S. HRG. 107–774

PREDATORY MORTGAGE LENDING: THE PROBLEM, IMPACT, AND RESPONSES

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

ON

THE EXAMINATION OF THE PROBLEM, IMPACT, AND RESPONSES OF PREDATORY MORTGAGE LENDING PRACTICES

JULY 26 AND 27, 2001

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PREDATORY MORTGAGE LENDING: THE PROBLEM, IMPACT, AND RESPONSES

THURSDAY, JULY 26, 2001

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:05 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Paul S. Sarbanes (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN PAUL S. SARBANES

Chairman SARBANES. The hearing will come to order.

Today is the first of two initial hearings on predatory mortgage lending: the problem, the impact, and the responses. This morning, we will first hear from a number of families that have been victimized by predatory lenders. Later this morning, and again tomorrow morning, an array of public interest and community advocates, industry representatives, and legal and academic experts will discuss the broader problem and the impact that predatory lending can have not only on families, but also on communities.

Homeownership is the American Dream. It is the opportunity for all Americans to put down roots and start creating equity for themselves and their families. Homeownership has been the path to building wealth for generations of Americans. And in my view, it has been the key to ensuring stable communities, good schools, and safe streets.

Predatory lenders play on these homes and dreams to cynically cheat people of their wealth. These lenders target lower income, minority, elderly, and often unsophisticated homeowners for their abusive practices.

Let me briefly describe how predatory lenders and brokers operate. They target people with equity in their homes, many of whom may be feeling the pinch of consumer and credit card debts. They underwrite the property, often without regard to the ability of the borrower to pay the loan back. They do not use the normal underwriting standards. In fact, they ignore them altogether. They make their money by charging extremely high origination fees and by packing other products into the loan, including upfront premiums for credit life, disability, and unemployment insurance, and others, for which they get significant commissions right at the outset, but for which homeowners continue to pay for years since it is folded into the mortgage.

The premiums for these products get financed into the loan, greatly increasing the loan's total balance amount. As a result, and

because of the high interest rates being charged, the borrower is likely to find himself in extreme financial difficulty.

As trouble mounts, the predatory lender will offer to refinance the loan. Unfortunately, another characteristic of these loans is that they have high prepayment penalties. So, by the time the refinancing occurs, with all of the fees repeated, the prepayment penalty included, the lender or broker makes a lot of money from the transaction and the owner finds that they are being increasingly stripped of their equity and, in the end, it may well be their home.

Nearly every banking regulator, Federal and State, has recognized this as an increasing problem. And I believe, predatory lending really is an assault on homeowners all over America.

Now I want to make one thing clear. These hearings are directed toward predatory lending practices. There are people who have credit problems who still need and can justify access to affordable mortgage credit. They may only be able to get mortgage loans in the subprime market, which charges higher interest rates. Clearly, to get the credit, they will have to pay somewhat higher rates because of the greater risk they represent.

So, we make the distinction. We recognize that there is a subprime lending industry that is performing an important function. But we are concerned to get at those within that industry who are engaging in these abusive practices. Families should not be charged more than the increased risk justifies. Families should not be stripped of their home equity through financing of extremely high fees, credit insurance, or prepayment penalties. They should not be manipulated into constant refinancings, losing more and more of their equity and of their wealth that they have taken a lifetime to build up, but which is consumed by each set of new fees by each transaction. They should not be stripped of their legal rights by mandatory arbitration clauses that block their ability to appropriate legal redress.

Some argue there is no such thing as predatory lending because it is a practice that is hard to define. Perhaps the best response to this was given by Federal Reserve Board Governor Edward Gramlich, who said earlier this year:

> Predatory lending takes its place alongside other concepts, none of which are terribly precise—safety and soundness, unfair and deceptive practices, patterns and practices of certain types of lending. The fact that we cannot get a precise definition should not stop us. It does not mean this is not a problem.

Others, recognizing that abuses do exist, contend that they are already illegal. According to this reasoning, the proper response is improved enforcement.

I support improved enforcement. The FTC, to its credit, has been active in bringing cases against predatory lenders for deceptive and misleading practices. However, because it is so difficult to bring such cases, the FTC further suggested last year a number of increased enforcement tools that would help to move against the predators. I hope that we will get an opportunity to discuss those proposals as these hearings progress.

I also support actions by regulators to utilize the authority under existing law to expand protections against predatory lending. That is why I sent a letter signed by my colleagues on the Committee

strongly supporting the Federal Reserve Board's proposed regulation to strengthen consumer protections under current law.

Campaigns to increase financial literacy and efforts within the industry to engage in best practices are also important parts of any effort to combat this problem. Many industry groups have contributed time and resources to educational campaigns of this sort or developed practices and guidelines, and I welcome this as part of a comprehensive reform to the problem of predatory lending.

Neither strong enforcement, nor literacy campaigns are enough. Too many of the practices we will hear outlined this morning and in tomorrow's hearings, while extremely harmful and abusive, are technically within the law. And while we must aggressively pursue financial education, we also recognize that education takes time to be effective.

Again, I want to reiterate that subprime lending is an important part of the credit markets. But such lending needs to be consistent with and supportive of the efforts to increase homeownership, build wealth, and strengthen communities. And in the face of so much evidence of abuse and of so much pain, we must work together to address this crisis and that is what we are setting out to do by launching these hearings this morning.

Senator Gramm.

STATEMENT OF SENATOR PHIL GRAMM

Senator GRAMM. Mr. Chairman, thank you for holding these hearings.

Let me say that one of the blessings of living in a strong economy, with a healthy savings rate that is made considerably better by the Federal Government running a surplus, is that for the first time in American history, we have an active outreach program by private lenders to lend to people who, under ordinary circumstances, would have a difficult time borrowing money, people who would end up borrowing from other sources such as, kinfolks or in the backstreet market where abuses would be substantial.

Let me assure you, Mr. Chairman, that I am committed to cracking down on crooks and people who abuse the system and who abuse borrowers.

I want to be absolutely certain that in trying to get at the bad guys we do not put into place policies that destroy a market that is serving an increasing number of people.

We will hear later today that the default rate in some areas of subprime lending is as much as 23 percent. That is a massive default rate, the good news is that 77 percent of those borrowers did pay the loan back, and they, in doing so, established good credit.

This is something that I feel very strongly about. Fifty-two years ago, my momma bought a house. She had three children and no husband. She was a practical nurse who worked in a system that when your number came up, you got to take the job.

And so, she did not have, for all practical purposes, a full-time job. She borrowed for a house that cost $9,200. She borrowed this money from a finance company, and she paid 50 percent more than the market rate for that loan. Now some people would say, prima facia, that was an abusive loan, that it was predatory lending. I would beg to differ.

