# Mortgage Product Substitution and State Anti-predatory Lending Laws: Better Loans and Better Borrowers?

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Raphael Bostic[1], Souphala Chomsisengphet[2], Kathleen C. Engel[3], Patricia A. McCoy[4], Anthony Pennington-Cross[5] & Susan Wachter[6]



## Abstract

Mounting foreclosures and disclosures of abusive lending practices led many states to adopt new anti-predatory lending (APL) laws. Researchers have examined the impact of such laws on credit flows and the cost of credit. This research extends the literature by examining whether the market responded to these laws by substituting different mortgage products for those restricted by APL provisions. The evidence indicates that the laws were effective in restricting loans with targeted characteristics, and that the market substituted other product types to maintain access to credit and affordability in the face of these restrictions. The

laws reduced the involvement of investor and second home purchases but appeared to impact borrower credit scores or down payments.

## Notes

1. Until passage of the Dodd-Frank Act in 2010, mortgage regulation was fragmented and many large originators were exempt from state APL laws. National banks, federal thrift institutions, and their operating subsidiaries were exempt from state APL laws. In addition, some states with those laws exempted state-chartered depository institutions from having to comply with state APL laws under so-called wild card provisions.

2. The APR and the true borrower cost can deviate substantially because the APR does not include all fees, prepayment penalties, and the ability of the borrower to pay off the loan early. As a result, APRs can be manipulated in many ways while maintaining lender yields (Green and Wachter 2010).

3. 12 C.F.R. § 226.32(a)(1), (b)(1). The Dodd-Frank Act amended HOEPA in 2009.

4. Similarly, many states enacted mortgage broker and banker licensing and regulation laws.

5. Specifically, Arkansas, California, Colorado, Connecticut, Florida, Georgia, Illinois, Indiana, Kentucky, Maine, Maryland, Massachusetts, Minnesota, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Utah, West Virginia, Wisconsin, Washington, and the District of Columbia.

6. For the most part, these laws are still on the books, either in their original form or as amended.

7. A handful of cities and counties passed predatory lending ordinances of their own. As a result of state enactments or court decisions, these ordinances either never took effect or only took effect briefly. Mini-HOEPA laws are not the only type of state APL laws. Some states have older laws that regulate prepayment penalties or balloon payments. Of the states with mini-HOEPA laws, thirteen combine an older APL law with a newer mini-HOEPA statute. Other states have an older APL law, but no mini-HOEPA law. By January 1, 2007, only six states —Arizona, Delaware, Montana, North Dakota, Oregon, and South Dakota —had no APL laws or laws regulating prepayment penalties, balloon clauses, or mandatory arbitration clauses in residential mortgages. Federal law preempted portions of these state laws at various times for certain types of lenders and loan products. See Bostic et al. (2008) for more detail.

8. The fully adjusted rate is typically calculated by adding the index defined in the loan documents (such as the London Interbank Overnight Rate or LIBOR) to the margin (or spread).

9. The interest rate on a hybrid loan is initially fixed for a longer period of time than the reset period.

10. Negative amortization allows the borrower to pay no principal and less than the interest due for a set initial period, resulting in a rising mortgage

balance over time.

11. These are loans that have been marketed as Alt-A loans to distinguish them from the rest of subprime. They typically document less and have higher credit scores to compensate, but in practice many loans in Alt-A pools look very similar to subprime loans along many dimensions.

12. The sample is reduced to the treatment and control zip codes associated with the following state APLs—Massachusetts, Maryland, District of Columbia, North Carolina, South Carolina, New Mexico, and New Jersey.

13. Given the aggregated nature of the empirical approach, it is impossible to provide very precise measures of how mortgage use changed while holding borrower credit quality constant. However, we created two subsamples to provide some preliminary results. The first sample restricts the observations to only those loans with credit scores one standard deviation below the mean (FICO of less than 589). The second sample restricts the observations to those loans with LTVs one standard deviation above the mean ($LTV > 90$). The results for these two subsamples, which include credit and down payment constrained borrowers, are very similar to Table 2 on most dimensions except the use of interest only loans. In particular, interest only loans tend to be used more frequently in both of the constrained subsamples (odds ratios of 2.79 for FICO less than 589 and 3.21 for LTV greater than 90) when a law is introduced.

14. The analysis in this paper is based on the laws as they stood in the sampling period. Since 2006, some states have amended their lending laws.

15. Additional tests (results available from the authors) looked for evidence that the introduction of a law could lead to higher costs. Overall, the results were inconsistent and largely insignificant for both fixed rate and hybrid loans.

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## Author information

### Authors and Affiliations

**School of Policy, Planning, and Development, University of Southern California, Los Angeles, CA, USA**

Raphael Bostic

**US Department of the Treasury, The Office of the Comptroller of the Currency, Washington, DC, 20219, USA**

Souphala Chomsisengphet

**Law School, Suffolk University, Boston, MA, 02108-4977, USA**

Kathleen C. Engel

**University of Connecticut School of Law, Hartford, CT, USA**

Patricia A. McCoy

**Department of Finance, College of Business Administration, Marquette University, Straz Hall–328, P.O. Box 1881, Milwaukee, WI, 53210-1881, USA**

Anthony Pennington-Cross

**University of Pennsylvania, Philadelphia, PA, USA**

Susan Wachter

### Corresponding author

Correspondence to Anthony Pennington-Cross.

## Additional information

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