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THE IMPACT OF NORTH CAROLINA'S ANTI-PREDATORY LENDING LAW: A DESCRIPTIVE ASSESSMENT

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Abstract

In this study, we examine changes in subprime lending activity before and after the North Carolina Anti-Predatory Lending Law was implemented in 1999 and 2000. Previous studies have noted a decline in overall subprime lending following the law's enactment. We suggest that such a finding is to be expected given that the purpose of the law was to reduce the number of subprime loan originations with predatory or abusive terms. To us, the relevant question is what component(s) of subprime lending declined, and which remained stable or increased after the law was implemented.

Using an analysis database of 3.3 million subprime loans covering 1998-2002, supplied to us under license by the company, Loan Performance, Inc., we find that the reduction in subprime originations observed from 1999 to 2000 is due to a decline in the number of refinance originations, while purchase originations actually increased. Most importantly, we find a large decline in subprime refinance originations with abusive or predatory terms. This is not unexpected since the law's intent was to curtail this type of lending. Overall, we conclude that after the North Carolina predatory lending law was fully implemented, the subprime market behaved essentially as the law intended: There was a reduction in predatory loans but no change in the cost of subprime credit or reduction in access to credit for high-risk borrowers.

Introduction

The 1990s were characterized by the aggressive expansion of credit to populations traditionally considered underserved, including those with limited or impaired credit histories, such as many minorities and recent immigrants. Financial institutions became more active in this so-called subprime area as a result of technological changes, a robust economy, and the need for new markets. Subprime borrowers have benefited from this expansion of credit, and institutions have seen profits increase through growth (Harvey and Nigro 2002).

In fact, subprime mortgage lending grew significantly over a very short period of time. Across the country, the volume of subprime mortgage originations grew from \$35 billion to about \$213 billion in only 8 years (1994-2002) (Mortgage Market Statistical Annual 2003). This increase reflects the growing involvement of secondary market institutions such as Fannie Mae and Freddie Mac in securitizing subprime mortgages. Securitized subprime loans increased from \$11 billion to \$83 billion from 1994 to 1999 (Harvey and Nigro 2002).

Subprime lending serves a wide range of borrowers, from those with minor credit imperfections to those with serious credit problems. In theory, the cost of borrowing increases as the quality of a borrower's credit declines, with the highest fees and rates charged to borrowers with the lowest credit quality. Problems may arise if unscrupulous lenders take advantage of uninformed

borrowers by charging fees and rates not reflective of the risk, by not informing borrowers of their least expensive loan alternatives, and by offering products and services without full disclosure of terms and options.

The term “predatory lending” refers to a set of abusive lending practices concentrated in the subprime sector. These include making unaffordable loans based on the assets of the borrower rather than on the borrower’s ability to repay an obligation; inducing a borrower to refinance a loan, often repeatedly, in order to charge high points and fees on the refinance (“loan flipping”); and engaging in fraud and deception to conceal from an unsuspecting or unsophisticated borrower the true nature of the loan obligation (Gramlich 2000). For service providers, regulators, and legislators, dealing with predatory lending requires a balancing act, because curbing these practices may curtail credit to some borrowers. Some borrowers may be so uncreditworthy that they can only get credit under conditions that are considered predatory. Historically, however, government has acted to curb abusive lending practices even if the regulations limit the flow of certain kinds of credit.

Predatory lending can have a devastating effect on families. Loans made without regard to a borrower’s repayment ability are likely to erode the borrower’s home equity position. This is especially true for minority and low-income families, for whom home equity comprises over 60 percent of their net worth (State of the Nation’s Housing 2002). In addition, most older

homeowners depend on equity to supplement other savings after retirement (Quercia 1997). The importance of home equity for these financially unsophisticated or vulnerable populations makes them potential targets of predatory practices (Carr and Kolluri 2001).

In the absence of direct evidence, and because predatory lending is largely a subset of subprime lending, the potential for abuse can be deduced by observing overall subprime lending patterns and changes over time. For instance, subprime loans are three times more likely in low-income neighborhoods than in high-income neighborhoods and five times more likely in black neighborhoods than in white ones. Furthermore, homeowners in high-income black areas are twice as likely as homeowners in low-income white areas to have subprime loans. Similarly, subprime loans are three times more likely among older borrowers than among younger borrowers (AARP 2003). These figures suggest that the negative impacts of abusive or predatory subprime practices may fall most heavily on those who have less access to prime credit (HUD 2000).

Unfortunately, there is no single, agreed-upon definition of what constitutes predatory lending. Those that exist are largely based on the definition of high-cost loans in the federal Home Ownership and Equity Protection Act (HOEPA) of 1994, which bans certain practices and requires additional disclosures and borrower protections. In 2000, about one percent of all subprime mortgage loans was estimated to fall under HOEPA (Gramlich

2000).¹ By contrast, estimates of predatory lending and actual settlements entered into by large subprime lenders suggest the true incidence may be considerably higher (for example, see Richardson 2003). Since 1994, several states and local jurisdictions have enacted HOEPA-like regulations and ordinances, so that high-cost or predatory loans have come to be defined as loans featuring one or more specified terms and underwriting practices, including exorbitant points and fees, balloon payments, prepayment penalties, loan flipping, as well as not requiring adequate documentation of repayment ability, and including interest rates on real estate-secured loans in and above the credit card range.

