

**Analysis of:**  
**Pennsylvania Human Relations Commission**  
**Proposed Predatory Lending and Reverse Redlining Guidelines**

April 11, 2005

These Proposed Guidelines attempt to establish parameters for the PHRC to evaluate the conduct of housing finance entities in relation to so-called predatory lending practices. While the PHRC generally does not have jurisdiction to administer or enforce the consumer credit laws, the assumption being made is that so-called predatory practices appear disproportionately in credit transactions where the borrower(s) are members of protected minorities, in comparison to borrowers not falling within a protected class. The PHRC would have jurisdiction over illegally discriminatory policies.

It should be noted at the outset that existing generic fair credit laws at both the federal and state levels clearly and comprehensively make illegal discrimination based upon certain protected categories. Thus it is illegal for a lender to make or deny loans or to offer any credit terms based upon the applicant's race, gender, marital status, etc. The identification of particular terms and practices which may, under certain circumstances, be considered "predatory" seems outside the purview of fair lending enforcement. Only where there is a disproportionate effect on minorities and other protected classes does so-called "predatory" lending implicate the fair housing laws. In other words, if a lender offers and makes the same "predatory" loans equally to the general public without regard to protected class, the PHRA would not be violated and the PHRC would have no power to impose sanctions simply because they consider certain loan terms and practice to be "predatory."

Secondly, there is concern that the PHRC will develop its own definition of "predatory" lending which may not comport with that of other agencies, such as the Banking Department, who are actually authorized by law to administer and enforce the consumer credit laws. This concern is exacerbated by the proposed guidelines because the PHRC, as it admits in the last paragraph on the second page of the Guidelines Proposal, is unable to establish a coherent definition of "predatory" lending. Instead, the PHRC seems to be using the definition of United States Supreme Court Justice Potter Stewart's definition of obscenity, in that they "know" predatory lending "when they see it."

The problem with that, and with the inherent subjectivity which the Proposed Guidelines inject into the determination whether a loan is "predatory," is that lenders, particularly bankers who are lending their depositors' money, want to have reasonable certainty in the rules which they must observe in making a loan. If there is a statutory cap on the interest rate that may be charged, then lenders know that they may not exceed that cap. That certainty is completely destroyed where, as here, an agency imposes a rule or guideline that evaluates the legality of that

interest rate on the basis whether the agency believes the rate is “unfair” or not reflective of the risk borne by the lender, rather than on the basis of the clear numerical statutory cap imposed by the legislature. What one person, as opposed to another, believes to be an “unfair” rate will vary widely. The Proposed Guidelines are largely objectionable because they call for the PHRC to substitute its judgment for the underwriting standards of the lending industry without any clear rules for determining what standards are appropriate, or how they will be consistently applied. In a way the Proposed Guidelines accomplish the opposite of their ostensible purpose. They do not guide anything, instead they make clear that, when it comes to deciding whether a loan is “predatory” there really are no measurable rules by which they intend to abide.

Specifically, comment must be made about the following specific provisions:

1. Balloon payments.

Balloon payments are loan features that establish a finite time for the lender (or holder) to be under the particular interest rate risk posed by a fixed rate loan. They were developed with the encouragement of Congress evidenced by the enactment of the Alternative Mortgage Transactions Parity Act of 1982. Balloon features help protect financial institutions and other lenders from being exposed to long-term interest rate risk. They have seldom (if ever) been considered to be “predatory” in and of themselves. The cited negative aspect of balloon features is that the loan must, generally, be refinanced when the balloon matures. This is a term to which a borrower agrees at the time the loan is made. It affects the periodic interest rate. Balloon loans generally are at lower rates than long term fixed rate loans. The federal Home Ownership and Equity Protection Act of 1994 (“HOEPA”)<sup>1</sup> places certain restrictions on balloons with respect to high rate loans.

2. Collection or Foreclosure Practices.

It is difficult to understand how collection and foreclosure practices, which take place after a loan is made and upon some sort of default for non-payment, factor into whether a loan is, from its inception, “predatory.” Moreover there are no standards established for “unjustified” or “exorbitant” late fees and penalties. The only ways in which a late fee can be “unjustified” is if the loan documents do not provide for a late fee or the payment was made on time, otherwise a late fee is unquestionably “justified” but may be “exorbitant.” The Proposed Guidelines do not establish any standards for what may be considered “exorbitant.” Generally in the industry, 5 % of the payment past due is a common late fee. For a \$150,000 loan at 10% (30-year fixed) the principal & interest payment would be \$1,316, which makes a 5 % late fee \$65.80. Whether that amount is exorbitant depends upon one’s point of view. However what is clear is that the Proposed Guidelines do nothing to clarify that issue.

3. Credit Insurance.

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<sup>1</sup> Which is codified as a part of the federal Truth-in-Lending Act, 15 U.S.C. §§ 1601 *et seq.*

Credit insurance is an optional product whose rates are controlled by filings with the State Insurance Commissioner. It is unlawful under the Insurance Code to charge more than the filed rate. The Proposed Guidelines talk about “exorbitant premiums” as being a harbinger of a predatory loan product. If the PHRC intends to impose a different standard than the filed insurance rate for determining whether a premium is “exorbitant” it would be very helpful for the Proposed Guidelines to list objective standards for how that determination will be made. Otherwise, there is no measurable standard established.

#### 4. Flipping.

The definition of “flipping” should include two additional factors: (1) the successive loans are made by the same lender, broker or originator; and (2) the refinance(s) are occasioned by the borrower’s default.

