

**NORTH CAROLINA'S PREDATORY LENDING LAW
IT'S ADOPTION AND IMPLEMENTATION**

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I. Introduction

It is a pleasure to present to you a paper on an important issue of public policy in which the State of North Carolina has taken a leading role. Although I was not one of the architects of North Carolina's predatory lending statute, as Commissioner of Banks I am one of its custodians and enforcers. These are responsibilities that I take very seriously.

In the discussion that follows, I will review the background of the North Carolina Predatory Lending Act (the "Act")¹ and its effect to date. I will then discuss implementation efforts to date, including the adoption of further legislation.

II. Background

As a starting point, let us review some fundamental issues regarding predatory lending: what is it and why is it an appropriate matter to be addressed by state legislation?

What is predatory lending? The definition of this term has been the subject of discussion and disagreement among parties interested in the issue; however, I believe there is a consensus around a number of factors that define this activity. In addition to high interest rates, predatory loan terms include high points, fees and associated charges (including single premium credit life insurance) that are financed through the loan itself. Further, predatory loans usually involve one or more of the following factors: (A) asset- rather than income-based underwriting; (B) inducing borrowers to continually refinance ("flipping"); (C) engaging in deceptive conduct to conceal the true cost of the loan or loans; and (D) excessive reliance on origination through brokers, home improvement firms and other third parties, with associated fees and expenses.

In discussing this topic, it is important to distinguish between predatory lending and subprime lending. Subprime lending, involving loans to borrowers who do not qualify for credit from banks or other "traditional" loan originators, provides an important source of credit for those who would not otherwise get it. Public policy often encourages such lending (*e.g.*, through the Community Reinvestment Act). Subprime lending generally involves interest rates that are higher than those for "prime" loans but does not involve the additional loan terms and lender conduct discussed above. While most predatory lending is subprime, not all subprime lending is predatory. People of good will can and do differ as to where to draw the line between acceptable subprime lending and predatory lending, but

¹ Senate Bill 1149, introduced by Senator Roy A. Cooper III (now North Carolina's Attorney General), was enacted as 1999 Session Law 332 and signed by Governor James B. Hunt, Jr. on July 22, 1999. The Act amended a number of provisions of Chapter 24 of the North Carolina General Statutes (Interest) and added new Section 24-1.1E relating to "high cost home loans."

our experience in North Carolina has been that a consensus can be reached and appropriate legislation enacted to prevent predatory lending.

Why is predatory lending an appropriate subject for legislation at the state level? Because predatory lending (i) is the result of substantial unequal bargaining power between borrower and lender, (ii) can result in significant damage to poor and working poor families and the elderly, and (iii) has not been adequately addressed at the Federal level. Let us review each of these factors in the order just stated.

Predatory lending is the result of unequal bargaining power between lender and borrower based on one or more of the following vulnerabilities on the part of the borrower: (i) low income and / or low wealth; (ii) lack of financial sophistication or, in the worst cases, gullibility; and (iii) diminished capacity (*e.g.*, effects of aging, diminished impulse control regarding consumer spending). In contrast to the “prime” market where competition among lenders and consumer awareness give consumers a reasonable chance to negotiate a loan on favorable terms, the asymmetry of knowledge and bargaining power in predatory circumstances, coupled with abusive conduct by predatory lenders, results in transactions that effectively strip the borrower’s home equity. Predatory loans have decimated the finances of a number of low-income, low wealth families and the elderly. In North Carolina and a number of other states, the need to address this socially undesirable circumstance has “trumped” countervailing policy concerns about interfering in private financial transactions.

Why is predatory lending an appropriate matter for state legislation? Because the worst abuses of predatory lenders have not been addressed effectively by Federal law. Although there is a substantial amount of Federal consumer protection legislation relating to mortgage lending (TILA, HOEPA, RESPA), the thrust of that legislation and the regulations issued under it has been to protect borrowers in the “prime” market. The impetus for the adoption of the Act was that predatory loans were being made in North Carolina in full compliance with the Federal legislation mentioned above. Further, under Alternative Mortgage Transaction Parity Act (“AMTPA”), a number of lenders were claiming that state government did not have jurisdiction over these loans.

The enactment of predatory lending legislation at the state and local levels has created a number of practical and legal issues. On a practical level, loan originators and purchasers have to include the effects of such legislation in their documentation and due diligence with regard to affected loans. In addition, such actions have resulted in a number of issues regarding the preemption of state and local statutes and ordinances by Federal law. The issue of predatory lending has been addressed by both the legislative and executive branches of the Federal Government, most recently by OTS’s proposed revision of its AMTPA rules. It is possible that preemptive action on this topic will be taken by Congress. Until then, and perhaps thereafter, state legislation and regulation has an important role.

