

October 6, 2003

By Facsimile Transmission: (202) 874-4448

Comptroller of the Currency  
250 E Street, S.W., Public Information Room, Mailstop 1-5  
**Attention:** Docket No. 03-16  
Washington, D.C. 20219

Re: OCC Working Paper: Economic Issues in Predatory Lending (July 30, 2003)

To whom it may concern:

Please accept this letter comprising my analysis of the Working Paper issued by the Office of the Comptroller of the Currency, Administrator of National Banks, dated July 30, 2003: "Economic Issues in Predatory Lending" (hereinafter, OCC Paper). That Paper purports to present "a summary and analysis of key statistics and studies on the issue of predatory lending" so as to answer a number of important questions about subprime and predatory home lending. OCC Paper at 1. However, the Paper then proceeds to base crucial parts of its analysis on a few unrepresentative data points and assumptions, rather than representative statistics. Further, the Paper's analysis of loan price largely neglects what in the subprime and predatory market can be a very significant component of price – upfront charges, fees and "points." The Paper also analyzes loan risk solely from the lenders' perspective, asking whether risk is priced appropriately, without accounting for the negative externalities in the form of injuries to neighborhoods and communities caused by loans at high risk of default and foreclosure. By ignoring key elements of home loan price and risk, and by relying on unrepresentative data points and assumptions, the Paper fails to meet the Office of Management and Budget's Guidelines for Ensuring and Maximizing the Quality, Objectivity, Utility, and Integrity of Information Disseminated by Federal Agencies, published at 67 Fed. Reg. 8,458 (Feb. 22, 2002) (hereinafter, OMB Regulations). The information disseminated in the Paper does not meet the requirement that information be presented in an "accurate, clear, complete, and unbiased manner," nor the requirement for information presented in financial contexts that "the original and supporting data shall be generated, and the analytic results shall be developed, using sound statistical and research methods." 67 Fed. Reg. at 8,459. My analysis of these problems with the Paper<sup>1</sup> is as follows:

Defining Predatory Lending:

The OCC Paper starts with a concern that predatory lending lacks a precise enough definition for it to be analyzed at all, and intimates, without providing any evidence whatsoever

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<sup>1</sup> I do not analyze here the paper's presentation of the various studies that have attempted to analyze the effect of North Carolina's anti-predatory lending law, as it is my understanding that others more familiar with the North Carolina data will be doing so.

for such a conclusion, that existing studies quantifying some of the costs to society of overpricing of predatory loans are not valid. OCC Paper at 6. I would offer the following definition: predatory home loans are home loans that are overpriced and/or overly risky. Overpriced loans take advantage of the fact that many borrowers do not price shop. They are loans priced significantly higher than others that were available on the market to the borrower, such that if the borrower had engaged in price shopping, the borrower would have saved more by finding the cheaper loan, than the borrower would have expended in tangible search costs. Overly risky loans take advantage of the fact that many borrowers do not understand the full risk of foreclosure posed by the loan, nor do some borrowers consider fully the alternatives that exist to taking the loan. They are loans taken when if the borrower had understood the risk of loss of home posed by the loan, and the existence of alternatives to taking the loan (such as foregoing the loan proceeds, declaring bankruptcy with a homestead exemption, selling the house on the open market instead of losing it at foreclosure, etc.) the borrower would not have taken the loan. Price and risk can be related from the borrower's perspective, in that an overpriced loan can endogenously create risk where the borrower would have been able to afford the payments on a competitively-priced loan, but can not afford the payments on an overpriced loan.