Critics have questioned whether legislative efforts to curb predatory practices would also increase the cost of serving particular segments of the market, reduce the supply of mortgage credit and raise the cost of borrowing (Elliehausen and Staten 2002 and 2003). Because North Carolina was the first state to enact anti-predatory legislation, its 1999 Anti-Predatory Law has received a great deal of attention. Examinations of the law's impact to date have had varied results.

This study is the first in a series to be prepared by the Center for Community Capitalism, a research center based in the Kenan Institute of Private Enterprise in the University of North Carolina at Chapel Hill, on the

¹ In 2002, revisions to Regulation Z (Truth in Lending act) expanded the definition of high-cost loans under HOEPA.

impacts of the North Carolina law and other issues related to subprime lending; all of which are to be supported by a database of subprime loans licensed to us by the company, Loan Performance, Inc.

This initial paper is entirely descriptive. We begin by enumerating the characteristics of the North Carolina Anti-Predatory Law and reviewing the literature to assess what is known of its impacts. Next, we describe the methodology and data used in this study; we introduce the Loan Performance database and compare subprime lending activities in the U.S., in selected Southern states, including North Carolina, and in the rest of the South. We examine changes in the number of subprime loans, both purchase and refinance, before and after implementation of the North Carolina law. We also examine changes in two measures that capture basic concerns about such laws: access to credit and the cost of credit for subprime borrowers. Next, we examine changes in subprime refinance originations with characteristics considered abusive or predatory.

Prior work on the impacts of the North Carolina law has focused on the overall subprime market. In contrast, the focus of our work is more properly on the impact of the law on specific market segments and on the supply of subprime credit with abusive or predatory features. In the final section, we discuss the directions for our future research.

The North Carolina Anti-Predatory Law: What Do We Know?

Enacted in 1999, North Carolina's Anti-Predatory Lending Law prohibits certain types of lending activities that are considered to be detrimental to consumers.² See Exhibit 1 for key characteristics of the law.

The law was enacted in two phases. In the fourth quarter of 1999, three elements of the law took effect. First, prepayment penalties were banned for loans up to \$150,000. Second, permissible classes of fees were defined for loans secured by real property and for fees to be paid to third parties in association with the loan. Finally, consumer home loan refinancing transactions were prohibited where they failed to provide a borrower with a *reasonable, tangible net benefit* (the “no flipping” provision). The remaining requirements of the law took effect on July 1, 2000.

We have identified five studies that have examined the impacts of the NC law to varying degrees. The first, conducted by the trade publication, *Inside B&C Lending* (2001), reviewed rate sheets of several top subprime lenders to assess the range of products and prices offered in NC after enactment of the law. This study finds that subprime lenders in North Carolina were continuing to offer a full array of products and that there was little or no variation in rates charged. Moreover, while some companies opted to leave the

² (S.B.1149, codified at NCGS 24-1.1E, 24-10.2; effective 7/1/00) (S.B.1149, codified at NCGS 24-1.1E, 24-10.2; effective 7/1/00).

market, the study concludes it was not clear what role, if any, the predatory lending law played in those decisions.

Elliehausen and Staten (2002 and 2003) used loan-level data from nine members of the American Financial Services Association (AFSA) to compare subprime lending originations in North Carolina to those in Virginia, South Carolina, and Tennessee. The authors find that the North Carolina law resulted in a decline in overall subprime originations and in originations to low-income borrowers (\leq \$50,000 income) in North Carolina relative to the other two states.

Ernst, Farris, and Stein (2002) examined the volume of subprime originations before and after enactment of the law using Home Mortgage Disclosure Act (HMDA) data to compare 1999 and 2000 subprime originations for North Carolina with the rest of the nation. They find that there was an overall decline in the subprime market in North Carolina between those two dates, but that North Carolina was still among the most active subprime origination markets in the nation. They also found that despite the overall decline in subprime lending in North Carolina, the percentage of all subprime originations to lower-income borrowers remained unchanged. On the basis of this finding, the authors conclude that the overall decline was not just in the lower-income portion of the market but was distributed across the income spectrum. They also calculate that the law saved an estimated \$100 million for North Carolina borrowers over the study period.

Morgan Stanley (2002) surveyed 280 subprime branch managers to assess the impact of predatory lending laws on lending activity across the country, and found that subprime residential lending volumes were not reduced in any significant way. The report specifically finds that “Even the toughest new laws, in states like North Carolina for example, do not seem to be affecting branch volumes” (Morgan Stanley: 2).

Finally, Harvey and Nigro (2002) examined loan application and denial rates in North Carolina and neighboring states using 1998-2000 HMDA data. They find that the law reduced the overall level of subprime mortgage lending activity in North Carolina relative to Virginia, Tennessee, South Carolina, and Georgia. However, they also report that the North Carolina decline was caused by a change in subprime loan application rates, not a change in denial rates. This suggests that the decline is a result of less demand rather than reduced supply.