III. The North Carolina Predatory Lending Act

As noted above, the Act was adopted because of a perceived need to address lending abuses that were not prohibited by the applicable Federal statutes and regulations. In its proposed form, the Act was the subject of substantial debate. As a result, the Act as finally adopted was the product of a consensus of banks, mortgage bankers and brokers, non-profit organizations and other stakeholders. In accordance with this consensus, the Act seeks to prohibit predatory conduct without also prohibiting acceptable subprime lending.

How does the Act attempt to achieve the goals noted above? By amending North Carolina's usury statute to include the following additional provisions:

Scope. The Act only covers residential mortgage loans of less than \$300,000; the presumption being that those able to borrow more are able adequately to protect themselves.

General Prohibitions. The Act adds provisions applicable to all home loans that prohibit: (i) prepayment penalties for loans of \$150,000 or less in principal amount; (ii) "flipping" of loans; (iii) the financing of single premium life insurance; and (iv) recommending or encouraging default on an existing or other debt in connection with a proposed refinancing.

High Cost Home Loan Provisions. A "high cost home loan" is a home loan that has one or more of the following characteristics: (i) points, fees and other charges of (A) if the loan is \$20,000 or more, more than 5% of the borrowed amount, or (B) if less than \$20,000, the lesser of 8% of the amount borrowed or \$1,000; (ii) an interest rate that exceeds by more than ten percent per annum² the yield on comparable T-bills; or (iii) a prepayment penalty that could be collected more than 30 months after closing or that is greater than 2% of the amount prepaid. With respect to high cost home loans, the Act imposes certain other prohibitions:

- a) no lending without counseling for borrowers;
- b) no lending without due regard to payment ability;
- c) no direct or indirect financing of any points, fees and closing costs;
- d) no call provisions;
- e) no points or fees charged on a high-cost home loan used to refinance an existing high-cost home loan held by the same lender;
- f) no home improvement contract loans where the proceeds go directly to the contractor;
- g) no balloon payments;
- h) no negative amortization;
- i) no increased interest rates on default;

² Eight percent (8%) per annum after October 1, 2002, on first mortgage loans.

- j) no advance payments (two months maximum);
- k) no modification or deferral fees.

Enforcement Provisions.

The Act does not set up a regulatory scheme with regard to proscribed conduct; rather it relies on enforcement through the existing provisions of the North Carolina usury and unfair and deceptive trade practice laws. Violation of the usury law can result in forfeiture of all interest and return of twice the amount of interest paid. Violation of the North Carolina unfair and deceptive trade practices law can result in imposition of treble damages and reasonable attorneys' fees.

IV. Effect and Implementation of the Act

In connection with the conduct of its regulatory business, the North Carolina Office of the Commissioner of Banks ("OCOB") keeps records of the consumer complaints it receives and the resolution of such complaints. As a rule, OCOB receives and handles about 1,000 written consumer complaints a year. In recent years, two-thirds of such complaints have related to mortgage matters, most having to do with brokers. The number and nature of consumer complaints we have received since the adoption of the Act has not changed significantly when compared to those received before. What has changed is our ability to achieve settlements in cases where predatory lending is alleged. The prospect of the imposition of the remedies referred to above has assisted in achieving settlements. To date, OCOB has not instituted formal proceedings under the Act; and we are not aware that the North Carolina Attorney General has done so. We are aware through the press of a pending private civil action under the Act.

What has the effect of the Act been on credit availability in North Carolina? Very little, as far as we can determine. According to the Coalition for Responsible Lending ("CRL"), in 2000, the first full year in which the Act was in effect, North Carolina continued to be one of the top 10 states in the United States for subprime lending, with 15% more subprime loans per capita than the nation as a whole. CRL quotes mortgage industry sources to the effect that North Carolina borrowers continue to have available to them a full array of products with little or no variation in rate. Further, evidence from published sources, and from OCOB's records, shows little or no reduction in the number of lenders who are conducting business in North Carolina. We are aware that the subprime lending unit of one major national lender has left North Carolina, but its absence does not appear to have had much effect.

Time to declare victory? In a word: no. The evidence we have on the Act's impact and effectiveness is preliminary and is not conclusive. The next step in dealing with predatory lending is to organize and implement a systematic enforcement program to ensure that North Carolina consumers get the benefit of the Act. In that regard, my office has received an additional and valuable

enforcement tool as the result of the General Assembly's enactment of the Mortgage Lending Act³ in its 2001 session.

Prior to the adoption of the Mortgage Lending Act, some mortgage bankers and all mortgage brokers in North Carolina were required to be registered with OCOB. The registration was required only of the firms engaged in these activities, not of individual loan originators. There were several general normative prohibitions in the predecessor law but limited bases for enforcement and little in the way of enforcement measures and resources.