First, my mother was the first person that I am aware of since Adam and Eve, in our branch of the human family, who ever owned the dwelling where she lived. She paid off that loan, and 52 years later, her credit is golden. Any bank in Columbus, Georgia would lend my momma money because in all her 52 years of record there was never a time when she has ever borrowed a penny that she has not paid back.

Now my point is the following. We have to be very careful in trying to deal with an abuse that exists so that we do not create a situation where credible lenders, non-abusive lenders, good lenders will get out of the subprime market.

If we end up doing that, if we end up falling victim to this rule or law of unintended consequences, the problem will be that the 77 percent of the people that are now paying these loans back will not get the loans. People will end up being forced to borrow in a more informal market. People will not be able to buy their own homes, and I think that this is something that we have to measure. All good public policy is based on cost and benefits, the intended consequence versus the unintended. This is something that I am going to try to watch very carefully because, again, subprime lending I view as a very good thing.

I never will forget when I was a Member of the House of Representatives, and someone came up to me and said, "Do you think 6 percent is a fair interest rate?" And I said, "Fair to whom?"

He said, "Well, fair to the borrower and fair to the lender—Do you think we ought to have a law that says the interest rate is 6 percent?"

Well, I said that would be great, but if the market did not produce more than a 6 percent interest rate, then you would have massive shortages of credit and you would disrupt the credit markets. In fact, I think zero interest would be a great rate. I would borrow a lot at it. But no one would lend me the money.

We have to be sure that we know what we are doing, not just focusing on the evil we hope to drive out of the system, but also take care that the good is not driven out of the system.

Finally, it is hard to define many things in the world, hard to define pornography, as they say, I agree with the old adage—I know it when I see it.

But I think when you are making law it is important to try to define what you are doing. My guess is if you ask 100 people in America to define predatory lending, you are going to get 100 different definitions.

Many people define predatory lending as lending at above prime. I am sure what is predatory lending to one person is not the same thing to another.

But it is important that we know what we are doing and that we know what we are trying to eliminate, and that we are aware of what the unintended consequences might be.

And, again, I want to thank you, Mr. Chairman. I have a Finance mark-up, and then we have a big trucking dispute on the floor, as all my colleagues know. So, I will be in and out.

But I am going to read the testimony that is given today. This is an area that I am very interested in, and I want to thank all of our witnesses for participating.

Chairman SARBANES. Thank you very much, Senator Gramm.

Senator Johnson.

STATEMENT OF SENATOR TIM JOHNSON

Senator JOHNSON. Well, thank you very much, Mr. Chairman I appreciate your leadership in calling today's hearing on predatory lending. I look forward to hearing from the witnesses who will come before this Committee both today and tomorrow.

Today's testimony, I am sure, will be moving. Nobody likes to hear that vulnerable members of our society have been taken advantage of. No one should be preyed upon to borrow money they do not need on terms that they do not understand.

We in Congress are in a unique position to shine some light on shady practices and to think through the best way that we can, in a constructive way, bring an end to those practices.

At the same time, Mr. Chairman, I urge caution that we not generalize the practices of a subset of lenders to an entire sector.

As we will hear today, predatory lending occurs in the subprime market. But as you wisely emphasized in your statement, only a fraction of subprime lending is predatory. Subprime is not, in and of itself, predatory lending. The subprime market provides a critical source of credit to many Americans who struggle to find economic opportunity in our country. To be sure, lenders can and do charge a higher rate to account for the higher risk associated with those borrowers. When it is done right, subprime lending gives people what they need, and that is more, not less, opportunity.

I have been encouraged by some noteworthy improvements in the subprime marketplace in recent weeks. A number of key players have announced new practices which I hope will have a salutary effect on the subprime sector.

We want to encourage lenders with household names who have every incentive in the world to protect their good reputations to remain in the subprime marketplace. We need to give their initiatives a chance to have an impact.

So, I would offer a word of caution, that while we should be vigorous in our efforts to eliminate the ugly instances of predatory lending, that we take care not to institute a policy that is in fact counterproductive, that would increase the cost of credit and, indeed, cut off critical sources of credit to the very members of society who need it most.

I look forward to today's hearing and hope that we can have a balanced and thoughtful discussion of how we can best accomplish our common goal of making credit available under fair terms to a broad segment of our society, keeping in mind that we have already a substantial level of law pertaining to these issues from HOEPA legislation to Truth-in-Lending to the Real Estate Settlement Procedures Act, to the Federal Trade Commission, and the Federal Credit Opportunity Act legislation.

That is not to say that there is not room for further Federal legislative action. It is to say that there is a context that this has to fit into and that we need to, on the one hand, address the abuses, but on the other hand, make it very certain that we do not pursue public policy that in fact is counterproductive.

Thank you, Mr. Chairman.

Chairman SARBANES. Thank you, Senator Johnson.
Senator Reed.

STATEMENT OF SENATOR JACK REED

Senator REED. Thank you very much, Mr. Chairman.

I want to commend you for holding this hearing. This hearing will shine a light on one of the dark corners of the financial markets. And in doing that, it will be helpful in and of itself.

I hope when we do that, we can not only identify and point out to the American public abuses, but we also can identify those companies that have high standards that should be emulated by all their colleagues, and at the end of the day, we can move all companies to the best practices that we will find in the financial services industry.

And in doing that, I think we can both allow for the continuation of credit for individuals that may have credit problems, and avoid the abuses that we will hear about today.

I welcome the witnesses. Your testimony is vitally important because you put a human face on what can be a lot of numbers, graphs, and statistics.

Again, let me thank you, Mr. Chairman, for holding this hearing and sending a very strong signal that we want to have a robust financial service industry, but one that certainly respects consumers and respects their clients.

Thank you.

Chairman SARBANES. Thank you, Senator Reed.
Senator Schumer.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Well, thank you, Mr. Chairman. I want to add my voice in thanking you for making this an early topic in your Chairmanship.

Our Committee is off to a great start under your leadership and we are doing a lot of good things. And this is at the top of the list. Thank you for that. I would like to make just three points.

One—two are a little bit in counter to what my colleague and friend from Texas, Senator Gramm, said. It is easy to talk about this stuff in the abstract. I hope, and one of our goals should be that Senator Gramm not only reads your stories, but hears it and just goes through what some of us have gone through when we meet people who are victims of predatory lending, the horror of it.

It is people who have lived by the American Dream. They are often people of color. They are often people who buying the home is the first time in their whole family that they have ever bought a home, and they live by the rules. They save their $25 and their $50 every month, did not serve meat on the table so they could achieve their piece of the American Dream and own a home.