Methodology and Data

As described above, all of the prior studies on the North Carolina Anti-Predatory Law focus on the impacts of the law on the overall subprime market. In contrast, we think the focus should properly be on the impacts of the law on market segments and market practices targeted by the law; in other words, on the law's impacts on the incidence of loans with predatory or potentially predatory characteristics. Thus, if the law has its intended effects, we would

expect to find a decrease in subprime refinance originations, since most predatory loans are refinances, but not in purchase originations. We would also expect to find a decrease in refinance loans with abusive or predatory features, such as long-term prepayment penalties, balloon payments, and loans with combined loan-to-value ratios (LTV) for second lien refinances over 110 percent. We use the latter as a proxy for loans that do not reasonably offer tangible net benefits to borrowers.³

Our analysis is based on loan-level information for 3.3 million securitized subprime loans originated from 1998 through 2002. As indicated earlier, the data were supplied under license by Loan Performance, Inc. (formerly Mortgage Information Corporation), a private company founded 20 years ago to provide mortgage market research for regional banks. Over the years, Loan Performance developed a system to track the performance of agency and non-agency loans and securities and in 1997 started tracking subprime loans. The data for the analysis come from the company's Asset Based Securities (ABS) loan-level database.

³ Repeated refinancing of first mortgages with financed loan fees secured by second liens is common to loan flipping practices, and are likely to result in high combined loan-to-value ratios in the range of 110 percent or more. That very high combined loan-to-value (LTV) ratios are indicative of abusive lending practices is suggested in, among others, a recent report from the Washington State Department of Banking, where the state regulator criticized one subprime lender for "steering borrowers into larger first mortgages" and "situations where the borrowers were required to take out a second mortgage primarily to pay points on the first mortgage...." (Washington 2002). The NC law aims to reduce this predatory practice through its prohibition on originating refinance loans that do not provide the borrower a net tangible benefit. High combined LTV ratios also serve as a deterrent to prepayment, locking a borrower into high interest rate loans by making it economically infeasible for a responsible lender to offer a refinance loan (Washington 2003).

The Loan Performance (LP) database represents a significant share of the overall subprime market, ranging from approximately 41.6 percent in 1998 to about 51 percent in 2002 (see Table 1) (Mortgage Market Statistical Annual 2003). There is an overlap between the LP database and HMDA, although we cannot define it with full certainty. Many ABS lenders and issuers that report data to Loan Performance also report data under HMDA, including eight issuers on HUD's list of subprime lenders (HUD 2001) and a major lender active in both the prime and subprime mortgage markets. Ten of the top 25 ABS home equity issuers for 2002 report to LP (Koren 2003).

Relative to Ellichausen and Staten's database of about 300,000 subprime originations from nine AFSA members in 1998 (2002 and 2003), our LP database for the same year is twice as big, containing approximately 640,000 loans, and 3.3 million subprime loans for the overall study period, that ranges from Q1 1998 through Q3 2002.

Changes in the Subprime Market from 1998 through 2002

In this section, we examine overall trends in the subprime market from 1998 through 2002. First, we examine national trends in subprime originations using LP data and compare them with data from other sources. Second, we examine these trends at the regional level and for North Carolina and selected neighboring states. Third, we examine purchase and refinance subprime activity nationally and then regionally and in the selected states. Next, in the same areas, we examine changes in overall subprime lending, and for purchase

and refinance activity, before and after the North Carolina law was implemented. Finally, we examine two specific concerns that have been raised about the law: its impacts on subprime borrowers' access to credit, and the cost of credit (Elliehausen and Staten 2002, 2003).

In comparing lending activity before and after the North Carolina Anti-Predatory Lending Law was enacted, it should be noted that the law was implemented in two steps that covered a transition period of three-quarters, or nine months. The first phase of the law became effective for loans originated on or after October 1, 1999 (i.e., at the start of the fourth quarter), and the second phase became effective on July 1, 2000 (the start of the 3rd quarter). Because this transition period was a time of uncertainty and adjustment for market participants that had to familiarize themselves with the new law, we do not believe that any short run changes in lending activity that occurred during this time are indicative of any long-term impacts of the law. This is why Tables 5-12 contain origination data going back seven quarters before the NC law was enacted, and seven quarters after the law was fully implemented, ignoring changes in activity that occurred during the 9-month transition period.

Decline in Subprime Originations

Nationally, there was a sharp decline in the total number of subprime loans originated from 1999 to 2000 (see Table 1), from almost \$160 billion in 1999 to about \$138 billion in 2000, a decline of about \$22 billion (14.3 percent). Since then, there has been a steady increase in originations, and they have surpassed the 1999 level (\$213 billion in 2002). The LP database shows

similar declines and increases over time. The main difference is an increase in national subprime lending in the LP database of about 43 percent in 2001, compared with an increase of 25 percent for the same year reported elsewhere. The main reason for this disparity is that the LP database covered a larger proportion of the total subprime market in 2001 than it did in 1999.⁴

Subprime loan originations in the Southern census region, seen in Table 2, follow the same national pattern depicted in Table 1.⁵ When the data are disaggregated, North Carolina and each of its neighboring states follow the same pattern observed nationally, with declines in all areas. From 1999 to 2000 subprime originations in North Carolina declined by 24 percent, in South Carolina by 18 percent, and in Virginia, by 17 percent. Tennessee, Georgia, and the rest of the South also experienced declines in subprime originations on a smaller scale.⁶

Although North Carolina experienced a somewhat greater decline in subprime originations from 1999 to 2000, it has also experienced a greater growth in such originations in 2001 and 2002 than the neighboring states of

⁴ If we adjust for the increased market coverage from 1999 to 2000, the growth in the LP database is 25.5%. Similarly, for 1998 to 1999, after adjusting for the increase in market coverage, the LP growth rate is 13.8%.

