

**TRIGGER HAPPY:
ENACTMENT AND AFTEREFFECTS
OF
NORTH CAROLINA'S
"PREDATORY LENDING" LAW**

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The North Carolina high-cost home loan or “predatory lending” statute was the first state statute of its kind. The basic design of the law has been emulated and followed in nearly forty states, municipalities and counties. Indeed, many have suggested that North Carolina’s law should be a model for other state laws. The background of North Carolina’s law, related North Carolina’s state legislative developments since the law’s enactment, and the actual impact of the law on the marketplace may point to another conclusion. The law emerged from a nearly unregulated setting for mortgage loan originations. In practice, the law has imposed usury ceilings in the guise of high-cost home loan “triggers.” Moreover, the consumer and community advocates who have pressed for enactment of similar state laws have rarely, if ever, supported the introduction and enactment of the North Carolina “model” itself. Rather, enactments in other jurisdictions demonstrate a picking and choosing among features of the North Carolina law, with the more severe, anti-creditor provisions (or variants thereof) finding their way into law. The proliferation of a national patchwork of unique, one-off high-cost home loan enactments makes federal preemption, coupled with uniform consumer protections, a necessity.

Historical Background

The creation of the “predatory lending” statute in North Carolina arose from a unique cooperative effort that was unprecedented in North Carolina for the enactment of major financial services legislation. In the fall of 1998, at the encouragement of the North Carolina Attorney General’s office, a group of attorneys and industry representatives gathered to consider some modest adjustments to the North Carolina usury statutes which would limit or eliminate so-called “junk fees” in residential mortgage lending.

The Attorney General’s office had fielded numerous complaints over the years and assembled significant quantities of data regarding perceived abuses in the residential mortgage loan business in North Carolina. This data led the Attorney General’s office and the North Carolina Banking Commissioner to conclude that North Carolina’s usury statutes and mortgage banking and brokering statutes were not strong enough to protect consumers from overcharging by mortgage lenders. Very often, the perceived overcharges manifested themselves in numerous, separately-named and itemized fees and charges imposed by mortgage brokers and mortgage

lenders, *i.e.*, “junk fees.” As these discussions took shape, it became apparent that, due to federal preemption, many mortgage lenders doing business in North Carolina were free to impose and collect these charges without state law limitation.

The Attorney General’s office in late 1998 was encouraged to include established consumer advocacy organizations in the state (including Self Help Credit Union and the Center for Responsible Lending) in the process. The consumer advocates soon were joined by additional industry representatives, such that, by the end of 1998, a regular “working group” was meeting to consider changes to North Carolina’s residential mortgage lending laws. It became obvious that the consumer advocates (with the support of the Attorney General) desired to expand the working group’s charge and that the General Assembly would be amenable to accepting a broad usury overhaul bill. Thus, a modest initiative to clarify certain permissible mortgage loan fees (which eventually found its way into law in S.B. 1149 as amendments to N.C.G.S. §§ 24-1.1A and 24-8) grew into a full-scale initiative to create a “predatory lending” law.

The consumer advocates (along with the Attorney General’s staff) presented compelling evidence of mortgage lending abuses, including videotapes of national newsmagazine broadcasts dealing with the worst cases of mortgage lending abuse. It was difficult, to say the least, for industry representatives to speak in “support” of such practices. Industry’s challenge was made more difficult by the fact that the largest (at the time) trade group for North Carolina community-based banks could not be seen as being against documented mortgage lending abuses in this state. (Some observers believe that the passage of the predatory lending law contributed to the disbanding of the “big bank” state trade group in North Carolina, which merged into the North Carolina Bankers Association not long after the General Assembly recessed in 1999.)

The alleged abuses arose in a state in which the non-chartered residential mortgage lending industry was largely unregulated. The original North Carolina mortgage bankers/mortgage brokers law, first enacted in the late 1980’s, was merely a registration statute. Mortgage bankers and mortgage brokers were not subject to the supervision of or examination by the North Carolina Banking Commissioner, nor was registration at the corporate level difficult. Loan officers had no duty even to register, such that anyone who could find employment with a registered mortgage firm could make loans to consumers. The Banking Commissioner was not given additional personnel to enforce the law, and the policing of mortgage banking and brokering practices fell to the Attorney General’s Consumer Protection Division. In addition, the law (Article 19 of Chapter 53 of the North Carolina General Statutes) exempted all HUD-approved mortgagees (in addition to customary exemptions for banks, credit unions, and savings institutions). As a result, many, if not the majority of, mortgage companies transacted business with little or no regulatory oversight in North Carolina.

By the time S.B. 1149 was introduced in the North Carolina Senate on April 15, 1999 by a powerful group of senators, most observers had concluded that the “train had left the station” and that some form of comprehensive consumer mortgage lending reform would emerge from the General Assembly’s 1999 session. As the working group continued to meet in the spring of 1999, the various efforts by representatives of mortgage lenders and mortgage brokers to derail

or substantially revise the legislation failed. Most observers believe the working group's efforts (as enacted into law) were better than could be expected, due in no small part to the Attorney General's extensive experience in interest rate regulation and the input from within the working group of seasoned bank lawyers.