And some bottom crawler comes in and not only sells them at a higher interest rate—that is what subprime is—but says, I will get you the right appraiser, I will get you the right lawyer, I will get you the right this and that. And what are they left with?

They end up buying a home where the boiler might break down, even though they were certified. Someone came in and said, this is a good boiler. Or the roof leaks the minute they move in.

They end up often paying with a balloon payment they cannot pay off, or the interest rates goes from 4 percent the first year to 12 percent the second and they have to give up their home. And these people are crushed for the rest of their lives, most of them, because they played by the rules and scrounged and then nothing happened. I have sat in my State of New York and listened to these folks. That is what motivates us, and I believe it is really important to remember that.

Second, also in reference to Senator Gramm and you, Chairman Sarbanes. You are both right to emphasize that the subprime market is a good market. And I know there is a tendency of people just to say anything above conventional mortgage is bad.

Well, that is not true. We want to give people the ability to buy a home when their credit is not so good that they would get a conventionally rated loan. And I agree with Phil that the free market has to help govern here.

There is a little statement that we make to remind ourselves of this. And that is, not all subprime loans are predatory, but all predatory loans are subprime.

Why? How come no conventional loans are predatory? You could have the same practices at a lower interest rate.

It is because we regulate the conventional market. And conventional lenders cannot get away with doing this. If someone tries to set up a little shady bank in the conventional way, regulators will come down on them.

Regulation makes a big difference. And the idea that we should shy away from any regulation when it has been so successful at keeping the conventional market on the up and up, does not make sense to me.

I want to commend some of the banks, for instance, that recently changed the way that they issued insurance on their own. They deserve credit. And all too often, I think many in the community lump everybody together and we have to separate the good ones from the bad ones. But we are not going to get rid of the bad ones unless we regulate. And just one quick final point.

Part of this is created because there is a vacuum of conventional lending in the inner city. All I want to say is we can make a large difference today where we could not 20 years ago, in getting conventional mortgages into working-class and middle-class neighborhoods of people of color which we could not before.

CRA has done that. Banks are eager to make those loans. But they do not have the ins. And we have to explore ways to get them the ins there. We are doing that in New York and I will share that with my colleagues later.

Thank you, Mr. Chairman. Sorry I went on too long.

Chairman SARBANES. Thank you, Senator Schumer.

Senator Miller.

STATEMENT OF SENATOR ZELL MILLER

Senator MILLER. I will take only a minute.

Thank you very much, Mr. Chairman, for holding this hearing. This is a very serious matter. This is an important topic and I commend you for holding this hearing. And I want to welcome all of

the witnesses here this morning. I look forward to hearing from you. I look forward to listening to the debate on this issue.

In the State of Georgia, we just got through a debate that raged for a long time and very heatedly, in the State legislature, where a predatory lending law was passed in the State Senate, but then died in the house.

So, this is a topic that I am very interested in hearing from the witnesses on, and I thank you for holding this hearing.

Chairman SARBANES. Senator Miller, thank you. We have had some good discussions between ourselves about this issue and I appreciate that very much.

Senator Carper.

STATEMENT OF SENATOR THOMAS R. CARPER

Senator CARPER. Mr. Chairman, thank you.

To our witnesses, I want to echo the words of welcome from Senator Zell Miller. We are glad that you are here. Thank you for taking time out of your lives to share this part of your day with us.

Mr. Chairman, and my colleagues, I am struck sometimes by how helpful simply scheduling a hearing on a particular subject can be.

[Laughter.]

I just want to point to a couple of examples.

One, I serve on the Energy Committee where Chairman Bingaman invited folks who serve on the Federal Energy Regulatory Commission to come and testify earlier this month. Two or 3 days before they testified, they took some remarkably positive steps to help alleviate the energy crisis in California.

Just yesterday, Chairman Joesph Lieberman held a hearing on legislation that he and others have sponsored dealing with the entertainment industry and questions about the quality of the entertainment that is provided to us from the music industry, the video game industry, the television industry, and the movie industry.

I found the comments from some of the industry representatives, talking about things that they had done voluntarily, were willing to do even more and better voluntarily, coming out of that hearing were encouraging.

Others of my colleagues have spoken here today about some of the very positive steps that some who are represented in this room have taken to make sure that some of the questionable practices they were involved in have been stopped or will be stopped. I join my colleagues in applauding those of you who have taken those steps or will take those steps.

I read an interesting piece by Robert Litan, whom some of you may recall. He used to be the number-two guy at OMB when Alice Rivlin was the head of OMB, and he is now over at the Brookings Institution. He has a very thoughtful piece that some of you may have seen. It is too long for me to go into at any length, but I think the points that he makes are good. They reflect the concerns that we have already heard that we want to make sure that the steps that we take here in this Committee and in this body, that we do no harm, that we make sure that those who are riskier borrowers still have access to credit, but they are not exposed to the kind of predatory practices which in many cases are already illegal.

And as we face this challenge and listen to our witnesses, we have to be smart enough and thoughtful enough to come up with ways to better ensure, one, that the laws that already make these predatory practices illegal are actually enforced, at the Federal, the State, and the local level.

Two, I think there is a lot to be said for embarrassing publicly those financial institutions who are actually violating the law and to put them under a spotlight and glare that they will not enjoy and will help to ensure that they and others cease those practices.

Three, we have an obligation to work with the private sector and others to better ensure that consumers are educated and know full well what is legal and what is not, and that they are better able to police those who are offering credit in ways that are inappropriate or illegal.

And last, I understand in reading this piece by Robert Litan that the Federal Reserve has undertaken the gathering of a fair amount of data that deserve to be studied, scrutinized, analyzed, as we prepare to take any action here in the Senate.

So let me conclude where I started, Mr. Chairman. Thanks for bringing us together today. And to those who have joined us to testify, both in this panel and other panels, we appreciate very much your presence and your testimony.

Thank you.

Chairman SARBANES. Well, thank you, Senator Carper.

Senator Stabenow.

And let me acknowledge Senator Stabenow's tremendous help and support in helping to put these hearings together and moving this issue forward and ensuring that it is high on our priority list and our agenda.

STATEMENT OF SENATOR DEBBIE STABENOW

Senator STABENOW. Well, thank you, Mr. Chairman very much for holding this hearing and for the witnesses that are here today. This is an incredibly important issue and I hope that we can come together and put forward a positive solution.

I know that there are literally thousands of horror stories around the country and I have heard many of them personally from my constituents in Michigan. Unfortunately, we do have unscrupulous lenders that are in the subprime market, while we also have ethical and responsible lenders in that market as well. But I have been pleased to invite one of our panelists today, Carol Mackey.

Carol Mackey is from Rochester Hills in the metro Detroit area. She came to a hearing that I held in May on this very issue, where I learned of her own difficult and tragic experience. Ms. Mackey, I am very appreciative that you are here with us today to share your experiences and help us to learn from what happened to you.

