

Title: A Primer on the 1994 Home Ownership and Equity Protection Act

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I. Executive Summary

The 1994 Home Ownership and Equity Protection Act¹ (“HOEPA”) amended the Truth in Lending Act² (“TILA”) with regard to its consumer protection guidelines on homeownership lending. This memo examines the role of HOEPA in the context of the federal and state legislative schemes and its role in the housing crash and subsequent global financial meltdown.

HOEPA sought to address a series of problems in residential mortgage lending: negative amortization, balloon payments, disclosures, and reverse redlining. During the 1980s and early 1990s, investigative journalists had published several articles that explored the landscape for borrowers who struggled to pay off mortgages due to fees or high interest rates. Congressional hearings from 1993 further explored constituents’ experiences with predatory lending in the mortgage market, and legislative ideas to address these concerns. In the final legislation, Congress charged the Federal Reserve Bank (“the Fed”) with enforcement of HOEPA.

This memo discusses HOEPA’s background, context, and content to illuminate the regulatory environment for mortgage lending in the decade preceding the 2008 Crisis. Although the Act’s enforcement mechanisms laid the groundwork for curbing predatory lending at the federal level, the Federal Reserve Bank failed to adequately enforce the Act. This stance facilitated a wildfire of predatory lending practices that ensued in the decade to follow. The memo also briefly sketches a 2013 rule adopted by the Consumer Financial Protection Bureau, which tightened up

¹ Home Ownership and Equity Protection Act, U.S. Code 15 (1994), § 1601.

² Truth in Lending Act, U.S. Code 15 (1968) § 1601.

federal oversight of mortgage lending, to provide context on the present-day federal landscape of mortgage lending consumer protections.

II. Policy Problem

At least two decades before the American mortgage market collapsed, lawsuits alleging abusive lending practices towards minority homeowners were in full swing. Throughout the 1980s, Attorneys General in Georgia and Massachusetts sued non-bank lender Fleet Finance, with private attorneys representing clients in Illinois, Alabama, and Arizona, for racial discrimination and violations TILA³. A newspaper article documenting the litigation described Fleet Finance as a “small and unregulated mortgage company... the choice for low-income borrowers considered too poor or financially unstable to qualify for a bank loan.”⁴

Although some of these loans were for first mortgages, most constituted second mortgages (when consumers already possessing a mortgage use their accumulated home equity as collateral for another loan). The second mortgage could pay for a housing repair, as it did in the case of a Georgia couple whose initial \$5,559 loan morphed into a \$69,167 debt. In this case, the mortgage lender added the balance of the original mortgage and extra fees to the loan, and tacked on an annual interest rate of 23%, more than double the nationwide average.⁵ The couple won their lawsuit against Fleet Finance, as did over 100 others between 1986 and 1991.⁶ After Fleet Financial paid \$4 million in damages resulting from a lawsuit in Massachusetts, the Federal Reserve Bank of Boston released findings that racial discrimination had become widespread in

³ AP. *"SHARK BITE: BIG BANK ACCUSED OF LOAN PRACTICES THAT PREYED UPON POOR: [FIVE STAR EDITION]."* (St. Louis Post – Dispatch, 1992).

⁴ Ibid.

⁵ Freddie Mac has a record of interest rates on fixed-rate mortgages dating back to 1971. In 1989, the same year the Georgia couple unknowingly agreed to a 23% interest rate, the average annual rate was 10%.

⁶ AP, *SHARK BITE*.

mortgage lending, especially that provided by non-bank lenders.⁷ As these local and state lawsuits and subsequent reports began making federal news, members of Congress took notice.

In 1993, members of the Senate Committee on Banking, Housing, and Urban Affairs gathered to discuss proposed legislation to improve regulation of mortgage lending.⁸ The Committee held multiple sessions on a bipartisan bill, hearing from constituents and policy experts on how to combat “reverse redlining,” which Senator and Chairman Donald Riegle (D-Michigan) identified as the critical problem for the envisaged legislation, eventually called the Home Ownership and Equity Protection Act (HOEPA), to solve.