The working group also considered the enactment of a comprehensive reform bill for mortgage banking and mortgage brokering. As a result of this effort, S.B. 866 was introduced two days before S.B. 1149. It became evident to the working group, and particularly the consumer advocates, that two major mortgage lending reform bills were not capable of passage in the time remaining in the Session. The legislators who introduced the bills elected, in effect, to focus legislative efforts on the passage of the anti-predatory lending bill. There is something fateful about this outcome; if the General Assembly had acted otherwise, perhaps the sweeping state "predatory lending" movement that started in North Carolina would not have begun at all. As it happened, the second component of the original working group's anti-predatory lending activity in North Carolina actually became law in 2001. This occurred after S.B. 866's successor, S.B. 904, passed the General Assembly after intense negotiations with consumer advocacy groups, the Attorney General's office, and industry representatives. The new law, the Mortgage Lending Act, came about with the support of the same consumer advocates and politicians who pressed for S.B. 1149 in 1999. In fact, the passage of S.B. 904 represented a continuation of the original effort to regulate "predatory lending" in North Carolina. The law, codified at Article 19A of Chapter 53 of the North Carolina General Statutes, is a comprehensive licensure, trade practices, supervision and examination statute, and became effective on July 1, 2002. (The impact of this new law is discussed below.)

In summary, in the activity in 1998 and 1999, consumer advocates in North Carolina did extensive homework, and presented a sizeable quantity of objective and compelling evidence of residential mortgage lending abuses. Even though national consumer advocacy groups were not directly involved in the legislation in North Carolina, they gained strength from what happened here. Technical, legal issues of compliance did not stop the enactment of a broad-ranging bill. Because of the time pressure to get S.B. 1149 enacted into law, compromise language (such as that dealing with loan "flipping") found its way into the bill. It was said more than once during the process that it would be "up to the courts" to clarify vague or subjective standards in the statute. It is not true that S.B. 1149 received the unanimous support of the lending industry in North Carolina; representatives of the consumer finance industry never signed off on the bill, the mortgage brokers became happy with a statute that did not directly regulate them, and community banks and credit unions could not comprehend at the time how the complex law would affect them. Industry representatives were reminded repeatedly during the bill's consideration that "it was not as bad as it could be," which has become a common refrain in the states.

Scope of North Carolina's Law

The high-cost home loan statute, S.B. 1149, was based on the federal Home Ownership and Equity Protection Act (HOEPA) and Regulation Z Section 32. The statute was not limited to

state licensed or state chartered lenders, but applied to all lenders making covered loans. This aspect of North Carolina's law created troubling precedent, because it was assumed that all residential mortgage lenders were in need of strict and punitive regulation, based not on a lender's legal or regulatory status or track record but solely on loan terms. For example, the North Carolina predatory lending statute and its progeny cover community and faith-based lenders such as Habitat for Humanity. New remedial provisions in the North Carolina statute compounded compliance risk for conforming lenders. For the first time, unfair and deceptive trade practice (UDTPA) remedies appeared in North Carolina's usury statute, including provision of treble damages and attorneys' fees. Many other states followed this example, by imposing potential unfair trade practice remedies on ordinary mortgage lending transactions.

S.B. 1149 arose in the context of a long and convoluted history of interest rate regulation in North Carolina. All of S.B. 1149 was codified in North Carolina's usury statute (Chapter 24 of the North Carolina General Statutes). The North Carolina usury statute has grown by legislative accretion over the years, and new legislative enactments have not always been accomplished with a close eye on existing usury law in North Carolina. The North Carolina usury law is more complicated and fraught with more ambiguities than would be expected in a financial institution-friendly state such as North Carolina. The working group for S.B. 1149 had the opportunity to accomplish a comprehensive rewrite of the usury statute. Instead, political considerations led to the creation of a totally new (and in itself difficult) high-cost home loan statute. Here again, use of North Carolina's statute as a "model" creates difficulties. The hyper-technical nature of the law, in part arising from the structure and function of existing North Carolina usury and lending law, may not be an appropriate template for states with existing rational schemes of mortgage origination and mortgage lending oversight and regulation.

North Carolina's "predatory lending" statute succeeded in enactment in part because of consumer advocates' distaste for the effects of federal preemption in the residential mortgage lending arena. In the course of the drafting of the legislation, federal preemption, particularly preemption under the Alternative Mortgage Transaction Parity Act (AMTPA), became a sort of demon for state regulators and consumer advocates. It became evident to the working group that capping fees and charges under the usury statute would have limited effect against the many lenders in North Carolina claiming some sort of federal preemption, including AMTPA preemption. The predatory lending act, then, was written with full recognition of, and some would say with a strong intent to negate, federal preemption in residential mortgage lending in North Carolina.

It was obvious, as well, that state regulators and consumer advocates in North Carolina were not pleased with the ability of out-of-state financial institutions to "import" interest rates and fees to North Carolina under the Marquette and Greenwood Trust group of cases and related federal banking statutes. In fact, at the North Carolina Bar Association's Real Property Section Annual Meeting in May of 1999, while the predatory lending bill was still under consideration by the General Assembly, one of the Attorney General's representatives in the predatory lending "working group" detailed his reservations about federal preemptions and OCC and FDIC interpretations thereof. The suggestion was made that the federal banking agencies, among other

things, had been misinterpreting Riegle-Neal regarding banks' ability to export interest rates. It follows that the proponents of North Carolina's predatory lending act desired the law to appear in the guise of "consumer protection" rather than in the form of direct limitations on rates and fees.

It may be said (as was emphasized by consumer advocates during the consideration of S.B. 1149) that the North Carolina predatory lending law has no effect on preemption itself. That is, the statute does not limit rates, fees, prepayment charges or other purely economic loan terms. Rather, the statute imposes a whole host of consumer protections and compliance requirements on mortgage lenders, coupled with severe remedial provisions, if a home loan carries a higher interest rate or fees. To the extent that this part of the statute discourages federally-preempted lenders from making "high-cost home loans" in North Carolina, the statute may be viewed as a "stealth override" of federal preemption. As of now, there are no opinions or interpretative letters from the federal regulators (FRB, NCUA, OCC, OTS or FDIC) regarding the efficacy of North Carolina's predatory lending statute itself. Moreover, there does not appear to be a reported case that is dispositive of whether the "stealth override" created by North Carolina's predatory lending act is valid. The national regulators have not remained silent, however. Both the National Credit Union Administration and the Office of Thrift Supervision have issued preemption opinions for the New York and Georgia high-cost home loan statutes, respectively. The Office of the Comptroller of the Currency has under advisement a regulation that could preempt all or part of the Georgia high-cost home loan statute.

