. Unfortunately, this is quite often incorrect, even for middle-income families. When one transfers short term debt into longer term debt, the cost of the additional interest is considerably increased. The effect of paying more interest on the debt, even at a lower rate, and even with the tax benefits applicable to that interest, does not outweigh the cost of paying higher interest for a much shorter term.

Moreover, the tax benefits are completely elusive for low income households. Often, the working poor have no tax liability because of the earned income tax credit, and thus a tax deduction for home-secured debt is of no value whatsoever. Others are paying at the tax system's lowest tax rates.

One consequence of limiting deduction of consumer debts to home equity loans is that many Americans are now paying much *more* interest on consumer debt, albeit generally at a lower rate per year. This is largely due to a lack of understanding and appreciation for the costs of financing debt over an extended period of time. Moreover, because of increases in predatory lending, consumers seeking to leverage their home equity are potentially subjecting themselves to abusive practices that may cost them their homes.

Generally, families are persuaded to pay off car loans, credit cards, and other non-housing related expenses with loans secured by their homes because of the perceived tax savings

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<sup>39</sup>Even Congress, which has been historically supportive of preemption, already has expressed its displeasure with OCC's unilateral actions. The House Financial Services Committee issued a strongly worded criticism of the OCC's rules, apparently concerned that preemption should remain a Congressional—not regulatory—prerogative. See Jathon Sapsford, *Bank Dispute Heats Up*, *Wall St. Jnl.*, Feb. 26, 2004. State officials, seeking to protect their role in safeguarding consumer rights, also have responded strongly. *Statement by Attorney General Elliot Spitzer Regarding Preemption of State Consumer Protection Laws*, Jan. 6, 2004, [http://www.oag.state.ny.us/press/2004/jan/jan07a\\_04.html](http://www.oag.state.ny.us/press/2004/jan/jan07a_04.html) (stating that a bipartisan coalition of attorneys general from all 50 states opposes the OCC's preemption rules).

<sup>40</sup>The Tax Reform Act of 1986, Pub. L. No. 99-514 (1986), *codified at* 26 U.S.C. § 1 et seq., eliminated deductions for consumer interest except for interest paid on the taxpayer's principal and one additional residence.

generated by the deductibility of interest related to home-secured debt. This perception of savings is generally misplaced; while the actual rate of interest is lower, the money is lent for a much greater length of time, resulting in a much higher cost to the homeowner, even after the tax benefits are considered. For example, consider the following example of a car loan refinanced into a home loan:

- *Car loan paid in installments.* A 5-year loan for \$20,000 with an interest rate of 15%, will have a ***total interest expense of \$8,548.***
- *Car loan refinanced into home equity loan.* A 30-year home loan, also for \$20,000, at an 11% interest rate effectively *costs* the homeowner more than four times as much in extra interest – even after counting the tax benefits. Interest charges alone on \$20,000 over 30 years will be \$48,567. Even if tax savings compensate for 30% of the interest expenses, the net cost of financing the car over the life of a home mortgage is still approximately 70% of \$48,567 or ***\$33,997.***<sup>41</sup>

A more serious consequence of the Tax Reform Act of 1986 is the increase in *the loss of equity for American households.* Even as the ratio of debt to savings for American families has risen over the past twenty years, the ratio of home equity debt to other debts has increased at a much greater pace. This change has been characterized by:

