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# NC's Anti-Predatory Lending Law:
# Doing What It's Supposed To Do:
# A Reply

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## Executive Summary

We reply to criticisms of our recent study about North Carolina's Anti-Predatory Lending Law reducing predatory loan terms and preserving access to credit (*NC's Anti-Predatory Lending Law: Doing What it's Supposed to Do*).

To examine whether the decline in overall subprime lending in North Carolina, following passage of the predatory lending law, was due to a decline in loans with legitimate terms or to a reduction in loans with abusive terms, we examined specific market segments and market practices using loan level data from the Loan Performance Asset Backed Securities (ABS) database. Our study revealed that, although the total volume of subprime originations in North Carolina declined, the number of home purchase loans was unaffected by the law.

Given the robustness of the LP data, we are baffled by the criticism and disappointed by confusion that has arisen over mistaken data interpretation. For reasons discussed in this paper, we stand by our descriptive study and will continue to use LP data in our future work.

**NC's Anti-Predatory Lending Law:  Doing What It's Supposed To Do:  A Reply**

**Michael A. Stegman, Roberto G. Quercia, and Walter R. Davis**

Despite criticisms -- often based on a lack of knowledge about our database  -- by a number of influential people inside the Beltway over the past few months, the study released June 25 by the Center for Community Capitalism at The University of North Carolina clearly shows that North Carolina's Anti-Predatory Lending Law is working as intended by reducing predatory loan terms and preserving access to credit. [1]

Our study asked the essential question that other studies failed to ask: was the decline in overall subprime lending in North Carolina following passage of the predatory lending law due to a decline in loans with legitimate terms, or to a reduction in loans with abusive terms?  To answer this question, we examined specific market segments and market practices using loan level data from the Loan Performance Asset Backed Securities (ABS) database. Studying loans down to their very terms (such as prepayment penalties of a certain length and balloon payments) gave us a strong indication of the frequency of predatory characteristics before and after the law.

Our study revealed that, although the total volume of subprime originations in North Carolina declined, the number of home *purchase* loans was unaffected by the law. While refinance originations did fall, much of the decline was in subprime loans with predatory features, which is what the law intended.  For example, refinance loans containing prepayment penalties of three years or more dropped 72 percent after the law's passage, while rising in neighboring states by as much as 260 percent.  We also found that the total volume of loans to North Carolina borrowers with credit scores below 660, the core of the subprime market, rose in the post-law period by a similar or greater percentage than it did in several neighboring states.

To our surprise, almost all of the criticism levied at our study has surrounded our use of Loan Performance (LP) data for the analysis. Although the name may be new, Loan Performance (formerly Mortgage Information Corp.) is a private company founded 20 years ago to provide mortgage market data and research for banks and other financial institutions. Loan Performance data have been used by OTS, Freddie Mac and Fannie Mae economists in their analysis of mortgage performance for many years.  Moreover, the LP database is the most comprehensive

data available on the subprime mortgage market. In our study, we analyzed 3.3 million securitized loans in all 50 states made by more than 20 lenders that are reported under LP's ABS loan-level database. In terms of market share, the LP data included 42 percent of the entire subprime market in 1998, the starting point for our analysis, and 51 percent in 2002, the endpoint.

Given the robustness of the LP data, we are baffled by the criticism and disappointed by confusion that has arisen over mistaken data interpretation. In August, the authors of an OCC "Working Paper"[2] severely criticized the data in our study, while uncritically accepting the data and findings of the Georgetown Credit Research Center's (CRC) study showing adverse effects of the North Carolina law.[3] The CRC study used a data set that included 1.4 million loans, analyzing just 300,000 of them in four states that were made by nine lender members of the American Financial Services Association (AFSA), an industry trade group that opposes anti-predatory lending laws. Compared to our LP ABS database, CRC's dataset represents a smaller segment of the subprime market, covers substantially fewer lenders, ends before many of the North Carolina law's provisions took effect, and is unavailable to other researchers for independent analysis.

Finally, Robert Litan, Director of AEI-Brookings Joint Center for Regulatory Studies, criticizes our study primarily because all of the subprime loans in the LP ABS database were securitized in the secondary market.[4] However, securitization is typical in the subprime market. *Inside B&C Lending* reports that nearly two thirds of all subprime loans were securitized in 2002. We know of no evidence that suggests the subprime loans lenders choose to securitize are fundamentally different from the non-securitized loans. Moreover, our calculations suggest that most of the loans made by subprime lenders that are members of AFSA - the data source for the CRC study that both Litan and the OCC praise – are also securitized.