Reverse redlining, as Riegle explained, occurs when creditors target minority and subprime borrowers⁹ to lend on unfair terms¹⁰. An attorney in one of the Georgia lawsuits against Fleet Finance used the same term when describing the lending practices used against his clients, all of whom were people of color.¹¹ Riegle expanded the definition of reverse redlining to include borrowers who could have normally qualified for prime loans, but because of their residential location or racial or socioeconomic demographic, financial institutions only offered them loans with high interest rates and extra fees.

Subprime loans attempt to offset the risk of nonrepayment by incorporating additional fees, higher and variable interest rates, and other requirements that facilitate collection in the case of

⁷ Carr, J.H. and Megbolugbe, I.F. (1993), “The Federal Reserve Bank of Boston Study on Mortgage Lending Revisited,” *Journal of Housing Research*, 4(2), pp. 277-313.

⁸ U.S. Congress, Senate, Committee on Banking, Housing, and Urban Affairs, *Home Ownership and Equity Protection Act of 1993: Hearings before the Committee on Banking, Housing, and Urban Affairs, 103rd Cong., 1st sess., 1993.*

⁹ For the purposes of this memo, subprime borrowers refer to individuals whose income and assets do not generate confidence in their ability to repay loans or debts. Chairman Riegle defines this class of borrowers as the target consumer demographic requiring protection in his opening statement, but does not call them subprime.

¹⁰ U.S. Congress, Senate, Committee, *Home Ownership and Equity Protection Act of 1993*, 1.

¹¹ AP, *SHARK BITE*.

nonpayment. The overall impact of extra fees, higher rates, and onerous terms can make the loan predatory, but not all lending to subprime borrowers is predatory per se. HOEPA aimed to clearly identify and combat these forms of unfair risk compensation.

During the 1993 Senate hearings, Senator Alfonse D’Amato (R-New York) also emphasized the need for greater consumer knowledge and access to information about lending practices and terms. D’Amato referenced extensive evidence that consumers frequently did not understand loan terms and provisions, and faced pressure from sales personnel to sign quickly.¹²

The trouble in addressing this problem, however, was that minority and low-income borrowers could face even more difficulty in accessing lines of credit. Senators did not want to exacerbate the reality of traditional redlining — the policy of refusing to lend or bank in majority-minority neighborhoods — by making lenders even more wary of subprime lenders. The resulting version of HOEPA did not outlaw this higher cost lending outright, as legislative drafters opted instead to increase oversight on these loans and offer resources to the communities in which they had become common.

III. Policy Content

HOEPA amended parts of TILA, the short title for Title 1 of the Consumer Credit Protection Act (CCPA). TILA was enacted in May 1968 and took effect on July 1, 1969, through CCPA’s Regulation Z.¹³ Its initial twin goals were to prevent fraudulent lending and to require banks to make proper disclosures. In the decade following, Congress passed several major amendments to TILA, covering specific types of credit, including automobile loans and residential mortgages.

¹² U.S. Congress, Senate, Committee, Home Ownership and Equity Protection Act of 1993, 6.

¹³ Consumer Finance Protection Bureau, *Laws and Regulations: Truth in Lending Act*, (2015), 1.

HOEPA promoted two primary objectives: (1) an increase of consumer awareness and (2) limitations on high rates and fees. To effectuate the first goal, the Act implemented information disclosure requirements; for the latter, HOEPA imposed numerical constraints and specific bans on certain fees.

The Act applied to any mortgage using a home as collateral, with fees at or before closing that exceed 8% of the loan amount or \$400, whichever was higher. The Act also applied to any mortgage with an annual percentage loan rate of 10 percent above Treasury securities. In effect, HOEPA designated these mortgages as potentially predatory, triggering specific limitations and enforcement mechanisms. As newspaper investigations and congressional testimony stressed, financial institutions had increasingly marketed mortgages in this category towards the low-income and minority groups that Congress wanted to protect.