⁵ In addition to North Carolina, the Southern Census Region includes MD, DE, VA, SC, TN, GA, FL, AL, MS, LA, TX, OK, and AR.

⁶ It should be noted that Georgia's anti-predatory law took effect on the last quarter of 2002. It is possible that there was a big increase in originations in months immediately before the law took effect—originations of loans that would fall under the protection of the new law on 10/1/2002—inflating the 3rd quarter numbers. Because we estimate the 2000 annualized figures in Tables 3 and 5 based on originations for the first three quarters of 2002, we may be overestimating the amount of actual 4th quarter originations in Georgia.

South Carolina and Tennessee. More broadly, the percentage increase in the number of loans originated in North Carolina after 2000 is comparable with that of the rest of the South.

Two general trends can be observed in the number and relative change in subprime purchase and refinance lending, both nationally and regionally (see Tables 3 and 4). First, the 1999-2000 decline in subprime originations was for refinance loans only, not for the market as a whole. Specifically, North Carolina's 2000 growth in the purchase segment is in line with the rest of the South and only slightly smaller than the national trend. Second, since 2000, refinances have grown nationally and in some comparison states but not in North Carolina or in some other Southern states. In contrast, originations of purchase loans show big jumps in North Carolina and some other states but not in others.

Nationally, subprime purchase lending grew consistently from 1998 to 2002, with annual growth rates ranging between 6.7 percent and 13.1 percent (Table 3). From 1999 to 2000, the nation saw subprime purchase loan originations increase by 7.2 percent, while subprime refinances actually declined by more than 17 percent. In contrast, subprime refinances increased nationally in 2001 and 2002.

We find in North Carolina overall patterns similar to those for the country as a whole, in the South, and in other selected Southern states (Table

4). With regard to these overall trends in subprime lending, there seems to be nothing unique about North Carolina. Like the national trend, the number of subprime purchase originations in North Carolina from 1999 to 2000 did not decline. In fact, the number of subprime purchase loans grew steadily from 1998 to 2002, with a growth of more than 35 percent in 2001.

As before, subprime refinance activity declined from 1999 to 2000 throughout the South: in North Carolina, by 26 percent; in Virginia by almost 25 percent; in Georgia by 16 percent; in Tennessee by 14 percent; in South Carolina by 12 percent; and by about 13 percent in the rest of the region.

Lending Activity Before and After Implementation of the Law

Our research shows that in all geographies, the declines over time in subprime lending were due to drops in refinance activity and not in purchase lending originations. We explore this in more detail by examining changes in subprime lending before and after the North Carolina Anti-Predatory Lending Law was fully implemented. We examine trends for both purchase and refinance loans. If no declines are observed in purchase activity after implementation, we can infer that the North Carolina law is not keeping people from becoming homeowners by constraining the flow of subprime credit.

With the exception of Virginia and Georgia, subprime originations declined between pre and post implementation in North Carolina as well as in other neighboring states, the rest of the South, and the U.S. as a whole (see

Table 5). In North Carolina, however, where subprime originations declined by almost 5,300 loans, the relative decline was much greater than in other areas—17 percent compared with 8.2 percent or lower.

Looking at subprime refinance loans only before and after implementation of the law (Table 6), we find a decline of 20 percent in North Carolina with declines of 9 percent in South Carolina, 7 percent in Tennessee, and about 3 percent overall in the United States. During the same period, Virginia experienced no change in refinance originations while Georgia had a 10 percent increase. The more detailed analysis presented below indicates that North Carolina's decline in subprime refinance lending is largely in loans with characteristics that could be considered abusive or predatory.

When we examine the number and relative change in subprime purchase first lien loans before and after implementation (Table 7), we find that originations increased by 43 percent in North Carolina, with comparable increases in Virginia (44 percent) and Tennessee (39 percent). Georgia, the rest of the South, and the U.S. as a whole, experienced slower growth in this sector.

We conclude from this that the law does not limit access to subprime credit for North Carolina homebuyers, an issue that is examined in more detail below.

Effect of Predatory Lending Law on Credit

In this section, we examine two criticisms about predatory lending laws such as the one in North Carolina: that they will likely restrict access to credit for high-risk borrowers and increase the cost of credit because of lenders' unwillingness to serve this market (Elliehausen and Staten 2002 and 2003).

Access to Credit for High-Risk Borrowers

Concerns have been raised about the potential of the North Carolina law to curtail access to credit for high-risk borrowers. Elliehausen and Staten (2002 and 2003), using low income as a proxy for high-risk borrowers, find a decrease in the number of subprime loans to borrowers in North Carolina with incomes at or below \$50,000.