#### 5. High Interest Rates and Annual Percentage Rates (APR) Not Justified by Risk

The establishment of percentages over the Treasury Bill rate which are different than those established by statute (federal and Pennsylvania) are arbitrary. Moreover there is no clue as to how the PHRC intends to evaluate whether and how a particular “risk” either justifies or fails to justify a particular interest rate. That analysis would certainly second-guess and may well undermine the underwriting process that every lender undertakes in evaluating how to price credit based on risk of default.

#### 6. Loan Padding

Here again the Proposed Guidelines fail to establish a coherent test for unreasonably high or “illegitimate” settlement fees and charges. The federal Real Estate Settlement Procedures Act, 12 U.S.C. §§ 2601 *et seq.* (“RESPA”) already imposes a substantial test for reasonableness for settlement service fees and charges which the courts have interpreted. That statute is administered by the federal Department of Housing and Urban Development. If a standard is to be applied by the PHRC, it should not differ from that of RESPA.

#### 7. Mandatory Arbitration Clauses

There are some terms in arbitration clauses that have been held unconscionable by the courts (such as designating a remote location for the arbitration to take place or imposing all of the costs of arbitration on the consumer borrower). However, the courts have generally favored arbitration as a simpler, less costly way to resolve disputes. There is a federal Arbitration Act which takes up all of Title 9 of the United States Code, and most states (Pennsylvania is no exception) have statutes authorizing arbitration as a contractual alternative to court action. Arbitration should not be considered a harbinger of predatory lending.

#### 8. Mortgage Broker Fees

Unlike many of the surrounding states, Pennsylvania does not regulate the level of fees which a mortgager broker can charge for his or her services. However, broker fees are included

in the calculation of up front fees and charges for purposes of determining whether a loan is a “high rate” loan under the federal HOEPA. Accordingly, most industry wholesale lenders cap broker compensation at around 5% of the loan amount. The PHRC suggestion that any loan broker fee exceeding 3% may be “abusive” unless it is “justified by reasons” is wholly arbitrary. Moreover there is no indication of what “reasons” would be considered in justifying a broker fee over 3%. Here again the Proposed Guidelines do not even suggest an objective standard.

#### 9. Points

The statement in the Proposed Guidelines regarding points discusses only “discount” points, not loan origination points. While discount points are used to “buy down” the interest rate, origination points have to do with the initial pricing of the loan, not volitional buy-down of the periodic rate by the borrower. Loans are priced based upon rate and points together. Some lenders do not offer buy downs, but still charge points because that is the pricing mechanism they use to maximize resale in the secondary market. There is nothing predatory about charging loan origination points.

#### 10. Yield Spread Premium

A “yield spread premium” is a fancy name for lender paid broker compensation. Generally wholesale lenders include any lender paid compensation in the 5% maximum broker compensation that they will allow by contract. It is the combination of lender paid and borrower paid compensation that is regarded under RESPA as the true cost to the borrower of the broker’s services. Under RESPA, total broker compensation is evaluated under a reasonableness standard which HUD has established and published Policy Statements supporting. While a yield spread premium may certainly be excessive in amount, it can operate to save the borrower up front cash needed for closing. Most brokered mortgage refinance transactions involve some sort of lender paid compensation to the broker. Quite often there is no “up front” broker fee charged to the borrower and the broker’s entire compensation is paid by the lender. This is so there will be no “up front” costs of refinancing that are not rolled into the loan. RESPA requires full disclosure of the lender paid compensation both on the Good Faith Estimate of Closing Costs and the HUD-1 Settlement Statement. Lender paid compensation to a broker cannot, however, be considered predatory in and of itself.

#### 11. Borrower Sophistication as a factor in “Predatory” lending

In paragraph 6 on the sixth page of the Proposed Guidelines, the PHRC states that it will evaluate a particular borrower’s experience and knowledge of complex financial transactions in determining whether a loan is “predatory.” This aspect could have a chilling effect on lending to persons who do cannot demonstrate to the lender, at the time the loan is made, sufficient understanding of all of the details of the transaction. While PACB should support consumer financial education and financial literacy, the PHRC should not impose its evaluation of a borrower’s intelligence and education in matters financial.

12. Falsification of underwriting documents and information.

Banks and other lenders are the victims, not the perpetrators of predatory practices involving falsification of documents, misstated income and other fraudulent activities by loan originators. PACB supports prosecuting originators who engage in fraud. However, legitimate lenders, including Banks, should not be subjected by the PHRC to charges that their lending policies are predatory because they have been defrauded by unscrupulous originators.

### **Summary Conclusion**

Overall, these Proposed Guidelines do very little to put the lending industry on notice as to the manner in which their lending practices will be evaluated for potential illegal discrimination. They do not establish any measurable objective standards for virtually any of the factors which the PHRC intends to take into account. There is no predictability as to what particular conduct, loan terms or underwriting practices will be considered illegal under what circumstances. The Proposed Guidelines are also internally inconsistent. For example, on the seventh page of the Proposed Guidelines, the PHRC states that it will consider television, radio and newspaper advertising targeted towards minorities and other protected classes as potentially indicative of an illegal attempt to “reverse redline.” In the next paragraph, however, the PHRC acknowledges that that such targeted advertising is not, in and of itself, violative of the fair housing laws. What the Proposed Guidelines utterly fail to do is inform how the PHRC intends to differentiate between permissible and impermissible targeted advertising. As such, the Proposed Guidelines are not guidelines at all, but mere warnings that the PHRC intends to exercise subjective discretion in analyzing lender policies and loan terms, and find “predatory lending” wherever it thinks it may exist.