The OCC Paper without citation claims that “economists<sup>2</sup> typically suggest that judgments as to whether a loan's price is high or abusive in the absence of additional concrete economic analysis of underlying risks, costs and other fundamentals, such as the level of demand for credit, are not a valid basis for defining predatory lending.” *Id.* at 6. But an economist would find perfectly acceptable the above definition of an overpriced loan, one produced in a market where vulnerable borrowers do not price shop even where the benefits of doing so would outweigh tangible costs, and some lenders price discriminate based on borrower vulnerability. The Paper largely ignores the problem of risk of loss of the home from the borrower and neighborhood perspectives, and therefore fails to even address this aspect of the definition I have set forth above. Without an analysis of the social cost of foreclosure, any cost-benefit analysis of predatory lending and anti-predatory lending legislation is neither accurate nor complete, in violation of the OMB Regulations.

#### Overpricing of Predatory Loans:

The OCC Paper asserts that “the empirical data do not support the contention that subprime providers in the aggregate are earning excess profits.” OCC Paper at 4. Instead, the Paper claims “economists generally view the subprime lending area as highly competitive with a strong correlation between price and borrower risk.” *Id.* at 9. The Paper goes on to present data from which it draws the conclusion that subprime loan delinquencies and defaults increase steadily as paper grade declines, and that the pricing structure of the loans is accordingly well-calibrated to account for the expected risk to the lender of loss of unpaid principal posed by each grade of loan. *Id.* at 8-10. The Paper uses the same data to make the extremely tenuous claim that because the price differentials between grades of subprime loans are roughly similar to the

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<sup>2</sup> The paper continually claims that on one side of the predatory lending debate sit “proponents of anti-predatory lending legislation” and on the other side sit “economists.” OCC Paper at 5, 6 & 8. This is both inaccurate and offensive. Many of the analysts who have advocated anti-predatory lending legislation are economists, including economists at Freddie Mac and Fannie Mae, various universities, and policy groups.

price differentials found between grades of corporate bonds, this data is evidence of a well-functioning competitive market for subprime loans. *Id.* at 11.

These assertions are all based on the pricing and loss rate data from a single subprime lender, Option One Mortgage Corporation. *Id.* at 8 (Table 1). The interest rates used in the analysis are for 30-year fixed rate loans from rate sheets in effect during a single week, the week of September 6, 2002, for two of Option One's loan programs in Colorado and Utah only, and the loss rates used in the analysis are Option One's reported loss rates for its existing portfolio of subprime loans in 2002. *Id.* There is no evidence that the practices of Option One as reflected in the rates for 30-year fixed rate loans on its rate sheets for one week in September, 2002 in two programs offered in Colorado and Utah, or the loss rates experienced by Option One on its portfolio in 2002, are particularly representative of the entire subprime industry, including predatory players in that industry. To the contrary, Option One has not been widely charged with predatory practices, and Colorado and Utah are not states where predatory lending has come to the fore as a particularly big problem. Moreover, predatory loans are frequently not 30-year fixed rate loans, but rather have short-term balloons, graduated increasing or variable interest rates, and other more complicated structures than 30-year fixed rate loans. There is simply no basis for making conclusions about the competitiveness of pricing in the entire subprime industry based on these totally unrepresentative data points, data points that were not generated using "sound statistical research methods" as required by the OMB Regulations.

Furthermore, the pricing analysis in the OCC Paper relies on unsupportable assumptions about the price of broker fees. In attempting to correlate borrower risk and loan price, the Paper assumes that the wholesale prices on Option One's September 6, 2002 rate sheets can be adjusted to retail prices by adding 50 basis points as average broker compensation. *Id.* No evidence supports an average broker fee of 50 basis points, and the Paper offers none. To the contrary, although no nation-wide randomly-sampled data are available, the only empirical studies of broker compensation show that brokers make between 186 and 230 basis points per loan.<sup>3</sup> This compensation is an amalgam of broker fees disclosed to borrowers as broker or origination fees, other fees paid to the broker such as processing or application fees, and fees extracted through yield spread premiums – upselling borrowers into higher interest rates than the borrower would qualify for from the lender, in exchange for which the lender gives the broker a kickback. Moreover, even if the Paper had used a realistic average estimate of broker fees, the problem of predatory lending is not the average pricing of subprime loans, but rather the overpricing of predatory loans agreed to by vulnerable borrowers. The only empirical evidence available on this point indicates that broker compensation varies significantly, not according to how much work the broker puts into securing the loan for the borrower, but rather according to how