Mr. Chairman, I also, would like to recognize a very special friend and guest of mine who I have asked to attend this hearing today—Rev. Wendell Anthony, who is the President of the Detroit NAACP chapter, which I might brag is the largest chapter in the United States.

Under the leadership of Rev. Anthony and the NAACP, they have been working very hard to raise awareness and to combat the issues of predatory lending, as well as increase affordable housing.

There was a very successful hearing and conference that was held on June 9 that I was pleased to be a part of in Detroit under Rev. Anthony's leadership. He informed me last evening there was a second follow-up meeting on issues of access to affordable housing and predatory lending issues, where on just a few days' notice, they invited people to come, expected 100 people and had 500 people show up. This is an example of how important issues of affordable housing and fair lending practices are, I believe, to the people that we represent.

I think, as this hearing gets underway, I would like to underscore, Mr. Chairman, something that I said earlier that many of my colleagues have said. And that is, subprime lending is not predatory lending. In fact, subprime lending serves a legitimate purpose in providing credit to consumers with risky credit histories. We know that. A thriving subprime market can serve higher credit risk communities well.

Our challenge is to focus on the bad actors, if you will, without giving the entire industry a bad name. And I think that is our challenge. And what we do not want to do is dry up capital in the subprime market. We do want to stop predatory lending practices.

I hope we are going to sort out these issues, and to increase educational outreach, that we are going to make sure that existing laws are enforced. I also hope we also will pass new legislation that will make illegal what is now unethical.

I do not believe it is enough just to promote education and enforcement without new legislation. Frankly, I think it is extremely important, given the fact that we are talking about thousands of dollars that have been taken from hard-working Americans, as well as their dreams—the dream of homeownership, the opportunity to build a secure future for themselves and their families. And that is why this practice is absolutely outrageous.

Again, Mr. Chairman, I want to thank you for your leadership in calling this hearing. I want to thank Ms. Mackey for being here, and Rev. Anthony for his leadership. I am very anxious to move forward in a way that allows us to be constructive and address what I believe is a very serious issue for our families.

Senator CARPER. Would the Senator yield for just a moment, please?

Senator STABENOW. Yes, I would be happy to yield.

Senator CARPER. Mr. Chairman, I misspoke earlier. I mentioned the hearings involving the Federal Energy Regulatory Commission and I gave the credit to the Energy Committee for holding them. Those were actually hearings called by Senator Lieberman, also, before the Governmental Affairs Committee. He held the hearings on the entertainment industry yesterday, the Federal Energy Regulatory Commission a week or two earlier.

He is probably going to have hearings now on predatory lending. I do not know what he is running for, but——

[Laughter.]

—he is a busy boy. But I want to give him the credit for it, and his staff.

Thank you.

Senator STABENOW. Thank you, Mr. Chairman.

Chairman SARBANES. Senator Bennett.

COMMENTS OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman. I do not have an opening statement, but I have read through the statements of the witnesses here and appreciate their willingness to come share their experiences with us.

I know it has to be a painful experience to come before the public and admit that you have gone through something like this and that you have been taken advantage of. Many people would prefer to simply hide and live with the sense of outrage that comes. We are very grateful to you for your willingness to expose yourselves to the lights and the heat of this kind of a circumstance because your information is very helpful. Once again, my gratitude to you. Thank you, Mr. Chairman

Chairman SARBANES. Thank you, Senator Bennett.

Our first panel consists of four individuals who have suffered from predatory lending practices. I am very quickly going to touch on each of the witnesses before I recognize them.

Carol Mackey is a retired substitute teacher who, as Senator Stabenow indicated, lives in Rochester Hills, Michigan. Her monthly mortgage payment doubled after she was encouraged to refinance her mortgage to pay off debt and undertake repairs to her condominium. And we will hear more about that in some detail.

Paul Satriano is a retired steel worker from St. Paul, Minnesota. He was solicited for a loan with high points and excessive fees, including single premium credit life insurance and prepayment penalties as well.

Leroy Williams is a retired shoe store assistant manager from Philadelphia, Pennsylvania. Mr. Williams received three mortgages, including two refinancings by three separate lenders over a 15 month period and he is currently fighting off a foreclosure.

And Mary Ann Podelco is a widow who resides in Montgomery, West Virginia. Mrs. Podelco's home was foreclosed upon in 1997, after her mortgage was refinanced seven times in 16 months by four separate lenders.

Let me say before we turn to you for your testimony, I want to express my appreciation to all of you, as Senator Bennett has just done, for your willingness to leave your homes and to come to Washington and to speak publicly about what you have been through. I know it must be very difficult for each of you. But I hope you appreciate and understand and take some pride in the fact that you will be contributing to a process that I trust will lead to action to put an end to the kind of practices that have caused each of you such heartache and such trouble.

I hope you will draw some strength and comfort from understanding that you are an important part of this process that we are undertaking here to try to correct this situation and to ensure that others do not go through the same experience which each of you have suffered. And so we are deeply appreciative to you for coming to be with us today.

Now Ms. Mackey, before I start with you, Senator Dodd has joined us. I do not know what his schedule is, but I will yield to him for just a moment for a statement.

STATEMENT OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Thank you, Mr. Chairman. I will be very brief. I apologize to my colleagues and the witnesses.

First, I want to underscore the comments just made by Chairman Sarbanes. The admiration I have for people who step out of private lives before a bank of microphones and cameras to talk about very personal matters deserves a special commendation. All of us are deeply appreciative of your willingness to do this. I want to thank Senator Sarbanes for holding this hearing. It is important.

But I think all of us up here, I hope, anyway, feel very strongly that predatory lending is a cancer. There is no other way to describe it in my view. Its causes should be catalogued, its manifestations should be carefully studied, its victims should be treated and made whole, and these practices should be cut from the body of healthy mortgage lending so that more people in our Nation can enjoy the American Dream of homeownership.

This hearing is going to go a long way to help us do that. We are already seeing reaction by the banking industry in this country, responding to it. So, if nothing else happens, just merely having these hearings has already had salutary effects. And a great deal of credit for that goes to the Chairman of this Committee, Senator Sarbanes, for insisting upon these hearings, that they be held.

And so, I thank you, Mr. Chairman, for doing so, and I thank our witnesses for your courage to be here with us this morning.

Chairman SARBANES. Thank you very much, Senator Dodd.

Ms. Mackey, we would be happy to hear from you now.

STATEMENT OF CAROL MACKEY
OF ROCHESTER HILLS, MICHIGAN

Ms. MACKEY. My name is Carol Mackey. I am from Rochester Hills, Michigan. I am a senior citizen and I am working. I was substitute teaching. That was really my calling. But because of retirement ages for teachers, I am now working as a secretary, which I find to be an interesting and challenging occupation as well.