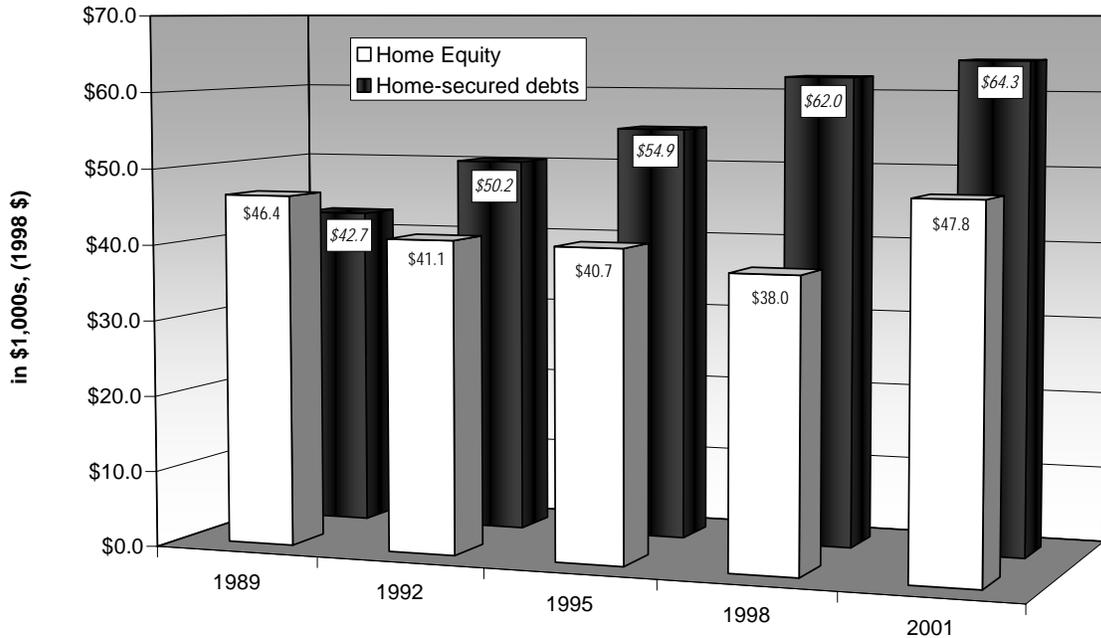
- U.S. families *switching* much of their debt from installment or credit card loans to home secured loans; and
- Significant reductions in home equity savings, a traditional method of building assets for American families.

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<sup>41</sup>Even when the *present value calculations* are applied to both the five-year car loan and the 30-year home loan, the comparison between the interest for the car loan to the total paid in interest *after tax deductions* for the home loan reveals that the 30-year home loan with the lower interest rate and the tax deductions is still almost three times as expensive as the five-year car loan. While consumers have a legitimate right to choose a credit option that works for them, the tradeoffs made when choosing home equity debt are often much greater than any of the paperwork, or marketing, would indicate.

Consider the following chart, which shows the dramatic *increase* in home-secured debt in the past decade, as well as the *decrease* in home equity.

**U.S. Median Value of Home Equity vs. Home-secured Debts, 1989-2001**



Source: Federal Reserve Bulletins, January, 2000 and January, 2003, using data from the Survey of Consumer Finances

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This bleeding of home equity causes a general diminution of the wealth and security of millions for American families.

### **Conclusion**

Federal consumer protection law relating to credit provides important, although minimal, regulation regarding the terms and conditions of most credit. State law regulates the rules of contract, the required terms of credit, the rules governing the ongoing relationship between the parties, the structure for repossession and foreclosure of secured property, and the definition of unfair practices. Federal law does not—and cannot—begin to provide the detailed and explicit rules for the conduct of everyday credit throughout the United States.

The government and the housing and lending industries have done an excellent job in recent years of expanding programs to create homeownership opportunities for low-income

families. The next challenge is to enhance the long-term sustainability of the homeownership experience for these families. The ultimate success of homeownership as an asset-building strategy will be measured by the degree to which new homeowners are able to afford proper maintenance, avoid foreclosures, build equity in their homes, and use their equity effectively as wealth.

Federal regulation *could* substantially protect consumers from predatory lending, if the laws were changed to provide real, enforceable incentives to the credit industry to stop making loans that strip homeowners of their assets and equity and force too many into bankruptcy and foreclosure.<sup>42</sup> However, the federal laws currently on the books do not provide adequate protection. Just the reverse is the case: federal law too often is the excuse for the reduction in essential consumer protections—those established by the states.

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<sup>42</sup>See NCLC's proposals in Margot Saunders, *Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit*, Testimony before the Subcommittee on Housing and Community Opportunity and Subcommittee on Financial Institutions and Consumer Credit (Nov. 5, 2003), [http://www.consumerlaw.org/initiatives/predatory\\_mortgage/content/AccessToCredit.pdf](http://www.consumerlaw.org/initiatives/predatory_mortgage/content/AccessToCredit.pdf).