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[1] Roberto G. Quercia, Michael A. Stegman, and Walter R. Davis, *The Impact of North Carolina's Anti-Predatory Lending Law: a Descriptive Assessment*, Center for Community Capitalism, University of North Carolina at Chapel Hill, June 25, 2003

[2] Comptroller of the Currency, *Economic Issues in Predatory Lending, OCC Working Paper*, July 30, 2003

[3] Gregory Elliehausen and Michael Staten, *Regulation of Subprime Mortgage Products: An Analysis of North Carolina's Predatory Lending Law,* Georgetown University, McDonough School of Business, Credit Research Center, November, 2002.

[4] Robert E. Litan, *North Carolina Predatory Lending Law: Still a Problem Despite New Study,* Joint Center AEI-Brookings Joint Center for Regulatory Studies, Regulatory Analysis 03-9, September 2003. Available at: http://www.aei-brookings.org/publications/abstract.php?pid=380

Litan also implies that the Home Mortgage Disclosure Act (HMDA) database is more suitable for predatory lending studies than our LP data because it "includes all mortgage lenders." While HMDA may be the database of choice for broader studies of the mortgage market, it leaves much to be desired when it comes to analyzing subprime and predatory lending. This is because of the way that HUD identifies subprime lenders. HUD designates lenders as being either subprime or manufactured housing lenders if at least half of their total originations are either subprime or manufactured housing loans.

Since the HMDA database contains no field designating an individual loan application as being either prime or subprime, by convention, 100 percent of all loan applications for a HUD-identified subprime lender are tallied as subprime, even if just 51 percent of the lender's applications were actually for subprime loans. Conversely, none of the applications for subprime loans submitted to prime lenders whose subprime lending activities accounts for less than half their total business are identifiable in HMDA as subprime loans. Because it both under-states and over-states the subprime lending activities of different lenders with no way of estimating whether the errors offset, and contains fewer loan-level variables of interest to predatory lending researchers, we don't share Litan's enthusiasm for HMDA as a subprime database of choice.

Litan also criticizes our LP database for containing too many Alt-A loans, which he argues are not risky enough to be classified as subprime mortgages. Although we disagree with him on substantive grounds, if Alt-As are really a problem, we wonder why he does not raise this problem with respect to the AFSA and HMDA databases. With regard to the LP ABS database, just 7 percent of all NC originations between 1998 and 2002 are Alt-A, including less than one percent of all 2002 loan originations. Because Alt-As, relative to prime loans, carry additional risk for lenders--due to higher LTV or payment to income ratios, low- or limited- documentation of borrower income, unstable income, or some combination of these features--our decision to include Alt-As in our subprime database is justified. Nevertheless, to test Litan's proposition that including Alt-A loans in our database somehow biased our results, we removed them, and then replicated the analysis in our study, and confirmed our original findings.

But we do agree with Litan's larger point that the mix of loans and lenders included in the several databases researchers use to assess the impacts of predatory lending laws can affect analysis outcomes. This is why we have taken pains to look at changes in specific loan features, and to disclose the composition of our LP data. This is also why it is important that our critics

turn their attention with equal vigor to the databases used in studies that claim the NC law had adverse impacts.

Litan also believes that our pre- and post-law analysis is unreliable because the market share of all subprime originations contained in the LP ABS database grew more rapidly than total originations over our study period.[5] We disagree. First, our conclusions are based as much on comparisons between North Carolina and neighboring states as they are on changes in the volume of originations over time, and there is no reason to believe that LP's relative coverage of North Carolina differs from that of neighboring states over time. Moreover, the fact that our database represents a growing share of all subprime originations means that for most of our analyses, we may be underestimating rather than overstating the law's positive impacts. Take, for example, our estimate mentioned earlier that post-law refinance originations with extended prepayment penalties declined by 72 percent in NC. Although our post-law database contains a 22 percent larger market share than our pre-law database, the fact that these abusive loans *declined* in NC while *increasing* in neighboring states by 35 to 260 percent, suggests that our estimates of the law's positive impacts are on the conservative side.

Finally, Litan suggests that an "LP *originations* database" is better suited for the kind of studies we are undertaking than our ABS dataset, but to our knowledge, no such database exists. While Loan Performance does license to third parties a *servicing* database that contains broader market coverage than the one we are using, it contains only aggregate data and no loan-level information, which is why it is unsuitable for our purposes.

In conclusion, we stand by our descriptive study that suggests that the North Carolina anti-predatory lending law is doing what it is supposed to do, and we will continue to use LP data in our future work, which includes a forthcoming paper that fully describes the loan-level composition of this important subprime database.

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[5] Although Litan doesn't acknowledge it, but Elliehausen and Staten's AFSA subprime database also expands over their analysis period, from about 8 percent to more than 12 percent of market coverage. This represents a 50 percent increase in relative market share, compared to our 22 percent increase.