I appreciate the opportunity to share my experience as a victim of what I believe to be predatory lending practices of American Equity Mortgage. I have been a stay-at-home mom most of my life. I just recently in the last 12 years had to go back to work full time.

I first heard about American Equity Mortgage in August 2000, from an advertisement on WJR radio in Detroit. Ray Vincent, the President of American Equity Mortgage, was on every morning as I was getting ready for work. I had been considering a home equity loan so I called the Southfield office of American Equity Mortgage and spoke with a loan officer. I told him that I wanted to get a home equity loan to pay off my debts and make some minor improvements to my condo.

According to the loan officer at American Equity Mortgage, even though I wanted a home equity loan to pay off some bills and do some minor home improvements, it was in my best interest to do a consolidation, which meant refinancing my old mortgage loan.

The mortgage loan officer of American Equity Mortgage explained that it was best for me because I would only have to make one payment instead of two, it would all be tax deductible, and with my bills paid off, I should be able to handle the new payment.

In addition, he implied that I would have difficulty getting a second mortgage because of my credit history. Not being a financial whiz, I relied on his expertise.

My old mortgage loan had a remaining balance of about $74,000, an interest rate of about 7.5 percent, and a monthly payment of about $510. Based on the State Equalized Value used for tax purposes, my home is worth about $151,000.

My new mortgage is for $100,750, has an interest rate of 12.85, an APR of 13.929 percent, a monthly payment of $1,103, and a prepayment penalty of 1 percent.

The $100,750, new mortgage was comprised of the $74,000 payoff of the old mortgage, $18,645, in additional funds to pay off bills and perform the minor improvements to my home, and points and fees totaling $8,105.

I did not understand the full cost of the additional money I received until several weeks later when I finally discussed the situation with one of my sons. Based on my son's calculations, American Equity Mortgage and their loan officer thought it was in my best interest:

To pay $8,105 in points and fees to receive $18,645 in additional funds; to pay an effective interest rate of 44 percent on the $18,645 in additional funds; to pay an extra $593 a month for the $18,645 in additional funds; and to pay an additional $201,608 in interest over the life of the loan for the $18,645 in additional funds.

After funds were disbursed to pay off some of my bills I ended up with just over $9,000 to spruce up my condo, but I had to pay off a credit card debt of $1,200 out of that, leaving me with $7,800. Since closing last September, I have had to dip into the $7,800 to make the mortgage payments that American Equity Mortgage arranged for me.

When my son and I discussed the outrageous cost of my attempt to get a home equity loan, it was apparent to us both that I had been victimized by a predatory lender.

My son contacted American Equity Mortgage on my behalf, and was directed to the General Counsel of the company. He explained to the General Counsel that he believed that I had been a victim of predatory lending practices by American Equity Mortgage.

Through a series of conversations, he discussed the facts of the situation as I have outlined them here today, and requested that American Equity Mortgage cancel the new mortgage and replace it with a revised mortgage that reflected the interest rate of my original mortgage, blended with what a reasonable interest rate on a second mortgage would have been.

American Equity Mortgage refused, on the basis that the mortgage loan officer stated that I had wanted to refinance my original mortgage from the outset. That is absolutely false. Why would I want to lose a perfectly good 7.5 percent mortgage?

If I had been able to get a home equity loan for $20,000, as I had sought, all of my debts would have been paid and I would still have the $10,000 that I wanted to spruce up my home. And I most assuredly would not be paying more than double what my mortgage payment was before this all started. All I needed was $20,000.

I am sharing my bad experience because I believe that I have been victimized. That American Equity Mortgage has perpetrated

a fraud and that they should be held accountable for their actions. I hope that by sharing my experience, other homeowners can recognize and avoid the predatory practices that I fell victim to. Moreover, I hope that appropriate laws can be put into place, at both the State and Federal level, to protect homeowners from being victimized and to punish lenders engaging in predatory practices.

Chairman SARBANES. Let me interject to be clear. This is the new mortgage the loan officer said that you should consolidate.

Ms. MACKEY. Yes.

Chairman SARBANES. And when you sought an equity loan for $20,000, just to pay the debts and fix up your condo, he suggested, no, what you should do is consolidate that with your old mortgage. So you, in effect, would get a new mortgage.

Ms. MACKEY. Well, what he suggested was a consolidation, yes.

Chairman SARBANES. Right. And so, this new mortgage is the result of that consolidation.

Ms. MACKEY. That is correct. And the new mortgage is for $100,750.

Chairman SARBANES. Yes.

Ms. MACKEY. The interest rate is 12.85 percent, with an APR of 13.929 percent, and a monthly payment of $1,103, with a prepayment penalty of 1 percent.

The new mortgage, which is $100,750, was comprised of $74,000 that paid off the old mortgage, $18,645 in additional funds to pay off the bills and do the spruce-up on my condo, and points and fees totalling $8,105. I think I have everything in there now.

Chairman SARBANES. Well, thank you very much.

Ms. MACKEY. Thank you. And I especially thank you for asking me to testify. And Senator Stabenow, thank you so much for taking an interest in my case. I appreciate that.

Chairman SARBANES. Mr. Satriano, just before I turn to you, we have been joined by Senator Bayh and Senator Allard. I do not know whether either has a statement they may wish to make.

COMMENT OF SENATOR EVAN BAYH

Senator BAYH. Thank you, Mr. Chairman. I do not want to interrupt our witnesses.

Thank you for the offer.

COMMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Mr. Chairman, I do have a statement.

I would just ask that it be made a part of the record. I would agree that we go on and hear the testimony from the witnesses.

Chairman SARBANES. Fine. Of course, it will be included in the record.

Mr. Satriano, we would be happy to hear from you.

STATEMENT OF PAUL SATRIANO OF SAINT PAUL, MINNESOTA

Mr. SATRIANO. Thank you very much. Good morning. My name is Paul Satriano and I am a member of Minnesota ACORN. Last November, I got a terrible home loan from Beneficial, which is part of Household, and over the last few months I have become active in ACORN's campaign against predatory lending, so that I can help

make sure that more people do not have the same problems that I do now.

For the last 8 years, I have been working as an auditor for Holiday Inn, and before that, I was working for the steel workers. I was also a member of the U.S. Air Force and I am a disabled vet. My wife, Mary Lee, works as a customer service representative for Road Runner Delivery Service and we have a daughter and two children that live with us in our house.