Later Enactments

The New York Banking Department began considering its own high-cost home loan regulations in 1999, before the North Carolina law became fully effective. New York looked to North Carolina's law as a template. Other states, such as Massachusetts, followed New York's example. So, the legislative history of anti-predatory lending in major financial institution states outside of North Carolina must be traced back to the pioneering effort in North Carolina. New York began with an earlier version of North Carolina's S.B. 1149, which included provisions that did find their way into law in North Carolina. So, comparisons of the North Carolina statute, the New York regulations, and other laws or regulations based on them become complicated by discrepancies between the final enactments.

After New York and Massachusetts acted by relying on an "outdated" version of North Carolina's law, other states joined in the regulatory and statutory parade. Each state, however, found the need to "tweak" the North Carolina approach. This occurred in part due to development by consumer advocates of their own model laws, including the influential AARP Model Home Loan Protection Act/Model State Statute. The AARP Model, issued on November 1, 2001, was prepared by the same consumer advocates who spearheaded the North Carolina legislative effort. The AARP Model was based the high cost home loan laws and regulations then extant from North Carolina, Illinois, Massachusetts, New York, and the District of Columbia (since repealed). The drafters of this model law, however, made it far stricter than any existing state law or regulation, with the inclusion, for example, of assignee liability and criminal

penalties. It was not long until some states, with encouragement from consumer advocates, started looking to severe, advocacy-driven laws as appropriate for enactment. For example, the Georgia Fair Lending Act, the New Mexico Home Loan Protection Act, and the New Jersey anti-predatory lending statute borrowed liberally from the AARP Model. Each of these states, unlike North Carolina, decided to include assignee liability provisions within a predatory lending statute.

Most states that have evaluated the need for high-cost home loan laws have opted to take a comprehensive, threshold-based approach, as expressed in the original North Carolina law. In some instances, such as Pennsylvania, Ohio, Michigan, Oklahoma, Florida, Texas and Kentucky, the state legislature adopted a comprehensive high-cost home loan statute that tracks the federal Home Ownership and Equity Protection Act (“HOEPA”). An equally common approach is the enactment of non-standard, “one-off” statutes or regulations that are comprehensive, punitive, and unprecedented in a particular state’s body of law. This occurred in Massachusetts, Illinois, the District of Columbia, Georgia, New Jersey, New Mexico, California, New York, Arkansas, South Carolina, and Maine, among other states. Generally speaking, all of the threshold-based laws are “modeled” after North Carolina’s groundbreaking statute, to the same extent that the S.B. 1149 was based on HOEPA. But like North Carolina’s approach vis-à-vis HOEPA, the “non-standard” states do not conform to either the best or the worst parts of the North Carolina law. There is now nothing less than a Tower of Babel in this country for multi-state mortgage lenders, particularly non-prime, higher-risk mortgage lenders, in terms of basic state law compliance.

In the last two years, an important trend has emerged: either a state high-cost home loan law will contain specific provisions aimed at mortgage loan origination (sales) practices or there will be a parallel state law on mortgage banking and mortgage brokering regulation or reform considered along with a threshold-based bill. This has occurred, for example, as to state statutes in Kentucky, Nevada, Arkansas, and South Carolina, all of which were enacted in the last six months. This particular trend in high-cost home loan legislation is in addition to the increasing number of state laws that amend existing mortgage banker/mortgage broker laws outside the immediate context of the passage of “predatory lending” statutes. These type of loan originator regulatory and oversight statutes have appeared in a large handful of states, including Washington, Ohio, Florida, and Nebraska (recalling that North Carolina’s law is intimately related to the state’s high-cost home loan statute).

This trend means that the “practice v. product” debate now is clearly manifested in the states. The debate, as recently framed by the recent OCC Advisory Letters on Predatory and Abusive Lending Practices (AL 2002-2) and Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans (AL 2002-3), is between proponents of threshold-based laws (products should be prohibited) and proponents of stricter regulation of mortgage loan originators (practices should be prohibited). For purposes of an overview of North Carolina’s experience, it is again noted that both the product-prohibitive statute (S.B. 1149) and the practice-prohibitive statute (S.B. 904) ultimately became law. The perceived prevalence in North

Carolina of abusive loans and abusive lending practices was addressed in both ways, but the order in which the laws took effect was, as discussed above, very nearly by happenstance.

Assuming that a practice-prohibitive law would create less disruption in the marketplace, and place culpability closer to the wrongdoer, then an effective practice-prohibitive law should be given the first opportunity to function. This did not occur in North Carolina, but could have and perhaps should have occurred. The states that are enacting relatively manageable product-prohibitive, HOEPA-based laws, coupled with stronger practice-prohibitive laws, are demonstrating the validity of this reasoning. The leading national trade group for mortgage brokers, the National Association of Mortgage Brokers (NAMB), supports stronger regulation of mortgage loan originators. In fact, NAMB has published a model statute for states that are considering new laws in this area. The states that enact punitive, threshold-based laws that extend liability to remote participants in the mortgage lending process, such as assignees and transferees, are selecting the more market-disruptive approach. Whether this is appropriate public policy is open to debate, and whether the “stricter” state laws actually will reduce the incidence of “predatory lending” practices without disrupting the legitimate flow of loan capital to deserving mortgage loan borrowers is not yet known.