There is a growing consensus among researchers in the field that the best measure of credit risk or creditworthiness is a borrower's credit score rather than income (Roche 2000), with a score below 580 considered to be a strong indication of high risk for default.⁷

Significantly, the North Carolina data show that loans to borrowers with credit scores below 580 have actually increased by almost one-third since the law was fully implemented (Table 8). This growth is consistent with that in neighboring states (except Tennessee), suggesting that changes in North

⁷ Borrowers with credit scores below 580 are generally considered B- and C- quality borrowers (Calomiris and Mason 1999, p. 27)

Carolina's regulatory environment have had no detrimental impact on the supply of subprime credit to these high-risk borrowers.⁸

At the same time, we also find a relative decrease in the number of originations to borrowers with credit scores at or above 660 (Table 9). Although we are unable to determine the actual reason for this decline due to limitations of the LP database, such a decline is consistent with the proposition that the NC law may have curtailed the extent of steering creditworthy borrowers--whose credit scores are high enough to qualify for lower cost, prime loans--to the subprime market.⁹

The Cost of Credit after Implementation of the NC Law

Concerns have also been raised that predatory lending laws will increase the cost of credit for subprime borrowers. Ellicheusen and Staten (2002 and 2003) report that North Carolina's regulation has reduced the flow

⁸ A word of caution is warranted. Some proportion of the increase is due to two factors. First, there was an increase in the coverage of the LP data, from 41 percent to 50 percent of the total subprime market over the study period. Second, there was an improvement in data reporting in LP. The percentage of records with missing FICO scores was reduced by more than half between 1998 and 2001. It is possible that lower credit scores are over-represented among the missing data. However, there's no reason to think those two factors would have a greater impact on North Carolina than in other Southern states. Thus, the conclusion that the experience in North Carolina has been similar to that of other states is still warranted.

⁹For instance, in 2000, Fannie Mae clarified its policies to minimize the potential steering of creditworthy borrowers to subprime products, and one would expect that borrowers with credit scores of 660 or higher would be among those referred to here. "For loans delivered to Fannie Mae, the company expects that lenders will have determined the borrower's ability and willingness to repay the mortgage debt regardless of the underwriting method the lender uses. In addition, lenders should have practices and procedures to offer mortgage applicants the full range of products for which they qualify, and should specifically avoid the steering of borrowers to high-cost products that are designed for less creditworthy borrowers if the applicants can qualify for lower-cost products. Similarly, consumers who seek financing through a lender's higher-priced subprime lending channel should be offered (or directed toward) the lender's standard mortgage product line if they are able to qualify for one of the standard products" (Raines 2000).

of subprime capital into the state. We do not agree. If the decline in overall originations had been due to lower capital flows, interest rates would be expected to rise in North Carolina relative to other states without predatory lending laws. If, however, the decline in subprime capital flows were demand-induced (i.e., the result of fewer subprime loan applications) interest rates would not be expected to rise. We examine this issue by comparing changes in the mean origination interest rates before and after implementation of the law, and discern no unique pattern in North Carolina compared with other states and the nation as a whole (Table 10). In fact, interest rates in North Carolina increased by 33 basis points (.33 of 1 percent) over the study period, which is below the corresponding national figure of 40 basis points.

Declines in Subprime Refinance Originations with Predatory Terms

As the earlier analysis indicates, after the law was implemented, North Carolina experienced a sharper decrease in subprime lending than neighboring states, with most of this decline concentrated in the refinance market. This pattern may be consistent with the intent of the law, because the refinance sector of the subprime market is generally more associated with abusive and predatory practices than other sectors.

We explore changes in the number of subprime refinance originations for loans containing at least one characteristic considered abusive or associated with predatory lending: prepayment penalty terms of 3 years or greater (Table 11), balloon payments (Table 12), and loan-to-value ratios of 110 percent or

greater (Table 13). As suggested earlier, the latter is a proxy for loans with no “net tangible benefit” to borrowers. We expect originations of refinance loans with these abusive characteristics to have declined relatively more in North Carolina after the implementation of the law.

From the pre- to the post-law period, the number of refinance loans with prepayment penalty terms of three years or greater increased everywhere except in North Carolina (Table 11). There the number of such loans declined by 72 percent, a reduction of over 2,800 loans. In comparison, the number of such loans increased elsewhere, from a low of 35 percent in Georgia and the United States as a whole to a high of 260 percent in South Carolina.¹⁰

Looking at the number of subprime refinance loans with balloon payments originated before and after implementation, we find a decline of 53 percent, or over 1,600 loans, in North Carolina, although the contrast with neighboring states is not as clear as in the prior finding (Table 12). There were significant decreases in the number of these loans in two other states (South Carolina and Tennessee) and smaller decreases nationally and in the rest of the South. Only Virginia had an increase.

¹⁰ We should mention, though, that South Carolina still has a very low incidence of originations with long pre-payment penalties. For example, prior to the NC law, only 5 percent of South Carolina's subprime originations had a 3-year or greater prepayment penalty. After the law, 16.6 percent of South Carolina originations had such penalties-- this compares favorably to a national average of 45.8 percent (and to VA, TN, and GA all with over 60 percent).