My father-in-law built our house in 1947. Four years ago, after my wife's mother passed away, we took out a mortgage to buy the house. Interest rates were falling, so we refinanced the following year. And then we found out that the windows, which were original, had to be replaced, so we took out a second mortgage for them. Our monthly payments were $791 on the first mortgage and $166 on the second, and we never had a problem with these loans, were never late on any payments.

A few years ago we dealt with Beneficial for the first time. They refinanced our car loan. They were very friendly at that time. Then they started sending letter after letter telling us how we can get up to $35,000 in cash. We had some credit card bills totalling $7,000, so we called and figured we are take care of them. Once they have you calling back, they had us. We were hooked.

We told the Beneficial representative that we just wanted to pay off our credit card bills. She convinced us that we should do that at the same time that we consolidate our first and second mortgages with them.

But the loan they ended up giving us only paid off $1,200 of our credit card bills. To do that cost us $10,000 in fees, plus almost $5,000 in credit insurance, and left us with a higher total interest rate and a couple of hundred dollars more each month to pay on our debts. We lost $15,000 in equity in our home and now we are locked into the higher rate in payments, both because the loan has a 5 year prepayment penalty for about $6,000, and because we now owe much more on our house than it is worth, and it is going to be harder to refinance it. Let me tell you how it happened.

A few hours before we were supposed to go to the signing for the closing papers, Beneficial faxed us the first written information we ever received about the loan. The paper they sent said the house was worth $106,000, and that would be the maximum amount of the loan. They laid out what the $106,000 would go to and none of it was for points or fees to Beneficial.

When my wife and I went in for the closing, they went through all the paperwork so fast, it was like a barker in a circus—they just keep talking, you put your money down, and you try to find the two-headed boy and you never saw one. It was over in less than a half hour.

During the closing, the branch manager said they could not pay off all our credit cards with this loan. But because you have a car loan with us and you are such a good person and you paid every month, that we can get you more money on that and we will pay off the credit cards. So, we thought that was okay.

When we got home later, we found out that there was a letter in our mailbox that the change in our car loan to include the credit card debt had been denied.

Beneficial implied that if we did not take our credit insurance, we would not get the loan. So, they added $4,900 to our loan amount for that. After talking with ACORN, I realized that we could ask for a refund on this $4,900. With what we got back, we paid off some of our credit card loans. But we are going to be paying the $4,900 for the rest of the loan, so it really does not matter at this point.

Also, the offer sheet Household sent us said our payments would be $1,168 a month, which was already more than we were paying before. But now we are paying them $1,222 a month, plus we are paying another $49 a month on the bills the Beneficial offer sheet said would be paid off, but were not. And despite our history of not a single late mortgage payment, Beneficial charged us an interest rate of nearly 12 percent. Standard bank 'A' rates were below 8 percent at the time.

Although we did not realize it, the fees and credit insurance put our loan amount over $119,000. Even without the prepayment penalty, the fact we owe more than the value of our house means we might be stuck in this loan for a while. ACORN was the one that really let us know that there was a prepayment penalty. We did not even know that there was a prepayment penalty.

Beneficial had also charged us 7.4 percent of the loan amount as discount points, and that is close to $8,900 on top of the $1,100 that they took out for third-party fees. Our loan also contains a mandatory arbitration clause which says, we cannot take Household to court.

After we sent in a complaint to the Minnesota Commerce Department, we eventually got a district manager from Household on the phone. But he told us everything was fine with our paperwork and that he could not do anything and he sent all the paperwork to the Commerce Department.

So, we are left with a loan amount much higher than the value of our home, higher payments, more debt staked against our house, a higher interest rate than before, and they paid off only a fraction of our credit card debt, which had been the original reason to refinance. Plus a prepayment penalty and Beneficial is protected from legal action by the mandatory arbitration clause.

My wife and I have faced some difficult times this year, and the financial stress caused by this loan has made things worse. In January, my sister died and I had to travel out to New Jersey, and I had to drive because my one sister could not fly. On the way back, our brakes went out and I had to pay $500 to get new brakes. Three weeks ago, my daughter-in-law died, and now my son and three children are going to need help.

This is not Beneficial's fault. But if we would have had the right kind of loan, we would have been in a better position to help these people now. Even without a predatory loan, we would be in a tough spot. Now we have higher payments on our debts each month and we owe more against our house. For the first time, this month, we were not able to make our mortgage payment.

What surprised me most in all of this is that I am not alone in getting a predatory loan. In the last few months I have heard from a lot of people who have also been hurt by bad loans, from Household and from other lenders.

The basic problem is that when you sit down at that closing table, the lender knows more than you do. You expect honest dealings, like you have had on past loans. And with predatory loans, that is just not what happens. That is why we are counting on our Senators to support strong protection for borrowers against abusive loan terms. And to say I am pissed is an understatement.

Thank you.

Chairman SARBANES. Thank you, Mr. Satriano.

Mr. Williams.

STATEMENT OF LEROY WILLIAMS

OF PHILADELPHIA, PENNSYLVANIA

Mr. WILLIAMS. Good morning. And thank you for inviting me.

My name is Leroy Williams. I am 64 years old. I live at 5617 Larchwood Avenue, Philadelphia, Pennsylvania. My income from Social Security is $826 a month.

I bought my home in 1975 for $10,000. I had a mortgage with payments of about $150 a month. The payments included my taxes and insurance. I finished paying my mortgage in 1996, and I retired the same year as an assistant manager of a shoe store.

Between October 1998 and January 2000, I ended up with three different mortgages on my home. My taxes and insurance were not included in the payments on any of the three loans.

In 1998, I was having trouble paying my gas bill. I was behind in the payments and I did not want the city to dig up the gas line in front of my home and turn off the gas. I saw an ad in the paper about loans to pay off your bills and I called. A man came out to my home and talked to me about getting a loan. He brought loan papers to my home for me to sign. The loan was with EquiCredit. The payments ended up being $215 a month. The payments were higher than my gas bill had been and I still had a high gas bill every month in the winter. My Social Security income when I got the EquiCredit loan was $779 a month.

The date I signed the loan was October 2, 1998. The loan from EquiCredit was $19,000. They gave me $3,000 in cash that I did not ask for. I used the $3,000 to pay the gas bill and other bills and help my sister. Her husband had just died and I used some of the money to go to the funeral in North Carolina and to help pay some of the expenses and to help my sister in general. I do not remember where the rest of the loan money went, just that they told me that the loan had to pay all my bills.

As far as I remember, I was making the EquiCredit payments okay. I do not remember just how I got into the next loan, with New Jersey Mortgage. There was a broker named Joe, but I do not remember his last name or what company he worked for. I threw out the papers from that loan because I was so mad about it. I had to take a bus outside the city to go sign for the loan. The date I signed for the loan was October 6, 1999, about 1 year after the EquiCredit loan.

