Fed Acts to Curb Predatory Lending Practices; Stricter Rules on Subprime Loans Enacted to Protect Unwary Borrowers

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Prodded by consumer complaints about rip-offs in home-equity loans and refinancings, the Federal Reserve Board yesterday approved the strongest federal response ever to predatory lending.

New rules, debated for more than a year, will increase the number of loans that are subject to scrutiny.

Consumer groups and congressional allies said that they welcomed the changes but that the Fed should have acted years ago and could have done more to protect borrowers.

Banking and financial industry groups generally accepted the Fed's changes as inevitable in light of the widespread consumer complaints. The changes significantly widened the pool of high-cost home-secured loans covered by the Home Ownership and Equity Protection Act of 1994, a federal law that guarantees extra disclosures and consumer protections to borrowers. The law does not cover loans to purchase houses.

According to Fed estimates, the new rules, which take effect next October, will cover about 38 percent of all high-cost first liens and about 61 percent of all high-cost second trusts. Currently, only about 12 percent of high-cost first liens and 50 percent of high-cost second trusts are covered.

Among the major changes the Fed made yesterday was lowering the threshold for what constitutes a high-cost first lien, reducing the interest rate trigger to 8 percentage points above comparable Treasury securities, down from 10 percentage points above such securities. That means that under the new rules, a 10-year loan would be considered high-cost at today's interest rates if the rate is above about 13 percent. The threshold for second trusts remained at 10 percentage points above Treasury securities.

The Fed also changed another trigger based on points and fees charged to borrowers by requiring lenders to include in their calculations the credit insurance financed through loans. Consumer groups have called financed credit insurance the "most egregious" predatory lending practice.

The Fed also added new protections, such as barring "loan flipping" -- refinancing of high-cost loans by the same lender or loan servicer within a year.

Lenders also will be presumed to have violated the law -- which says loans shouldn't be made to people unable to repay them -- unless they document that the borrower has the ability to repay.

Lenders that violate the rules face cancellation of loans and penalties equal to the finance charges paid.

John Taylor, head of the Washington-based National Community Reinvestment Coalition, said the Fed's actions were "inadequate to address the magnitude of the predatory-lending epidemic."

Consumer advocates say the chief victims of predatory lenders are elderly, minority and female homeowners in cities. Such borrowers often are pressured into refinancing to pay debts or make home improvements and don't understand the terms of the loans or claim not to have been told about them.

Industry groups argue that legitimate lenders are not the problem, and that tightening the rules discourages responsible lenders.

"Restricting certain lending terms or conditions for loans at a certain interest rate is not the remedy for abusive lending problems," said a statement by the American Financial Services Association, which represents about 500 companies including consumer finance giants such as Household International Inc. "The vast majority of the anecdotes seen in media stories involve . . . fraud. Regrettably, bad actors in the mortgage industry . . . will continue to find ways to do so."

Industry groups yesterday were studying the new rules. "It's not like opening up a Christmas present, but it's relatively well balanced" between lenders' and consumers' concerns, said Jeffrey Zeltzer, executive director of the National Home Equity Mortgage Association, the trade group for what are called subprime lenders, who make higher-cost loans to people with blemished credit histories.

Zeltzer said the changes might cause "some reduction in lending" by those that don't want to be tarred as "high-cost" lenders. But "in order for us to get American consumers' confidence back, we'll have to work hard to adapt to the Fed's new rules."

Fed staff members told board members yesterday that "we don't anticipate a significant restriction of credit."

Fed staffers and board members acknowledged the difficulty of writing rules that balance the need to protect vulnerable borrowers with the need to ensure the availability of loans.

"The [new] rules are a measured response that balances various concerns, so as not to impede the growth of the legitimate subprime mortgage market," said Fed Governor Edward M. Gramlich, chairman of the committee that drafted the regulations.

More than 30 states and a dozen cities, including Washington, have debated anti-predatory-lending proposals in the absence of new federal laws.

"Regulatory changes alone cannot solve the problems associated with predatory lending," Gramlich said. The "best defense," he said, is education, plus vigorous law enforcement.

Consumer advocacy groups, however, say new laws must be passed to combat abuses connected to an explosion in subprime lending since 1994.

According to federal housing data, the number of subprime home-equity loans grew 13-fold from 1993 to 1999. While not all subprime loans are predatory, almost all predatory loans are subprime.

No new legislation is expected soon from the Republican-controlled House Financial Services Committee, despite the efforts of Rep. John J. LaFalce (D-N.Y.), the ranking minority member, and Rep. Janice D. Schakowsky (D-Ill.). Both have offered bills backed by consumer advocates.

Senate action is possible next year because consumer activists have a key ally and bill sponsor in Banking Committee Chairman Paul S. Sarbanes (D-Md.).