As discussed above, the North Carolina law was the result of months of negotiations and compromise. A number of the features of the North Carolina law that have made it less troublesome for lenders have not always found their way into later anti-predatory lending enactments. This is most obvious in the area of assignee liability. S.B. 1149 was silent on the issue of assignee or transferee liability, such that ordinary holder-in-due course rules apply even to loans subject to the law. The other primary example is the special fee-shifting rule in the “anti-flipping” portion of the North Carolina law (at N.C.G.S. Section 24-10.2(d)). Here the North Carolina law permits the creditor to offer to correct the absence of “reasonable tangible net benefit” which, if rejected by the borrower, may void the borrower’s entitlement to attorneys’ fees in later litigation. This subtle subsection of North Carolina’s law has protected lenders behaving in good faith from “flipping” claims. No other state predatory lending law contains this language, except for the recent amendments to the Georgia Fair Lending Act.

Any state or other jurisdiction that enacts non-standard, threshold-based high-cost home legislation will create unique and unprecedented compliance burdens on all residential mortgage lenders, particularly if the legislation includes general prohibitions or limitations on certain practices. This has occurred over and over again in the states, because non-standard (non-HOEPA-based) statutes contain novel, ambiguous definitions and calculation tools for determining the thresholds or triggers. In addition, because many of the new statutes and ordinances are not consistent with HOEPA and Regulation Z, compliance with HOEPA will not always equal compliance with state high-cost home loan laws and rules. If the increased incidence of abusive mortgage lending practices, with widespread adverse impacts on homeowners and communities, must be regulated, it is not clear that a patchwork of non-standard, threshold-based state and local laws is a better approach than sales practices reform or a single federal statute for all high-cost home loans.

Deficiencies in the North Carolina Law

Virtually all residential mortgage lenders doing business in North Carolina have elected *not* to make “high-cost home loans” that are subject to N.C.G.S. § 24-1.1E. Instead, lenders seek to avoid the “thresholds” established by the law. Attorneys advising mortgage lenders in North Carolina, then, work on *avoidance* rather than *compliance* strategies. Moreover, even “conforming” lenders must concern themselves with the law. This is due to the structure of the HCHL statute (any loan exceeding one of the statutory thresholds is “predatory”), ambiguities in the law itself and the existence of certain general provisions in the law, including “anti-flipping” and prohibitions on financing insurance premiums.

The North Carolina statute, particularly the high-cost home loan provisions (codified at N.C.G.S. § 24-1.1E), was created from whole cloth by a legislative drafting committee consisting of the North Carolina Attorney General’s staff, banking and mortgage lender industry representatives and consumer advocates. The high-cost home loan (“HCHL”) statute loosely followed HOEPA, but most of the statute was drafted without reference to a model statute or other standard. Inevitably, even the best-intentioned drafters could not contemplate every potential technical problem with the new law. As pointed out below, compliance-oriented lenders have found certain parts of the HCHL statute difficult (if not impossible) to follow. The North Carolina General Assembly thus far has elected not to take on a HCHL “technical corrections” bill, in spite of widely-acknowledged deficiencies that could be addressed (at least in theory) in a politically neutral way. Any legislative or regulatory body now considering legislation or regulation based on the North Carolina statute should also take into account a host of unresolved technical compliance issues. In addition, any state or federal body using North Carolina’s HCHL statute as a template should realize that the statute may be the subject of future amendments in North Carolina.

The North Carolina statute presents a host of compliance issues, even for lenders wishing to avoid the statute completely—

- Ambiguity in the definition of “points and fees,” particularly as to how prepayment fees should be treated;
- Questions of the coverage of retail installment sales of manufactured/mobile homes used as primary residences;
- Coverage of the “cure” provisions, with the current understanding that the cure provisions are of no use to a lender who inadvertently “trips the triggers”;
- Inclusion of fees (such as prepayment fees, rate lock fees, and mortgage insurance premiums, including FHA and VA, and fees payable to affiliates) in the “points and fees” test that likely serve little or no meaningful consumer protection goal;

- Questions on interest rate buydowns and similar fees or charges under the definition of “points and fees”;
- The impossible task of creating an objective compliance standard for the “anti-flipping” law, which states that in any refinance transaction, the borrower must receive a “reasonable, tangible net benefit under all the circumstances”; and
- Inconsistency with HOEPA and the “two sets of standards” problem for compliance. This is particularly acute for an industry that relies heavily on automation in the origination and documentation of loans.

The impact of the North Carolina law must be viewed in terms of increased risk to compliance-oriented mortgage lenders and increased compliance costs. Even the most diligent and risk-averse lenders may be penalized under the law’s strict liability provisions. That is, there is no measure of intent; if the triggers are “tripped,” the lender becomes liable for not complying with the many additional requirements imposed in the HCHL part of the law. The law is troubling, with its ambiguous, non-standard definitions, along with meaningless cure opportunity, capped off by the imposition of strict liability. It is important to note, as North Carolina’s predatory lending law is being touted as a model, what it did *not* contain: assignee liability. Neither the GSE’s (Fannie Mae, Freddie Mac) nor other parties involved in the securitization of home mortgage loans needed to concern themselves with liability of remote holders of North Carolina high-cost home loans. The experience in the marketplace of states with assignee liability provisions within high-cost home loan statutes (such as Georgia and New Jersey) is adverse, and has led or is leading to reduction in availability of mortgage credit for consumers. This particular disruption obviously did not occur in North Carolina, following the effectiveness of S.B. 1149.

An increased compliance burden alone is not a rationale for avoiding the protection of consumers, in the deregulated atmosphere that led to the North Carolina law’s enactment. The question becomes, is North Carolina’s heralded predatory lending law working, without an adverse impact on the availability of legitimate mortgage credit?