In limiting payable fees and/or interest rates, HOEPA aimed to put an end to loans that involved ongoing payment of interest and fees without any reduction in the loan principal. The Act prohibited lenders from levying additional fees before, after, or during the loan term, or requiring any advance interest payments. HOEPA also banned prepayment penalties—charging a consumer an extra fee if they paid off any of their mortgage principal ahead of schedule—with four exceptions. The most relevant exception allows prepayment penalties if lenders verified a borrower’s income and expenses at loan closing. Another key provision forbade balloon payments for mortgages with a term of less than five years.¹⁴ Furthermore, the Act proscribed negative amortization, which occurs when borrower payments do not even cover the interest on the loan, resulting in monthly increases in the principal balance owed. In addition, HOEPA

¹⁴ This prohibition meant that loan terms had to provide for borrowers to pay down the balance of their loan amount, and so not just pay interest for five years and then owe a lump sum for the initial loan amount at the conclusion.

prohibited interest rate spikes triggered by consumer default. Each of these provisions aimed to eliminate costs that lenders frequently wrote into the mortgages that they offered to low-income and minority borrowers.

HOEPA further mandated that lenders had to consider the customer's ability to pay, including "current and expected income, current obligations, and employment."¹⁵ The legislation, however specified no detailed practices in this regard. Although this element of HOEPA action appears to focus on protecting lenders from engaging with inadequate borrowers, it also sought to provide additional protection for consumers. The emergence of a robust secondary mortgage market had allowed financial institutions to make a loan, siphon off fees, and then sell that loan to another financial enterprise. Original creditors no longer bore any risk, incentivizing them to solicit customers and extend mortgages, even if they were not financially viable.

With regard to the goal of supporting consumer knowledge about loan terms, a large portion of the Act mandated verbal and material disclosures about mortgage terms. In the loan agreement, the lender had to include specific sentences explaining that the customer did not need to sign the agreement simply because they had begun the application process. The lender also needed to disclose the annual percentage rate, amount of monthly payment, and the fixed-interest rate. The legislation also required that once agreed upon, lenders make these disclosures at least three business days ahead of finalizing the mortgage and terms.

An additional type of lending that HOEPA addressed involved reverse mortgages -- loans through which homeowners can borrow against the value of their homes and receive monthly payments until they transfer the home (and agreement) to another entity or die, after which the

¹⁵ Home Ownership and Equity Protection Act, U.S. Code 15 (1994), § 1601.

borrower returns the principal with interest. The practice is commonly known as equity stripping. HOEPA required that lenders disclose the projected total cost of the mortgage, amount of the payments owed to the homeowner, and statements informing the consumer they were not obliged to sign the agreement just because they had begun applying.

The effectiveness of many of HOEPA's provisions depended on ongoing oversight provided by the Fed's Board of Governors. HOEPA empowered the Fed to create regulations to enforce the legislation and required the Board to monitor of the Act's effectiveness by conducting a study within the first two years of enactment and holding hearings on the home equity loan market.

IV. Stakeholder Analysis

The primary stakeholders most directly affected by HOEPA's passage included lenders who marketed to subprime borrowers, borrowers and consumer organizations, and relevant government agencies. The types of mortgages that HOEPA addressed were not prevalent among prime borrowers and lenders, so a middle or upper-class borrower saw few changes in the course of obtaining a mortgage. In the case of reverse mortgages, the most common users of this type of lending (primarily older populations and the financial institutions that targeted them), confronted significant new limitations and disclosures. Within the federal government, the Fed saw especially significant changes at the hand of HOEPA.

Lenders could still market the mortgages covered by HOEPA. Instead, if lenders wanted to continue originating mortgages above the threshold rates specified in the Act, they merely had to follow specific disclosure and fee guidelines. As noted above, the legislation required creditors to provide clear disclosures given to the customer many days before the customer could sign off, prohibited certain fees and payment schemes, and compelled some process to ensure consumers

could afford the obligations they were taking on. These requirements, according to the legislation, were to be enforced by the Fed.