Enactment by the North Carolina General Assembly of the Mortgage Lending Act has altered the regulatory landscape described above in a number of ways. The Mortgage Lending Act:

1. Requires all mortgage bankers and brokers to be licensed and extends the licensure requirement to each individual involved in the origination of mortgage loans in North Carolina, as a result of which (a) we now can discipline individuals as well as firms in cases of prohibited conduct and (b) fee revenues from licensing have significantly enhanced our resources available for enforcement activities.
2. Requires continuing education and testing for mortgage loan officers.
3. Contains a comprehensive set of normative provisions, violation of which can result in withdrawal of a license, civil penalties, and in certain circumstances, criminal penalties. Violation of the Act is one of the prohibited activities under the Mortgage Lending Act, providing a new and powerful vehicle for the enforcement of that statute.

Enforcement of the Mortgage Lending Act is the responsibility of the North Carolina Commissioner of Banks. As noted above, that statute has also provided me with revenues to conduct enforcement activities and my office is gearing up to do just that, in concert with our colleagues at the North Carolina Department of Justice.

Implementation of the Mortgage Lending Act is a daunting task on which my colleagues in OCOB and I are hard at work. Although the statute is essentially self-implementing, some implementing regulations are required and are in process. The Commissioner of Banks is the initial hearing officer for enforcement proceedings, so we are also hard at work setting up a legal infrastructure to handle a case load that we expect to be large. Finally, we are enhancing our consumer complaints and investigations units to handle these new

³ Senate Bill 904 was enacted as Session Law 2001-393 and signed into law by Governor Michael F. Easley on August 29, 2001. This legislation repeals Article 19 of N.C. G. S. Chapter 53 (Registration of Mortgage Bankers and Brokers) and replaces it with a new Article 19A (Mortgage Lending Act), effective July 1, 2002.

responsibilities. As manager of this process, my biggest concern at present is to define our enforcement objectives and see that our efforts are focussed in a way that gets us as close to these objectives as we can with the resources available.

V. Conclusion

The North Carolina General Assembly's actions to address the issue of predatory lending were supported by a broad consensus of stakeholders in the issue that I believe remains intact to this day. Through the adoption of the Mortgage Lending Act, that consensus has now provided the Office of Commissioner of Banks with enforcement tools that are expected to remove predatory lenders from the marketplace and keep them out. The effectiveness of this approach to the predatory lending remains to be determined. While the early evidence of the Act's impact (without the new enforcement regime) is encouraging, we have a long way to go. Optimist that I am, I believe we will succeed.

REFERENCES

Set forth below are resources referred to in the preparation of this paper and some additional resources that readers may find of interest.

Coalition for Responsible Lending

?? “Long Summary of NC Predatory Lending Law,” at http://www.responsiblelending.org/nc_law/longsumm.cfm

?? “How Is it Working?” at http://www.responsiblelending.org/nc_howits_working.cfm

?? “Testimony of Martin Eakes, Self-Help CEO and Coalition for Responsible Lending Spokesperson Before the Senate Committee on Banking, Housing and Urban Affairs on Predatory Lending” July 26, 2001, at <http://www.responsiblelending.org/legislation/testimony.dfm>

Conference of State Bank Supervisors. The following documents are available at http://www.csbs.org/government/regulatory/pred_lending/pl_home.asp

?? State Initiatives to Battle Predatory Lending (June 2002).

?? Barbara Kent, Director, Consumer Affairs & Financial Products, New York State Banking Department – CSBS Predatory Lending Testimony Before National Counsel of State Legislators (August 14, 2001).

?? Thomas J. Curry, Commissioner of Banks, Commonwealth of Massachusetts – CSBS Testimony on Predatory Lending before House Committee on Banking and Financial Services (May 24, 2000).

Donald C. Lampe, “The North Carolina Predatory Lending Usury Statute,” The Conference on Consumer Finance Law Quarterly Report (Winter 2001)

Note, “Will North Carolina’s Predatory Home Lending Act Protect Borrowers From the Vulnerability Caused by the Inadequacy of Federal Law?” North Carolina Banking Institute (Vol. 4 April 2000).

Stephen F. J. Ornstein, “North Carolina Senate Bill 1149 Prohibiting Predatory Lending,” and other articles on comparable state and local laws at <http://www.tpwlaw.com> under “Articles / Real Estate.”

Margot Saunders, “The Increase in Predatory Lending and Appropriate Remedial Actions,” North Carolina Banking Institute (Vol. 6 April 2002).

Joseph A. Smith, Jr., “The Federal Banking Agencies’ Guidance on Subprime Lending: Regulation with a Divided Mind,” North Carolina Banking Institute (Vol. 6 April 2002).