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<sup>3</sup> See Jack Guttentag, *Another View of Predatory Lending*, Wharton Financial Institutions Center Working Paper #01-23-B at 10 & Table 2 (Aug. 2001) (based on study of 800 loans made between December 2000 and January 2001, reporting mortgage broker profit ranging from 1.86% to 2.30% of loan amount); Howell E. Jackson & Jeremy Berry, *Kickbacks or Compensation: The Case of Yield Spread Premiums* at 71 & 91 Fig. 13 (unpublished manuscript, 2002, reflecting data collected for expert report submitted July 9, 2001 in *Glover v. Standard Federal Bank*, Civ. Action No. 97-2068 (DWF/SRN) (D. Minn.)) (based on study of 2,947 loans sampled in litigation against a small number of lenders accused of predatory overpricing practices, finding average total broker compensation of about 2.25% of loan amount).

vulnerable the broker thinks the borrower is,<sup>4</sup> and that African-Americans and Hispanics on average pay significantly more in broker compensation than do white borrowers.<sup>5</sup> The 50 basis point assumption again is data developed without the use of sound research methods.

#### Spurious Explanations of Loan Pricing Differentials:

A similar problem infects the Paper's later claim that the spread between interest rates "includ[ing] average points and fees" on prime 80% loan to value ratio (LTV) mortgages and subprime 80% LTVs where the borrower has a 680 FICO score can be explained entirely by differences in higher risk and cost of the subprime loan. OCC Paper at 13. Without citation to any source, the Paper asserts that the interest rate plus average points and fees on a prime mortgage of this type in September 2002 was 6.14%, and the interest rate plus average points and fees on a subprime loan of this type was 8.1%. *Id.* Without citation, there is no way to independently verify the accuracy of this data, in violation of the OMB Regulations. But more importantly, predatory loans do not come with "average" points and fees; they have higher points and fees not attributable to risk and cost. Therefore, whether the price differential between an average prime and average subprime loan can be explained by price and risk has little bearing on whether predatory lending is a problem.

Further, the reasoning of the Paper here is that because it is more costly to service loans to borrowers with blemished credit records than prime borrowers, *id.* at 12, 40 basis points of the price difference between the 680 FICO average subprime borrower and the comparable prime borrower is explained by servicing cost. But a 680 FICO score would indicate that this subprime borrower is not any more costly to service than the prime borrower, so the 40 basis points difference seems pulled from thin air, without any real underlying support.<sup>6</sup> Similarly, the Paper claims that because the different grades of subprime loans are priced at about 111 basis points between each grade, 111 basis points of the difference between the 680 FICO subprime borrower and the prime borrower is explained by risk. *Id.* Again, there is simply no sound statistical or research methodology being followed to come up with these non sequiturs.

#### Competition in the Secondary Market Does Not Ensure Competitive Pricing for Borrowers:

Next, the OCC Paper sets forth the relationship between coupon rates and serious delinquency rates, based on limited Mortgage Information Corporation (MIC) subprime data, and asserts that because delinquency rates generally rise as coupon rates rise, the price of subprime loans reflects their risk. OCC Paper at 10 (Chart 3). The first problem with this assertion is that the data upon which it is based is not representative of the entire subprime market – MIC data for subprime lenders includes only 27 lenders, and does not include any loans from ten states, several of which are particularly known for having difficulties with predatory

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<sup>4</sup> Guttentag at 8 ("According to the brokers, [a] major determinant of profit per loan is the sophistication of the borrower relative to the sales skills of the loan officer."); Jackson & Berry at 81-85.

<sup>5</sup> Jackson & Berry at 125-128.