The 1994 Act bolstered consumer protections, especially for low-income and minority borrowers. Under HOEPA, at-risk borrowers no longer confronted surprise fees or varying principal amounts. The prohibition of negative amortization specifically addressed a primary goal of facilitating the accumulation of home equity among these groups. Potential borrowers also faced less pressure to agree to a mortgage, even if they had begun paperwork. In the past, lenders could tell borrowers that once paperwork had started, there was no backing out, but with the disclosures HOEPA required, they could no longer legally deploy such pressure tactics. The amount of disclosures and time requirements meant that borrowers might have to wait longer before obtaining a mortgage, but Congress presumed that the extra time would encourage sober economic calculation and responsible lending and borrowing.

The Board of the Federal Reserve System shouldered new responsibilities after the passage of HOEPA. The Act allowed 180 days for The Fed to issue regulations for enforcement, and required it to conduct a series of studies and hearings conducted within the first few years. According to legislative testimony from Board Governor Lawrence B. Lindsey before the Senate Banking Committee in 1993, the Fed was reluctant to enforce HOEPA through promulgation of rules.¹⁶ Lindsey argued that such regulation would stifle lending and thereby limit individuals' access to credit. Lindsey's comments presaged consistent Fed policy preferences to provide leeway to residential mortgage lenders, and a permissive regulatory posture under HOEPA. A 1998 policy, for example, absolved Fed offices of the need to conduct routine consumer

¹⁶ U.S. Congress, Senate, Committee, Home Ownership and Equity Protection Act of 1993, 6-9.

compliance examinations of nonbank subsidiaries of bank holding companies¹⁷. This policy attracted significant criticism, at the time by the General Accounting Office¹⁸ and much later from the Financial Crisis Inquiry Commission, for allowing lenders to ignore federal legislation through “a lack of regulation.”¹⁹

After several hearings in which Fed officials heard testimony from representatives of consumer organizations about ongoing abuses in residential mortgage lending, the Fed Board did propose more regulation under HOEPA. Citing a six-fold increase in subprime lending from 1994 to 1999²⁰ as reason for concern, the Fed adopted a rule in 2001 that reduced the interest rate threshold for triggering HOEPA requirements, prohibited loans made without consideration of a consumer’s ability to pay, expanded disclosure requirements, and prohibited several predatory practices, such as refinancing of a HOEPA loan within a year unless doing so was in the interest of the borrower. Despite the stated interest of Board Secretary Jennifer Johnson to protect the homeowners, particularly the elderly, women, and minorities²¹, the added rules underneath the 2001 regulation only covered 1% of subprime loans.²² In short, “these initiatives went nowhere (and) the market did not stand still.”²³

V. Subsequent Legislative History

¹⁷ Griffith L. Garwood, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, *To the Officers and Managers in Charge of Consumer Affairs Examination and Consumer Complaint Programs*, *Consumer Affairs Letter* CA 98–1, (Washington, D.C., 1998).

¹⁸ U.S. Government Accountability Office, *Large Bank Mergers: Fair Lending Review Could Be Enhanced with Better Coordination*, GAO/GGD-00–16 (Washington, D.C., 1999), 20.

¹⁹ Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, (Washington, D.C., 2011), 78.

²⁰ Board of Governors of the Federal Reserve System, *Proposed Rule: Truth in Lending*, (Washington, D.C., 2000), 3.

²¹ Board of Governors, *Proposed Rule*, 2.

²² Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report*, 12.

²³ *Ibid.*, 80.