The number of refinance loans originated with a combined LTV equal to or greater than 110 percent pre- and post-implementation decreased by 35 percent, or about 650 loans, in North Carolina (Table 13). Half of the other study areas experienced an increase, while the others had declines much smaller in magnitude than in North Carolina.¹¹

Conclusions

In this study, we examined changes in subprime lending activity before and after the North Carolina Anti-Predatory Lending Law was implemented. Using a database of 3.3 million subprime loans, we find a reduction in subprime originations from 1999 to 2000 due to a decline in the number of refinance originations, not loans for purchase, with most of the decline associated with loans having abusive or predatory terms. Rather than criticizing North Carolina's anti-predatory lending law for curtailing this kind of credit, it should be celebrated. Such a decline is not unexpected, since the law was enacted to curtail this type of lending. Moreover, we find that access to credit for high-risk borrowers and the cost of subprime borrowing in North Carolina have followed patterns similar to those elsewhere. Overall, we conclude that, after the law was fully implemented, the subprime market in North Carolina behaved essentially as the law intended—there was a reduction

¹¹ The findings in Tables 11-13 need to be put in context. This is because of two factors. First, there was an increase in the coverage of the LP database, from 41 percent to 50 percent of the total subprime market, over the study period. Second, there was an improvement in data reporting in LP, such that there is more missing information on loan characteristics in earlier than in later years. However, there is no reason to think these two factors would have a greater impact on North Carolina than in the other states. Moreover, if abusive or predatory characteristics were under-reported in early years, then our pre-post law examination is likely to understate actual declines in the number of loans with these features.

of loans with predatory terms without a restriction in access to or increase in the cost of loans to borrowers with blemished credit.

The analysis indicates an overall reduction of about 5,300 subprime loans pre- and post-implementation. Although we cannot estimate at the moment the precise degree of overlap, the analysis also indicates that this decline is largely due to a decrease in the number of loans with abusive characteristics. These include about 2,800 fewer loans with prepayment penalty terms of three years or more, about 1,600 fewer loans with balloon payments, and about 650 fewer loans with combined loan-to-value ratios over 110 percent. From this perspective, the observed decline cannot be considered undesirable or unanticipated by policymakers.

In closing, the findings from our initial study are strongly suggestive that the North Carolina Predatory Anti-Lending Law is doing what it is supposed to do. However, these findings cannot be considered definitive. In our future research, within a multivariate framework, we will incorporate confounding variables in the analysis (e.g., economic influences) to isolate the impacts of the North Carolina law on subprime lending activities.

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Exhibit 1
Key Features of the North Carolina Anti-Predatory Law

- Prohibits prepayment penalties on first-lien mortgages of less than \$150,000;
- In high-cost home loans, prohibits the financing of fees, balloon payments, negative amortization, and lending without regard to a homeowner's ability to repay, where high-cost was defined generally as loans with fees in excess of 5 percent, or annual percentage rates over federal law trigger level, which is currently more than 8 percent above comparable U.S. Treasury Securities;
- Prohibits lenders from refinancing an existing home loan when there is no reasonable, tangible net benefit to a borrower;
- Prohibits the financing of single premium credit insurance; and
- Requires that would-be borrowers of high-cost loans receive financial counseling before entering into the transaction.

Source: N.C. Session. Law 1999-332, Section 5.

Table 1
 Subprime Loans in the National LP ABS Database
 Number and Volume
 U.S. 1998-2002

Year	Number Of Loans, LP Database	Percentage Change	Total Volume, LP Database (\$billions)	Percentage Change	Total National Subprime Volume (\$billions)	Percentage Change	LP Database as Percent of All Subprime
1998	649,726	--	\$62.4	--	\$150.0	--	41.6%
1999	718,873	10.6%	\$66.2	6.1%	\$160.0	6.7%	41.4%
2000	616,254	-14.3%	\$61.4	-7.3%	\$138.0	-13.8%	44.5%
2001	696,324	13.0%	\$87.6	42.7%	\$173.3	25.6%	50.6%
2002*	769,745	10.5%	\$108.4	23.7%	\$213.0	22.9%	50.9%

* Annualized estimate based on originations for the first three quarters of 2002

Source: Loan Performance database and the 2003 Mortgage Market Statistical Annual, vol. 2

Table 2
Subprime Loans in the LP ABS Database
Number and Volume
Selected Southern States and Remainder of the South, 1998-2002