<sup>6</sup> The only data cited by the Paper for this point is that servicers charge 25 more basis points to service subprime loans than prime loans, a number that the Paper inflates to 40 basis points based on a statement made by a failed auto lender that auto loans cost 75 more basis points to service if they are subprime than if they are prime. OCC Paper at 13. This is slim evidence, and certainly not data generated using "sound statistical methods."

lending.<sup>7</sup> The more fundamental problem with the assertion is that coupon rates do not reflect the price paid by the borrower for the loan. The coupon rate is the rate paid on the paper in the secondary mortgage backed securities (MBS) market, generally the note interest rate, not the price paid by the borrower. That the coupon rate in the MBS market would be appropriately priced for the risk of default, and that a very competitive subprime MBS market exists, is not surprising. But the competitive pricing structure of the MBS market need not be passed on to subprime borrowers, and abundant evidence exists that it is not passed on. Instead, borrowers pay a wide range of upfront broker fees, origination charges, and “points” that do not buy down the note interest rate<sup>8</sup> – fees extracted at the retail level by the broker and originating lender. For predatory loans, these fees reflect not only origination costs, but also borrower vulnerability. A similar phenomenon exists in the stock market and brokerage commissions; although stocks are sold on the stock market at competitive prices, stock brokers can charge commissions to clients that are not competitively set, but instead are based on the broker’s sense as to how vulnerable the investor is to overpricing of brokerage services.<sup>9</sup> The Paper’s reasoning here once again lacks a sound basis.

#### Prepayment Risk:

The OCC Paper briefly argues, without citation to evidence, that higher prepayment risk in the subprime market leads to higher prices to cover that risk. OCC Paper at 11. No explanation is given to explain why prepayment penalties alone would not be sufficient to cover prepayment risk. Further, the unstated assumption is that prepayments are always costly for the lender, when in fact, subprime loans prepay even when interest rates are rising, when lenders should be happy to have their funds freed to reinvest in a higher-rate environment, provided transaction costs are not too high. Further, when it is the same lender or related entity that is doing the refinancing, as is frequently the case for predatory loans that are repeatedly “flipped” by the same lender, that lender loses nothing from prepayment, and is able to charge a host of new origination fees at the refinancing, leaving no justification for the imposition of a prepayment penalty.

The Paper states that subprime loans prepay when borrower creditworthiness improves, *id.*, without noting that where the subprime loan was predatorily overpriced, the borrower’s credit need not improve to be qualified for a lower interest rate loan – that is, where the borrower was qualified for a prime or lower rate subprime loan at the time she took the loan, her creditworthiness need not improve for her to chose to prepay and refinance at the lower rate for which she qualified all along.<sup>10</sup> Rather than charging a higher interest rate to cover for the risk

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<sup>7</sup> Fred Phillips-Patrick, Eric Hirschhorn, Jonathan Jones & John LaRocca, *What About Subprime Mortgages?*, 4 Mortgage Market Trends 5-6 (OTS Research & Analysis, June 2002).

<sup>8</sup> Up-front fees (“points”) that do buy down the note rate would have to be passed on to the secondary market to sell the loan in such a price competitive environment. But predatory loans often include up-front charges for “points” that do not buy down the interest rate. See Washington State Department of Financial Institutions, *Expanded Report of Examination for Household Finance Corporation III* 15 (April 30, 2002) (demonstrating that lender charged 7.25% in “points” without lowering, and in some cases even while increasing, the borrower’s note rate).

<sup>9</sup> See Jackson & Berry at 64-65.

<sup>10</sup> It is estimated that between ten and fifty percent of borrowers with subprime loans were qualified for lower prime interest rate loans, based on their credit history and loan profile. See Business Wire, *Fannie Mae Has Played Critical Role in Expansion of Homeownership* (March 2, 2000) (50% estimate); Freddie Mac, *Automated Underwriting*:

that she might prepay, the lender should have charged a lower rate so the borrower would not be tempted to prepay in order to obtain that lower rate. A prepayment penalty in such a scenario could prevent a borrower from obtaining a competitively-priced loan, contrary to free market principles.