In the 109th Congress (2005-2007), there were four unsuccessful attempts to amend HOEPA.²⁴ These proposals sought to expand the scope of protections for moderate-income borrowers, increase the Low-Income Housing Tax Credits available, and allow the Federal Housing Administration to base mortgage premiums based on the borrower's risk. Following the housing crash and Financial Crisis of 2008, Congress refocused its efforts on regulating the mortgage market. In 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which amended TILA and established the Consumer Financial Protection Bureau²⁵ (CFPB). In doing so, it transferred HOEPA enforcement power from the Fed to the CFPB. Dodd-Frank also amended HOEPA coverage tests, expanding the number of mortgages that could fall under regulation from the CFPB, and mandated homeownership counseling before closing for any mortgages that the CFPB deemed "high-cost."

The CFPB issued a rule in 2013 to enforce HOEPA. This CFBP Rule explained coverage tests that determine which mortgages were subject to the act, and detailed the homeownership counseling addition from Dodd-Frank. In effect, the regulation extended the Dodd-Frank amendments to TILA. The rule also prohibited additional business practices, such as recommending default or purposefully evading HOEPA, and required counseling for first-time homeowners regardless of loan type. As of 2020, the 2013 Rule constitutes the most recent amendment and enforcement mechanism for HOEPA.

VI. Policy Context

²⁴ U.S. Library of Congress, Congressional Research Service, *Housing Issues in the 109th Congress*, RL32899 (2007).

²⁵ Wall Street Reform and Consumer Protection Act, U.S. Code 12 (2010), § 5491.

The 1994 Act broke new ground in its definition of high-cost mortgages, identification of predatory lending practices like negative amortization, and extension of disclosure requirements. The impact of some provisions, however, disappointed many observers and policy analysts, especially the requirement to verify a customer’s payment ability, which had “vague” statutory definitions.²⁶ On the consumer protection side, this legislation brought “reverse redlining” into the national conversation and attempted to protect historically marginalized sections of the country. Considering the increase of loans marketed toward subprime borrowers cited in the Federal Reserve’s 2001 rule, HOEPA did not have the impact that its sponsors intended. Even that later rule did little to stunt the housing bubble’s growth in the years preceding the crash. Creditors continued to side-step HOEPA’s provisions through “forged signatures, falsification of incomes and appraisals, illegitimate fees, and bait-and-switch tactics,”²⁷ with many minority and elderly individuals remaining unaware of the illegality of these practices.

VII. Policy Relevance (Conclusion)

The 1994 Home Ownership and Equity Protection Act paved the way for federal and state regulation of mortgages, specifically those catering towards subprime lenders. In the Federal Reserve’s 2001 rule update to HOEPA, Secretary of the Board Jennifer Johnson commended several states²⁸ on introducing their own anti-predatory lending legislation concerning mortgages. HOEPA did encourage state legislative bodies to consider the lending circumstances in which many low-income and minority borrowers found themselves, and encouraged

²⁶ Jones, Christian T. “New Federal Regulation of Home Equity Credit: The Home Ownership and Equity Protection Act of 1994.” *Banking Law* 113, Issue 4 (1996): 328-379.

²⁷ Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report*, 78.

²⁸ A 2007 comparison of state laws to HOEPA found 25 states enacted laws with much broader protections than their federal counterpart. U.S. Library of Congress, Congressional Research Service, *Predatory Lending: A Comparison of State Laws to the Federal Home Ownership and Equity Protection Act*, by Kamilah Holder and Kate Manuel, RL32784 (2007).

regulation of these mortgages through disclosures and specific practice prohibitions. The legislation successfully identified the mortgages at the root of “reverse redlining” and developed a set of rules to regulate them. The Federal Reserve Board, however, instituted a “hands-off approach to the regulation of mortgage lending.”²⁹ The ability of individuals to obtain mortgages without income verification or adequate disclosures long after the passage of the Act exemplifies the lack of enforcement from the Board, foreshadowing its eventual transition into the hands of the CFPB in 2010. The history of HOEPA reflects legislative engagement with a serious issue in the subprime market, but then constrained enforcement mechanisms in the years preceding 2008.

²⁹ Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report*, 77.