Impact of the Law

As soon as it appeared that the “working group” was devising a broad-ranging version of a “predatory lending” bill, mortgage loan industry representatives in North Carolina began to express concerns about the availability of credit under the new law. Obviously, these arguments did not win the day. In a compromise maneuver, the General Assembly agreed to add a rider to S.B. 1149, providing for the appointment of a legislative study committee (to report to the Legislative Research Commission) to study the effect of SB 1149 on the availability of credit. The appointment of this study committee was not mandatory, and the leadership of the General Assembly ultimately did not appoint this committee.

It is not too cynical to believe that consumer advocates believe that high-cost home loans should not be made available to consumers in the first instance. This was borne out in the testimony before the Federal Reserve Board at the Home Ownership and Equity Protection Act hearings in Charlotte, North Carolina in late July of 2000. There, one of the Attorney General's staff who participated in the original "working group" stated that the drafters of the law intended to prevent high-cost home loans from being made in the first instance. Experience is showing that legitimate lenders will not tolerate the compliance burdens, coupled with the substantial legal risks of non-compliance and the significant reputation risk, imposed by the North Carolina statute. This was borne out in recent statements by another one of the Attorney General's staff involved in the original "working group," who stated that, to his knowledge, fewer than fifty instances of required home ownership counseling had occurred in North Carolina since the effective date of S.B. 1149. If this is the case, it follows that a statistically insignificant number of high-cost home loans have been made in North Carolina, especially considering that the occurrence of counseling does not mean that the subject loan actually closed. Bank compliance lawyers in North Carolina concur that their clients have adopted a novel compliance strategy for the high-cost home loan law: avoidance. It is beyond debate in North Carolina that no compliance-oriented lender doing business in the state is (knowingly) making high-cost home loans that are subject to N.C.G.S. Section 24-1.1E. Thus, the North Carolina laws "triggers" form usury ceilings in the state.

Whether state law usury ceilings themselves are valid public policy objectives is beyond the scope of this manuscript, but economists have asserted for many years that such legislation is undesirable. From the experience in North Carolina, it safely can be assumed that complex, non-standard, threshold-based, punitive predatory lending statutes establish usury ceilings at the interest rate/APR and "points and fees" thresholds. That makes the legislative task of deciding "how low to go" for thresholds much more significant and the question of availability of credit that much more important. Also, the recognition by federal banking regulators and perhaps the U.S. Congress of the usury-ceiling affect of these state and local laws should inform the preemption debate. There is evidence of this in the regulatory guidance issued thus far from OTS and NCUA, and the OCC is considering this as it seeks to regulate predatory lending in the national bank arena.

Few lenders announced publicly that they would "pull out" of the mortgage lending business in North Carolina following the enactment of S.B. 1149. Based on both published reports and anecdotal evidence, perhaps up to six to ten non-prime mortgage lenders withdrew from North Carolina completely. It is possible that many more lower-volume lenders, seeing marginal economic return in North Carolina against significant new compliance costs, withdrew from the state. It is widely known that residential mortgage lenders gave increased scrutiny to product offerings and loan terms. For example, some mortgage lenders in North Carolina coped with the high-cost home loan statute by expanding open-end credit offerings, which, as with HOEPA, are not covered by North Carolina's HCHL statute. (Lenders must exercise caution in this approach, however, because any intentional evasion of the state statute by structuring a transaction as an open-end loan is an unfair and deceptive trade practice.) The general "anti-flipping" section of S.B. 1149 probably caused a greater impact on credit availability than the rest of the statute

combined. This statute (N.C.G.S. § 24-10.2(b)) applies to *all* residential mortgage loan refinance transactions of less than \$300,000. The borrower must receive a “reasonable, tangible net benefit considering all of the circumstances” in any refinance transaction. A number of large, otherwise-responsible mortgage lenders doing business in North Carolina simply stopped making refinance loans in the state as a result of this statute. This was over and above any action to stop making “high-cost home loans” in North Carolina. Thus, the statute has had an adverse impact on the availability of conforming, lower cost credit. Just how many lenders have reacted negatively to the anti-flipping statute by ceasing to make refinance loans in North Carolina is not known. Given product migration and increased difficulty of making refinance loans following the enactment of S.B. 1149, it seems that any consideration of the North Carolina law’s impact on the marketplace must deal with the law’s incentives and disincentives to make certain credit products available to consumers in North Carolina.

At first, there was no significant litigation under North Carolina’s statute, which became finally effective July 1, 2000. Some “lead time” between enactment and lawsuits or other disputes is to be expected, however. Typically, legal questions do not arise at the time a residential mortgage loan is closed. Rather, disputes and lawsuits arise at the time of pay off or upon acceleration and foreclosure. In the past year or more, there has been a significant uptick in the number of lawsuits filed in the courts in North Carolina containing “predatory lending” claims. These cases ordinarily are filed as injunctions against foreclosure, a remedy which North Carolina recognizes by statute. It is common for these lawsuits to assert generally “predatory lending” because of alleged threshold violations, without specifying how the plaintiff is “doing the math.” Any analysis of the impact of North Carolina’s law should recognize that the decision of any particular lender to curtail lending in North Carolina, or even leave the state completely, will be influenced by the lender’s experience at the hands of the plaintiffs’ bar and the courts. This is to say, the decision of whether to make home loans in North Carolina or to withdraw from this market may be a long-wave phenomenon.

The volume of mortgage credit in North Carolina appears to have been affected by the effectiveness of the new Mortgage Lending Act. This Act became effective on July 1, 2002, and for the first time imposed license requirements on individuals involved in making or brokering residential mortgage loans in North Carolina. These, individuals include all employees of mortgage bankers or mortgage brokers who are “loan officers,” “branch managers,” and “managing principals.” These individuals now are required to have significant levels of experience in the business, and must take a course and pass an examination under the Act. Keeping in mind that chartered financial institutions (banks, thrifts, credit unions) are exempt from the Mortgage Lending Act, the Banking Commissioner’s office received *over ten thousand* individual “loan officer” applications during the initial licensing period. The Banking Commissioner rejected about six hundred of these applications, or approximately 5% of the total, usually on grounds of moral turpitude (most often, past criminal convictions or incidents of financial fraud), misleading application statements, or low credit scores.