The loan from New Jersey Mortgage was $26,160. I do not remember what all the loan paid for, but I think I received $400. The payments ended up being $320 a month. I did not want payments that high, so I cancelled the loan. But they called me and told me

I had to make payments or I was in jeopardy of losing my home. I kept telling them that I cancelled the loan.

Right after I signed the loan from New Jersey Mortgage, I got a card in the mail from someone named Keeler. The card said I could get a better deal on my mortgage. I called Keeler and he told me not to send payments to New Jersey Mortgage and he would get me a better deal. Then it took a long time for him to set up the loan, and I kept getting calls from New Jersey Mortgage.

Keeler drove me to an office in New Jersey to sign for the loan. He would not come into the office with me. He told me he had to go get gas. The loan Keeler set up was from Option One. The date was January 3, 2000. The loan was for $32,435. The payments are $315, but I know now the payments can go up to $348 or higher after 3 years because the interest rate will change.

I signed for the Option One loan because I thought I was going to lose my home if I did not, even though I told Mr. Keeler that I needed payments around $240 a month. I tried to make the payments at first, but I had too many bills to pay and it was so hard. And it was making me more and more angry, so I stopped making the payments.

I know now that Option One paid New Jersey Mortgage around $2,300 more than the amount of the New Jersey Mortgage loan—because of interest and a penalty of 5 percent of the loan if I paid it off early. I have also learned that the New Jersey Mortgage loan had a balloon payment. I understand now that means I could have paid $320 every month for 15 years and still owe most of the loan.

When you are a certain age and you have lived in a place for 20 years, you just want to dwell there until your time comes, but I do not have any peace because of all this.

Thank you again for inviting me to talk with you.

Chairman SARBANES. Thank you very much, Mr. Williams.

Mrs. Podelco.

STATEMENT OF MARY PODELCO
OF MONTGOMERY, WEST VIRGINIA

Ms. PODELCO. Mr. Chairman, thank you for the invitation to speak here today. My name is Mary Podelco and I live in Montgomery, West Virginia. I grew up in West Virginia and went through the 6th grade. I moved to Indiana where my husband and I worked in factories. I had four children with my husband of 19 years and was widowed for the first time in 1967. After I was widowed the first time, I moved back to West Virginia and worked as a waitress, paid all my bills and rent in cash. When I remarried in 1987, my husband Richard and I were very proud that we were finally able to purchase our own small home. He worked as a maintenance worker and passed away in June 1994. I became the sole owner. In July 1994, I paid off the $19,000 owed on the home from the insurance from my husband's death. Before my husband's death, I had never had a checking account or a credit card. I had always paid my bills in cash and tried to be an upstanding, responsible citizen. I do not drive and never owned a car.

In 1995, I received a letter from Beneficial Finance offering to lend me money to do home improvements. I thought it was a good idea to put some new windows and a new heating system in my

home. I signed a loan with Beneficial in May 1995. This was the beginning of my troubles. My monthly income at that time was $458 from Social Security and my payments were more than half of this. They took a loan on my house of about $11,921. The very next month, Beneficial talked me into refinancing the home loan for $16,256. I did not understand that every time I did a new loan, I was being charged a bunch of fees.

I began getting calls from people trying to refinance my mortgage all hours of the day and night. I received a letter from United Companies Lending telling me that I could save money by paying off the Beneficial loan. On September 28, 1995, I signed papers in their office. More fees were added and the loan went to $24,300, at an interest rate of 13.5 percent.

Just a few months later, I received a letter from Beneficial telling me I could save money by paying off United and going back to Beneficial. The loan was about $26,000. On December 14, 1995, according to the papers, Beneficial paid off United again, charging me more fees and costs.

In February 1996, Beneficial advised me that it was time for me to refinance again. The loan papers show that I was charged a finance charge of $18,192 plus other fees and an interest rate of 14 percent. By the end of February, I had five different loans in 10 months. I did not understand that they were adding a lot of charges each time.

After that I was called by Equity One by telephone to refinance the loan. On May 28, 1996, I signed papers with Equity One in Beckley, West Virginia. The new loan paid off the Beneficial loan—which was for 60 months—and replaced it with a loan for $28,850 for 180 months which I understand increased my total loan from $45,000 to over $64,000. I got $21.70 cash out of the loan. My monthly payments were $355.58. They charged me closing costs of over $1,100. Then on June 13, Equity One suggested that I needed another loan to pay off a side debt and they loaned me $1,960, at over 26 percent interest. Monthly payments were $79. This loan brought my monthly payments to Equity One to over $434 a month. My monthly income at that time was $470. I really could not make the payments. My granddaughter had a monthly income from SSI, but by law, I cannot use her money for my benefit.

Then on August 13, Equity One started me on another loan. I was later told that Equity One was acting as a broker for an out-of-state lender—Cityscape. This new loan was all arranged through the Equity One office to help me by lowering my payments. This loan included $2,770 in new fees and costs. There were a whole lot of papers with this Cityscape loan that I did not understand. The payments were still too much.

I missed my first payment when my brother died in December 1996. Cityscape said they would not take a late payment from me unless I made up for the missed payment. I could not do it. Later in 1997, I lost my home to foreclosure by Cityscape. I now understand that these lenders pushed me into loans I could not pay. Adding all of these fees and costs each time caused me to lose my home, one I owned free and clear shortly after my husband died.

Thank you.

Chairman SARBANES. We thank all the witnesses.

We have been joined by Senator Corzine from New Jersey.

Jon, I do not know if you have an opening statement.

COMMENT OF SENATOR JON S. CORZINE

Senator CORZINE. I just appreciate very much your holding this hearing, Mr. Chairman, and to all of the witnesses, I respect and admire your willingness to speak out on this issue.

Chairman SARBANES. Thank you very much. I am going to be very brief, but I just want to—Ms. Mackey, I would like to go through your situation because you skipped over a part and then you put it at the end and I want to try to do it in sequence so that we get a very clear picture on what happened.

As I understand it, before you responded to this radio ad that you heard because they were advertising that you could get a home equity loan and you wanted to do some fixing up of your condo and also pay off some other debts, you had a mortgage loan of $74,000, before you went to them.

Ms. MACKEY. Before I went to the home equity loan, yes.

Chairman SARBANES. $74,000, at an interest rate of 7½ percent, and you were making a monthly payment of about $510.

Now, as I understand it, they said to you that, to get this home equity loan, it would be in your best interest to do a consolidation, which meant refinancing your old mortgage loan and then having a new loan included therein. And you went ahead and that is what you did. Is that correct?

Ms. MACKEY. Yes, that is correct.

Chairman SARBANES. All right. Now the new mortgage that resulted out of all of this was for just over $100,000, instead of $74,000.