Further, the Paper attempts to explain prepayment penalties not as compensation for lost interest income stream, but rather as compensation for origination fees that subprime lenders “don’t collect ... upfront but build ... into the loan amount.” *Id.* at 15 n. §§. This cryptic and slightly misleading<sup>11</sup> reference is to yield spread premiums, brokers fees that lenders pay upfront and then collect from the borrower over time in the form of a higher interest rate. But lenders could refuse to pay yield spread premiums, or could only pay these premiums after confirmation that borrowers actually agreed to the full broker’s fee and chose to have the fee paid through the premiums instead of financing them in the principal of the loan. Where the borrower chose to finance the fees rather than paying for them through a yield spread premium, this would obviate the necessity for prepayment penalties, because the lender would collect the financed origination fee as part of the principal balance paid off at refinancing. It would also result in brokers’ fees that would in all likelihood become more competitively priced because borrowers would discover the price they are paying for broker services and could use this information to shop among brokers.

Even a Loan that Is “Correctly-Priced” for Risk Can Be Predatory:

The OCC Paper makes the assumption that so long as home loans are priced according to risk, cost, and supply and demand factors, the loans cannot be predatory or otherwise problematic. The Paper states: “there remains much debate about whether the higher rates and fees charged on many subprime loans are predatory or simply reflect higher borrower risk, servicing costs, or demand factors related to the macroeconomy.” OCC Paper at 26. But a loan can be priced strictly according to these factors, and yet still be overly-risky, when viewed in comparison to the alternatives the borrower would have chosen if she had understood the true risk presented by the loan. Where a borrower would have been better off by foregoing the loan proceeds, defaulting on unsecured debt rather than paying it off from home loan proceeds, selling the house on the open market, or declaring bankruptcy with a homestead exemption, rather than taking a predatory loan, it is inefficient, in the sense of not putting resources to their highest and best use, for the borrower to take the predatory loan. But that borrowers would agree to loans that are overly-risky is not surprising, given that no lender tells the borrower the actual risk of foreclosure the borrower is going to face with this loan, according to the risk models the lender used, at least initially, prior to any excess price the broker or loan officer discovered he could extract, to price the loan. Further, the costs of very risky loans are borne, ultimately, not only by the borrower and the lender, but also by the borrower’s family/household and by the neighborhoods and communities that are affected by the instability caused by foreclosure. The

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*Making Mortgage Lending Simpler and Fairer for America’s Families*, 5-6 & Ch. 5 (Sep 1996) at [www.freddiemac.com/corporate/reports/moseley/chap5.htm](http://www.freddiemac.com/corporate/reports/moseley/chap5.htm) (10 to 35% estimate); *Half of Subprime Loans Categorized as “A” Quality*, INSIDE B & C LENDING (June 10, 1996) (50% estimate).

<sup>11</sup> The origination fees are not built into the loan amount, they are built into higher interest rates. If the fees were merely financed into the loan amount, the lender would not lose them at a refinancing, because they would be paid off as part of the principal balance by the new lender.

pricing of risky loans cannot internalize to either the lender or the borrower the negative externalities caused by high risk loans. Because predatory loans are concentrated in minority and low-to-moderate income communities, the impact of foreclosures and neighborhood instability are borne disproportionately by these communities. The failure of the OCC Paper to grapple with these costs of predatory lending renders its analysis neither accurate nor complete.