Assuming that the persons denied the ability to (lawfully) work in the mortgage lending business may have more of a proclivity to engage in abusive or “predatory” practices, then the impact of

the North Carolina Mortgage Lending Act should be the reduction of allegedly predatory, or abusive home loans. In addition, the licensing, education and experience requirements should, if the Act serves its original purpose, reduce the overall incidence of abusive mortgage lending practices in North Carolina. Thus, any study that points to a reduction in “predatory loans” in North Carolina since July 1, 2002 must account for the impact of the North Carolina Mortgage Lending Act.

The question remains: are loans that would otherwise be made (with home mortgage credit for North Carolina consumers) not being made because of the predatory lending law? (There is anecdotal evidence that broker-originated FHA loans nearly disappeared after the effective date of S.B. 1149, because there is little space under the “points and fees” threshold for FHA premiums, broker compensation, and other routine closing costs.) The consumer-oriented studies on this topic to date are inconclusive at best, and misleading at worst. The other studies on the law’s impact, prepared from an academic perspective, do not fully account for external or extrinsic factors, such as the functionality of the North Carolina law and the later enactment of mortgage banker/mortgage broker reform. The context of the law’s passage, its affect on credit product offerings, and other factors that may influence any statistical analysis of credit availability in North Carolina post-S.B. 1149 are discussed above. The remainder of this manuscript discusses the studies and analyses of the impact of S.B. 1149, including the consumer-oriented studies of the Center for Responsible Lending (CRL) and the Center for Community Capitalism at the University of North Carolina at Chapel Hill (CCC/UNC). The conclusion is that these latter studies represent advocacy for the promotion of North Carolina’s scheme rather than an objective depiction of the impact of North Carolina’s predatory lending law. NOTE: The author recognizes that no study is perfect, given the variegated sources of data about the amount and type of residential mortgage lending in a particular jurisdiction. There is no “final word” from these studies and reports on the impact and effectiveness of S.B. 1149, and the debate in North Carolina continues.

Consumer-Oriented Studies

That the groundbreaking North Carolina predatory lending law has attracted the attention of academics and other impassioned observers is no surprise. It is not the intent here to survey the studies. Such a survey necessarily would lead to an analysis of statistical data that forms the basis of the previous studies, and on to difficult or imponderable questions such as the reliability of Home Mortgage Disclosure Act (HMDA) data and the appropriateness of assuming that all sub-prime mortgage loans have inherently predatory features. As discussed above, none of the studies to date take into account important externalities, such the unique backdrop of North Carolina original predatory lending law, its actual legal terms, and the subsequent enactment of a comprehensive mortgage lender/mortgage broker law.

The moral instinct behind North Carolina predatory lending law, and the seriousness of its proponents, is not in question. As discussed above, the evidence of the need for reform in residential mortgage lending practices in North Carolina was more than anecdotal. At the time of the consideration and enactment of the original North Carolina predatory lending law, lending

industry representatives could not be seen to be opposing serious reform. Moreover, other than the limited applicability of HOEPA, few mainstream lenders in North Carolina had any experience in the area of higher-cost home lending and no one knew exactly how the marketplace would respond. There is no intent here to disparage the proponents of North Carolina's important law. If one thing became clear from the predatory lending debate in North Carolina, passions run high on matters of social justice and economic impact of new regulation. None of these considerations, however, should detract from the need for scrutiny of studies on the impact of the law, particularly since S.B 1149 is being held up as a model for other states.

The most recent study is the CCC/UNC assessment of the impact of North Carolina's anti-predatory lending law, by Quercia, Stegman and Davis, dated June 25, 2003 (referred to hereinafter as the "CCC/UNC Study"). This is a preliminary work, intended to be "entirely descriptive." The authors acknowledge that, "Examinations of the law's impact to date have had varied results." The CCC/UNC Study received funding from the Center for Responsible Lending (CRL), the affiliate of Self-Help Credit Union in Durham, North Carolina and its roll-out assessment ceremony in Chapel Hill included CRL and AARP representatives. It seems fair, then, to construe the CCC/UNC Study as consumer advocacy-oriented. The other comprehensive consumer advocacy-oriented study is the report from the CRL issued on August 13, 2002, "North Carolina's Subprime Home Loan Market After Predatory Lending Reform," by Ernst, Farris and Stein (referred hereinafter as the "CRL Report"). The authors are employees of Self-Help, the primary proponent of the original S.B. 1149. The CRL Report finds that "subprime home lending continues to thrive in North Carolina," while reductions in predatory lending saved North Carolina consumers at least \$100 million. The initial CCC/UNC Study attempts to refine these findings, by focusing on "specific market segments" that are assumed to contain a higher incidence of home loans with predatory features. This refinement on CRL's analysis of the overall home loan market in North Carolina resulted in the CCC/UNC Study reaching opposite (albeit preliminary) findings from the CRL Report.

The CCC/UNC Study briefly reviews the previous academic work in this area. This includes the studies of Elliehausen and Staten (2002 and 2003), which demonstrate a decline in overall subprime originations, and the Harvey and Nigro (2002) analysis of HMDA data. The Harvey and Nigro abstract finds a decline in "subprime" loan originations in North Carolina following enactment of the predatory lending law, due to a decline in loan applications. The CCC/UNC authors posit that subprime lenders may have been less aggressive in marketing loans post-enactment, because the number of lenders did not decline post-enactment. (The CCC/UNC authors did not speculate on whether the decline in loan applications may have been due to certain higher-cost credit products not being available at all.) Each of these studies shows a decline in "subprime" lending in North Carolina after S.B. 1149 was enacted, but only the CCC/UNC Study finds the decline desirable. This is because the CCC/UNC Study ties the decline to home loans considered likely to have abusive characteristics.