State	Year	Number Of Loans	Percent Change	Total Volume (\$millions)	Percent Change
North Carolina	1998	16,174	--	\$1,162	--
	1999	19,647	21.5%	\$1,459	25.6%
	2000	14,893	-24.2%	\$1,183	-18.9%
	2001	15,664	5.2%	\$1,564	32.2%
	2002*	16,413	4.8%	\$1,796	14.8%
South Carolina	1998	8,767	--	\$569	--
	1999	10,355	18.1%	\$717	26.0%
	2000	9,229	-10.9%	\$713	-0.6%
	2001	8,834	-4.3%	\$890	24.8%
	2002*	8,908	0.8%	\$965	8.5%
Virginia	1998	12,862	--	\$1,098	--
	1999	15,277	18.8%	\$1,252	14.0%
	2000	12,605	-17.5%	\$1,105	-11.7%
	2001	16,602	31.7%	\$1,855	67.9%
	2002*	18,688	12.6%	\$2,427	30.8%
Tennessee	1998	12,349	--	\$871	--
	1999	15,072	22.1%	\$1,091	25.3%
	2000	13,226	-12.2%	\$996	-8.7%
	2001	13,679	3.4%	\$1,137	14.2%
	2002*	13,764	0.6%	\$1,191	4.7%
Georgia	1998	20,624	--	\$1,763	--
	1999	24,069	16.7%	\$2,066	17.2%
	2000	20,998	-12.8%	\$2,046	-1.0%
	2001	25,218	20.1%	\$2,815	37.6%
	2002*	28,323	12.3%	\$3,295	17.0%
Rest of South	1998	133,137	--	\$9,785	--
	1999	151,529	13.8%	\$11,258	15.1%
	2000	136,672	-9.8%	\$10,830	-3.8%
	2001	144,284	5.6%	\$13,698	26.5%
	2002*	157,380	9.1%	\$16,560	20.9%

* Annualized estimate based on originations for the first three quarters of 2002
Source: Loan Performance database and authors' calculations

Table 3

Subprime Loans in the National LP ABS Database
Purchase and Refinance Loans
U.S., 1998-2002

Year	Purchase, 1 st Lien	Percent Change	Refinance	Percent Change	Other/ Missing
1998	160,003	--	386,572	--	73,792
1999	179,204	12.0%	472,258	22.2%	44,423
2000	192,019	7.2%	389,909	-17.4%	20,441
2001	204,950	6.7%	435,697	11.7%	5,683
2002*	231,871	13.1%	458,804	5.3%	1,861
Total	968,047		2,143,240		146,200

* Annualized estimate based on originations for the first three quarters of 2002
Source: Loan Performance database and authors' calculations

Table 4
 Subprime Loans in the LP ABS Database
 Purchase and Refinance Loans
 Selected Southern States and Remainder of the South, 1998-2002

State	Year	Purchase, 1 st Lien	Percent Change	Refinance	Percent Change
North Carolina	1998	3,050	--	10,151	
	1999	3,490	14.4%	14,070	38.6%
	2000	3,694	5.8%	10,369	-26.3%
	2001	5,021	35.9%	9,982	-3.7%
	2002*	5,115	1.9%	10,280	3.0%
South Carolina	1998	1,426	--	5,840	
	1999	1,974	38.4%	7,213	23.5%
	2000	2,474	25.3%	6,355	-11.9%
	2001	2,541	2.7%	6,023	-5.2%
	2002*	2,653	4.4%	5,887	-2.3%
Virginia	1998	2,678	--	7,663	
	1999	3,087	15.3%	10,567	37.9%
	2000	3,275	6.1%	7,955	-24.7%
	2001	4,305	31.5%	9,879	24.2%
	2002*	5,276	22.6%	9,981	1.0%
Tennessee	1998	2,500	--	7,894	
	1999	2,954	18.2%	10,470	32.6%
	2000	3,626	22.7%	9,015	-13.9%
	2001	3,953	9.0%	8,699	-3.5%
	2002*	4,177	5.7%	8,026	-7.7%
Georgia	1998	6,253	--	11,602	
	1999	6,558	4.9%	15,455	33.2%
	2000	6,747	2.9%	13,025	-15.7%
	2001	7,231	7.2%	15,553	19.4%
	2002*	8,039	11.2%	16,483	6.0%
Rest of South	1998	39,781	--	73,381	
	1999	45,717	14.9%	91,885	25.2%
	2000	48,367	5.8%	80,353	-12.6%
	2001	49,759	2.9%	84,911	5.7%
	2002*	54,499	9.5%	85,916	1.2%

* Annualized estimate based on originations for the first three quarters of 2002

Source: Loan Performance database and authors' calculations

Table 5
 Number and Relative Change in Subprime Loans 7 Quarters Before and After NC Law
 Selected Southern States, Remainder of the South, and the U.S.

Period	NC	SC	VA	TN	GA	Rest of South	Entire US
Pre-Law (Q1 1998 – Q3 1999)	31,184	16,284	24,629	23,550	38,660	245,600	1,190,755
Post-Law (Q3 2000 – Q1 2002)	25,898	14,948	26,979	22,583	41,689	242,537	1,157,489
% Change [(pre-post)/pre]	-17.0%	-8.2%	9.5%	-4.1%	7.8%	-1.2%	-2.8%

Source: Loan Performance database and authors' calculations

Table 6
 Number and Relative Change in Subprime Refinance Loans
 7 Quarters Before and After NC Law
 Selected Southern States, Remainder of the South, and the U.S.