#### National Banks and Predatory Lending:

The OCC Paper claims that federally-regulated banks and their direct subsidiaries are not involved in predatory lending based on statistics as to what proportion of lenders classified as primarily subprime are national banks or their direct subsidiaries, and what proportion of national banks and their direct subsidiaries are classified as primarily subprime lenders. OCC Paper at 7. The relevant statistic here would be not the number of lenders, but the number of loans. That is, the relevant question is what proportion of subprime loans are made or held by national banks or their direct or indirect affiliates, either directly or through brokers or purchases of subprime mortgage-backed securities. Although the Paper characterizes bank purchases of securities backed by predatory loans or originations of predatory loans through brokers as “inadvertent[.]” and “unintentional[.]”, *id.*, these purchases are the result of a deliberate decision by the bank as to the degree of due diligence it exercises in purchasing and originating the loans. Moreover, bank practices of paying brokers yield spread premiums to sell borrowers higher-priced loans than the borrowers’ risk and cost profile would garner, and service release premiums based on the size of the loan, encourage predatory practices of upselling borrowers to over-priced loans and loans that are larger, and thus more risky, than what the borrower needs. Further, the numerous lawsuits brought against national banks, their operating subsidiaries and their affiliates by the federal government for predatory practices, including the case brought by the Federal Trade Commission against The Associates and Citifinancial and the cases brought by the Department of Justice against Long Beach Mortgage Company, Huntington Mortgage Company, Fleet Mortgage Corporation, and First National Bank of Vicksburg, are striking evidence that banks, their operating subsidiaries and their affiliates have engaged in predatory lending.

#### Conclusion:

When one goes to the underlying sources cited by the OCC Paper, one sees a very different picture painted of the empirical information we have about subprime lending, including predatory lending, than the picture that emerges from the OCC Paper. The Paper draws its empirical data<sup>12</sup> largely from two sources: a single Freddie Mac paper<sup>13</sup> and a single Office of Thrift Supervision (OTS) paper.<sup>14</sup> Those sources contain numerous caveats about the data not being representative; for example, the OTS paper relies on data from the Mortgage Information Corporation (MIC), but cautions that the MIC data for subprime lenders includes only 27 lenders, and does not include any loans from ten states, several of which are particularly known for having difficulties with predatory lending.<sup>15</sup> Further, those sources contain some discussion

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<sup>12</sup> Apart from the data regarding the effect of anti-predatory lending laws in North Carolina, not addressed here.

<sup>13</sup> Amy Crews Cutts & Robert Van Order, *On the Economics of Subprime Lending* (Freddie Mac, March 2003).

<sup>14</sup> Fred Phillips-Patrick, Eric Hirschhorn, Jonathan Jones & John LaRocca, *What About Subprime Mortgages?*, 4 Mortgage Market Trends (OTS Research & Analysis, June 2002).

<sup>15</sup> *Id.* at 5-6.

of parts of the data that indicate a potential problem with predatory overpricing of some loans. For example, the OTS paper notes that about 16 percent of the A-minus borrowers in the MIC data set had credit scores over 680, scores correlated with prime credit risk, raising the possibility that these were predatory loans, high cost subprime loans given to prime risk borrowers. But the caveats about the lack of representativeness of the data and the discussion of the predatory pricing implications of the data appear nowhere in the OCC Paper. One cannot help but be concerned about the bias being displayed here, a bias that consistently understates the problem of predatory lending.<sup>16</sup>

Please contact me if I can be of any further assistance in this matter.

Very truly yours,

Lauren E. Willis  
Lecturer & Fellow

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<sup>16</sup> Similarly, the OCC Paper tries to refute Freddie Mac's analysis of inefficiency in pricing in the subprime market by arguing that the subprime loans Freddie examined are possibly riskier, and thus arguably should be higher priced, than the Freddie study allows. OCC Paper at 15 (citing Howard Lax, Michael Manti, Paul Raca & Peter Zorn, *Subprime Lending: An Investigation of Economic Efficiency* 17-18 (Freddie Mac, Dec. 2000)). Nowhere does the Paper note that the prices examined by Freddie are note interest rates, not including upfront brokers' fees, origination charges, and "points", all of which would most likely make the pricing differentials between prime and subprime loans substantially greater, and less explainable by differences in risk and cost, than the price differentials assumed by the study. That the OCC Paper would point out possible small understatements of the risk differential between the prime and subprime loans examined, without noting the likely large understatement of the price differential between the prime and subprime loans examined, displays a distinct bias.