The CRL Report was released at a news conference led by North Carolina Governor Mike Easley. The CRL Report's contents represented a validation of years of intense effort by leading consumer advocates in North Carolina. The flaws and biases in the CRL Report, however,

reveal that it properly should be viewed as advocacy rather than analysis. The bona fides and the veracity of the authors is not in question here. However, the assumptions behind and methodology of the CRL Report reduces its usefulness (as least for now) as an objective tool for promoting the North Carolina high-cost home loan statute as a solution for other states. Critics of the CRL Report must acknowledge that its initial flaw, that is, relying upon incomplete data, may be curable in later work.

The CRL Report based its statistical analysis on HMDA data from 1999 and 2000, while acknowledging that the findings “must be treated as initial results rather than final answers.” The CRL Report’s most important finding, that “subprime” lending remains robust in North Carolina, comes from interpreting data through a foggy lens. This is HUD’s determination of “subprime” lenders. HUD prepares its “manufactured housing and subprime lender list” by assuming that certain lenders, by name, are “subprime,” with validation by telephone interviews. This type of “lender profiling,” inappropriate in other legal settings, also is unreliable in this context, simply because not every lender thought to be “subprime” always originates “subprime” loans. Moreover, some mortgage lenders on the HUD list originate a significant volume of “prime” loans, which results directly in over-counting of “subprime” loan volume. (This is evident from the listing in Table 4 of the CRL Report.) Other statistical flaws emerge from the use of HUD’s list. For example, the list includes manufactured home lenders, which could result in over-counting of retail sales financing transactions, which are not subject to the North Carolina “predatory lending” law in the first place. The HMDA data, as interpreted through the HUD list, also fails to account for the possibility of overall lower credit scores in the state of North Carolina or the state’s lower-than-average median income.

The CRL authors discuss the limitations on the timeframe of the HMDA data used and the basic limitations on the use of HMDA data generally. These limitations will be curable, to some extent, based on expanded HMDA subprime reporting requirements becoming effective in 2004. The additional evidence that the CRL Report includes reference to an *Inside B&C Lending* analysis published March 5, 2001. This analysis purportedly showed no change in the type and prices of loan products offered in North Carolina post-S.B. 1149, compared to other states. The CRL Report provides no explanation of methodology of the *Inside B&C Lending* analysis, which was informal. The other collaborating evidence mentioned in the CRL Report was the Morgan Stanley & Co. research report of August 1, 2002 (“Channel Check: Surprisingly Strong Subprime Growth”). This research report found little impact on subprime lending originations following the enactment of tougher mortgage lending laws. The use of this research report to support objective analysis of the impact of North Carolina’s law, however, is flawed. The findings in the Morgan Stanley research report are based primarily on interviews of finance company branch managers, and not on actual market data. The research report was intended to provide equity research, for buy-sell decisions as to specific equities (stocks), and as such was not intended to support academic research. Moreover, Morgan Stanley indicated in the report that recent economic weaknesses had led to a stronger, inelastic demand for subprime loans. The company also noted possible “big fallout” for consumers needing smaller loans (\$20,000 or less), and the needs of consumers in this market not being met. Finally, the company pointed to

healthy competition in the market as a whole, with technology making branch managers more efficient, as a reason for increased subprime loan volume.

The CRL Report's conclusions as to cost savings of North Carolina consumers are speculative. The incidence of certain lending practices simply is assumed, based on a previous Coalition for Responsible Lending paper. Then, this is factored into a hypothesized decline in "subprime" originations, with the resulting calculation yielding gross dollar amounts of "savings to consumers." Fully 20% of this savings is attributed to elimination of single premium credit insurance, a result which could have been achieved in North Carolina by a simple amendment to the credit insurance law. The largest savings component, 35%, is attributed to the prohibition of prepayment penalties on first mortgage loans, which was the law in North Carolina prior to the enactment of S.B. 1149. In this regard, S.B. 1149 simply raised the prohibition trigger from \$100,000 to \$150,000 in principal amount.

The CCC/UNC Study also relies on flawed assumptions and inadequate attention to externalities. (In fairness to the authors, the study is only preliminary.) The authors of the CCC/UNC Study should have ample opportunity to adjust and refine the findings in the coming months. The possibility of external or extrinsic factors as relates to any North Carolina-specific data is discussed above. The following points may be worth additional scrutiny by the authors in future research:

- The *Loan Performance* database appears to cover only "securitized" home loans or home loans sold into the secondary market in RMBS transactions. Many "subprime" lenders, especially consumer finance companies, do not sell or securitize home loans, but maintain them in portfolio. In addition, the *Loan Performance* database does not appear to account for loans sold to private investors, unless those loans find their way into RMBS transactions. Moreover, as the CCC/UNC Study itself acknowledges, only 10 of the top 25 ABS home equity originators report to LP. It follows that use of this database likely results in an undercounting of "subprime" originations, calling into question the decrease in subprime originations observed by the CCC/UNC Study.
- The assertion that "most predatory loans are refinances," and the assumption that *all* subprime refinances are "predatory." These assumptions create a hypothesis-driven result.
- The similar assumption that loans with longer-term prepayment penalties, balloon payments, and high LTV's are inherently undesirable. These are terms that may or may not be desirable, depending on the circumstances of a particular mortgage loan transaction.
- The impact of the North Carolina Mortgage Lending Act on aggregate loan originations after July 1, 2002.