Period	NC	SC	VA	TN	GA	Rest of South	Entire US
Pre-Law (Q1 1998 – Q3 1999)	20,710	10,989	15,732	15,595	23,092	140,754	740,378
Post-Law (Q3 2000 – Q1 2002)	16,499	10,026	15,736	14,506	25,492	140,001	716,683
% Change [(pre-post)/pre]	-20.3%	-8.8%	0.0%	-7.0%	10.4%	-0.5%	-3.2%

Source: Loan Performance database and authors' calculations

Table 7
 Number and Relative Change in Subprime 1st Lien Purchase Loans
 7 Quarters Before and After NC Law
 Selected Southern States, Remainder of the South, and the U.S.

Period	NC	SC	VA	TN	GA	Rest of South	Entire US
Pre-Law (Q1 1998 – Q3 1999)	5,622	2,845	4,949	4,666	11,054	73,168	289,042
Post-Law (Q3 2000 – Q1 2002)	8,037	4,404	7,127	6,488	12,251	85,255	350,523
% Change [(pre-post)/pre]	43.0%	54.8%	44.0%	39.0%	10.8%	16.5%	21.3%

Source: Loan Performance database and authors’ calculations

Table 8

Number and Relative Change in Subprime Loans to Borrowers with FICO below 580
 7 Quarters Before and After NC Law
 Selected Southern States, Remainder of the South, and U.S.

Period	NC	SC	VA	TN	GA	Rest of South	Entire US
Pre-Law (Q1 1998 – Q3 1999)	6,608	3,976	3,656	5,602	7,814	53,164	220,911
Post-Law (Q3 2000 – Q1 2002)	8,671	5,253	5,017	6,712	10,319	68,124	289,392
% Change [(pre-post)/pre]	31.2%	32.1%	37.2%	19.8%	32.1%	28.1%	31.0%

Source: Loan Performance database and authors' calculations

Table 9

Number and Relative Change in Subprime Loans to Borrowers with FICO 660 and Above
 7 Quarters Before and After NC Law
 Selected Southern States, Remainder of the South, and U.S.

Period	NC	SC	VA	TN	GA	Rest of South	Entire US
Pre-Law (Q1 1998 – Q3 1999)	4,771	2,176	6,093	3,239	7,129	35,993	369,881
Post-Law (Q3 2000 – Q1 2002)	3,432	2,099	5,920	2,973	6,431	36,471	356,139
% Change [(pre-post)/pre]	-28.1%	-3.5%	-2.8%	-8.2%	-9.8%	1.3%	-3.7%

Source: Loan Performance database and authors' calculations

Table 10
 Changes in Mean Origination Interest Rates
 7 Quarters Before and After NC Law
 All Subprime Loans
 Selected Southern States, Remainder of the South, and the U.S.

Period	NC	SC	VA	TN	GA	Rest of South	Entire US
Pre-Law (Q1 1998 – Q3 1999)	10.27	10.34	10.34	10.20	10.01	10.16	9.88
Post-Law (Q3 2000 – Q1 2002)	10.60	10.60	10.42	10.60	10.31	10.57	10.27
% Change Pre to Post	3.3%	2.5%	0.8%	3.9%	3.0%	4.0%	4.0%
Basis Points Change Pre to Post	33	26	9	40	30	41	40

Source: Loan Performance database and authors’ calculations

Table 11

Percentage of Subprime Refinance Loans with Prepayment Penalty Terms of 3 years or Greater
7 Quarters Before and After NC Law
Selected Southern States, Remainder of the South, and the U.S.

Period	NC	SC	VA	TN	GA	Rest of South	Entire US
Pre-Law (Q1 1998 – Q3 1999)	3968	435	5170	7535	11653	53577	247573
Post-Law (Q3 2000 – Q1 2002)	1101	1569	8530	9318	14605	63895	296457
% Change [(pre-post)/pre]	-72.3%	260.7%	65.0%	23.7%	25.3%	19.3%	19.7%

Source: Loan Performance database and authors' calculations

Table 12
 Number and Percent Change in Subprime Refinance Loans with Balloon Payments
 7 Quarters Before and After NC Law
 Selected Southern States, Remainder of the South, and the U.S.

Period	NC	SC	VA	TN	GA	Rest of South	Entire US
Pre-Law (Q1 1998 – Q3 1999)	3092	1273	1427	1720	2172	10276	68146
Post-Law (Q3 2000 – Q1 2002)	1451	430	1981	766	1544	7566	57480
% Change [(pre-post)/pre]	-53.1%	-66.2%	38.8%	-55.5%	-28.9%	-26.4%	-15.7%

Source: Loan Performance database and authors' calculations

Table 13

Number and Percent Change of Subprime Refinance Loans
 With a Combined Loan-to-Value of 110 Percent or Greater
 7 Quarters Before and After NC Law
 Selected Southern States, Remainder of the South, and the U.S.

Period	NC	SC	VA	TN	GA	Rest of South	Entire US
Pre-Law (Q1 1998 – Q3 1999)	1,827	783	3,160	815	2,152	11,067	55,792
Post-Law (Q3 2000 – Q1 2002)	1,189	809	2,923	1,122	2,056	13,308	56,818
% Change Pre to Post	-34.9%	3.3%	-7.5%	37.7%	-4.5%	20.2%	1.8%

Source: Loan Performance database and authors' calculations