North Carolina and the Case for a National Standard

The non-standard, punitive approach to regulating mortgage lending origination which began in North Carolina grew to encompass over 35 states and municipalities. North Carolina began with a complicated threshold-based “predatory lending” law, which intentionally or not, placed significant compliance (or avoidance) burdens on all residential mortgage lenders. The North Carolina approach began to spread around the country without regard for the historical reasons for the need for stronger regulation in North Carolina in the first place. Also, this movement began before the North Carolina General Assembly finished the initiative to curb “predatory lending” that began in earnest in 1998. As discussed above, the “rest of the story” in North Carolina was the enactment of a comprehensive mortgage banker/mortgage broker reform statute that became effective in 2002.

The 35-odd state and municipal threshold-based “predatory lending” laws now in effect bear reasonable similarities to each other, but no two are exactly alike. A compliance-oriented multi-state lender must deconstruct each of these laws or ordinances, to determine the basic application, mathematical rules, and potential downside risk. Again, the design of nearly all of these laws is product-based rather than lender type-based, so it rarely is prudent for any particular lender to assume that a state or local law will not apply to it.

Against this background of proliferation anti-predatory lending laws, the most significant issue today in the national debate over these laws is whether a “single federal standard” is appropriate. This standard, presumably, would impose a single set of rules, applicable as a matter of federal law, to classes of loans deemed to be in need of closer regulation. The most convenient way to achieve this would seem to be by way of amendments to HOEPA, coupled with federal preemption of contrary state law. The Ney-Lucas bill (the proposed Responsible Lending Act) achieves this, but adds significant additional consumer protections regarding sales practices in loan originations. For example, Ney-Lucas requires the creation of a national database for mortgage brokers. In short, the Ney-Lucas bill takes on both “product” and “practice.” As a first step, the Ney-Lucas bill seeks balance. This bill already is drawing fire, because it could negate years of consumer and community advocates’ success with product-related state-by-state regulation.

Ultimately, a preemptive federal statute may not be necessary, if the federal banking agencies continue to issue preemptive rulings and interpretations of state anti-predatory lending laws. But reliance on federal banking agency preemption would result in a competitive disadvantage to non-chartered or non-bank-affiliated mortgage companies, who cannot claim the benefits of federal preemption. This is why, at least from the point of view of the non-bank mortgage lending industry, a single-point federal standard is more desirable than a series of preemption interpretations or rulings issued from time to time by federal banking agencies. It is well known that the residential mortgage lending industry is national in scope. The great majority of residential mortgage loans, whether bank or mortgage company originated, are securitized. Thus, originators all over the country rely on capital from a national market. If nothing else, the plethora of state and local anti-predatory lending laws reduces the velocity of capital from national sources to originators acting locally. This is shown in the recent announcements of the Wall Street rating agencies, reacting to state anti-predatory lending laws in Georgia, New Jersey,

and elsewhere. Obviously, whether this reduction in funds available to borrowers is salutary is part of the debate. Some consumer advocates believe that under existing laws, certain home loans simply should not be made. As discussed above, the design and impact of North Carolina's anti-predatory lending law is an example of consumer advocates prevailing in this view.

Would the creation of a single federal standard, with preemption of contrary state laws, constitute an unacceptable infringement on states' rights and state-level policymaking for consumers in the states? The question seems to answer itself, based on the enormous growth in the federal regulation of residential mortgage lending in the past generation. The residential mortgage lending business now is subject to TILA, RESPA, ECOA, HOEPA, HMDA, FCRA, and Gramm-Leach-Bliley among other federal laws, as well as implementing regulations for these laws. Congress has spoken again and again by enacting uniform, federally-based regulation of credit granting and loan funding in the residential mortgage lending arena. Even when Congress has acted, however, there have been "strings attached," such as recognition of stricter state laws. Particularly with respect to interest rate regulation, Congress has seen fit, in times of market disruption due to state laws, to create leveling agents, such as Section 501 of the Depository Institutions Deregulation and Monetary Control Act and the Alternative Mortgage Transactions Parity Act. It follows that a national standard, with appropriate consumer protections, is consistent with past lawmaking and policy in this area.

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Author Biography

Don Lampe is a Member/Partner of Womble Carlyle Sandridge & Rice, P.L.L.C, a 450-lawyer firm with nine offices across the southeastern United States. He is a member of the Firm's Regulatory, Compliance and Consumer Credit Practice Team within the Capital Markets Practice Group. He received his J.D. from Duke University School of Law in 1982, and his B.S. from Massachusetts Institute of Technology (Phi Beta Kappa) in 1978. Mr. Lampe is Chair of the Access to Services Subcommittee, American Bar Association Consumer Financial Services Committee and he serves on the American Bar Association Predatory Lending Task Force. He is on the Governing Committee of The Conference on Consumer Finance Law, and is the North Carolina Editor for both HOUSELAW and CARLAW. He was a Public Member of the Credit Insurance and Mortgage Credit Committee, North Carolina General Assembly Legislative Research Commission, and an invited Panelist at the Federal Reserve Board Hearings on Predatory Lending Practices in Home Equity Lending, July 27, 2000, Charlotte, North Carolina. He is a frequent speaker at national conferences on topics of predatory lending, fair lending and consumer credit laws. Some of his recent publications include articles on predatory lending, consumer credit legislation, customer privacy/G-L-B, motor vehicle finance, ECOA litigation, mortgage broker regulation, and usury laws in residential mortgage transactions. For the last several years, he has been involved extensively in legislative and administrative initiatives on the state and federal level to regulate predatory lending, "payday" lending and other types of consumer financial products, as well as consumer privacy. In this regard, he has served as counsel on high-cost mortgage lending issues to several national lending trade organizations, as well as to state lending trade groups in North Carolina, Georgia, Kentucky, Tennessee, and New Mexico. He recently was selected for inclusion in "The Best Lawyers in America" in the corporate practice area. He is admitted to practice in North Carolina (1986) and Texas (1982).

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