Ms. MACKEY. That is right, $100,750.

Chairman SARBANES. That mortgage had an interest rate of 12.85 percent.

Ms. MACKEY. That is correct.

Chairman SARBANES. The old mortgage had 7½ percent. Correct?

Ms. MACKEY. That is correct.

Chairman SARBANES. 12.85 percent. Your monthly payment jumped to $1,103, and there was a prepayment penalty included of 1 percent.

Ms. MACKEY. That is correct.

Chairman SARBANES. Okay. This meant you got this $100,750 new mortgage, $74,000 of that to pay off the old mortgage.

Ms. MACKEY. Right.

Chairman SARBANES. There were points and fees of $8,105.

Ms. MACKEY. That is right.

Chairman SARBANES. And then that left you with $18,645, in additional funds to pay off bills and do the improvements.

Ms. MACKEY. Yes.

Chairman SARBANES. So that is how you arrive at this point that to get the $18,645 additional, you paid $8,105 in points and fees.

Ms. MACKEY. That is right.

Chairman SARBANES. Actually, you went to an interest rate on the new mortgage of 12.85 percent for all of it, whereas before, you had an interest rate of 7½ percent on the $74,000 mortgage. You now ended up paying an extra $593 a month in monthly payments.

That jumped from $510 to $1,103. And you will pay over a couple hundred thousand dollars in interest over the life of the loan.

Ms. MACKEY. Yes.

Chairman SARBANES. Well, that is a pretty dramatic example of what we are trying to address here today and I very much appreciate your coming and telling us that story.

Now, Ms. Podelco, in the time that is left to me, because I explained to the panel, we do 5 minute periods amongst the Members and then we move on to the next Member. I am not going to go all the way through this, but I want to explain it.

When your second husband died, you and your second husband had finally purchased a small home of your own. Correct?

Ms. PODELCO. Yes.

Chairman SARBANES. Then he passed away. You became the sole owner. You received an insurance policy payment after his death.

Ms. PODELCO. Yes, that is right.

Chairman SARBANES. And you took $19,000 of that insurance policy payment to pay off the mortgage on your home. Correct?

Ms. PODELCO. Yes, so that I would have a home.

Chairman SARBANES. That is right. And you had a home free and clear of any debt. Correct?

Ms. PODELCO. Yes, at that time.

Chairman SARBANES. That is right. And then you got this letter about doing home improvements and you thought, you needed some new windows. You needed a new heating system and so forth.

Ms. PODELCO. Yes.

Chairman SARBANES. So, you went and signed a loan just under $12,000—$11,921. Right? To begin with.

Ms. PODELCO. Yes.

Chairman SARBANES. Okay. At that time, your income was $458 a month from Social Security and the payments on this loan would be more than half of that.

Ms. PODELCO. I know.

Chairman SARBANES. Of course, that is a dramatic illustration of the fact that these predatory loans are made without relationship to the borrower's ability in terms of their income to repay the loan. It is completely geared to the equity in the home, which is one of the points that we are trying to stress.

And then what happened over time, one or another company kept coming to you to get you to refinance your loan. And unfortunately, you proceeded to do that. Of course, they charged you fees and everything each time they did it. So the amount of mortgage on your home and the monthly payment you had to make kept going up. Is that correct?

Ms. PODELCO. Yes.

Chairman SARBANES. In fact, it went up to the point—well, the last figure I have here—of course, there were some add-ons after that. It reached over $64,000, the mortgage.

The total loan went over $64,000. And of course, your monthly payments escalated as well. And in the end, you were not able to meet the payments. Is that correct?

Ms. PODELCO. That is correct.

Chairman SARBANES. And you lost your home.

Ms. PODELCO. Yes.

Chairman SARBANES. I believe that is a very dramatic example. I just say to my colleagues, we have really have to pinpoint this thing and do something about it.

Here is someone who worked all their lives, bought a home, took the insurance policy money on their husband's death in order to pay off the remaining mortgage on a home to own the home free and clear, and then was manipulated over a period of time, successively, by these operators, until finally they ran the mortgage loan way up, ran the monthly payments way up. In effect, they stripped the equity out of the home, when they foreclosed and took it away.

Thank you very much for coming and being with us.

Ms. PODELCO. You are welcome.

Chairman SARBANES. Thank you all.

Senator Johnson.

Senator JOHNSON. Mr. Chairman, I thought the testimony here was extraordinary and I am appreciative of your calling this panel. I do not have any questions of my own here, other than simply to say thank you to all four members of this panel. I think that you have contributed in a very meaningful way to the overall debate on this very difficult issue.

Chairman SARBANES. Senator Reed.

Senator REED. Well, Mr. Chairman, the testimony is disturbing, shocking, to think that, as you so aptly characterized it, people work all their lives and then have their homes taken from them through manipulation, through a pattern of deceit and dissembling, is despicable. I do not think there is any other word for it.

I do not know what I can add in terms of questioning, but it struck me when I was listening to Mr. Satriano and reading his testimony, that because of an arbitration clause in your own mortgage, you could not even go to court. Is that correct?

Mr. SATRIANO. That is right, sir.

Senator REED. And I wonder, Ms. Mackey, did you ever address some type of court filing?

Ms. MACKEY. I have spoken with the Legal Aid Society of Oakland County. They referred me to an attorney who never returned my calls. I am going to pursue it. It is just not fair.

Senator REED. And Ms. Podelco, when you were in your dilemma, did you try to get any legal assistance to try to upset the contract?

Ms. PODELCO. No, that is where I made my mistake, until I realized that they were ready to foreclose.

Senator REED. The other thing I should point out, Mr. Chairman which I find disturbing is that, when we have had our debate upon the bankruptcy bill, and we have had companies come in and argue about how we have to reform the bankruptcy laws because they are being taken advantage of.

And we now have stripped away many basic rights that previously people had to protect themselves. And you find out that—and I would not suggest the linkage between specific companies, but you find out that within the same financial services operations, there is a great deal of shenanigans going on. And yet, we are hearing that we should not take any action. We cannot do anything. That it is the market.

But certainly, when it comes to the bankruptcy bill, we were implored that we had to take action. It just seems to me unfair.

Thank you, Mr. Chairman.

Chairman SARBANES. I just want to underscore, in Ms. Podelco's case, her income was her Social Security payment. And these companies were clearly making loans to her that could not be repaid from her income. Obviously, they were targeting this home that had been paid free and clear and which had equity. So the whole process was geared to taking the equity out of that home.

Senator Stabenow.

Senator STABENOW. Well, thank you, Mr. Chairman. And thank you again to each of you for coming.

As we are wrestling with what to do, I would like very much to know from each of you, from the information standpoint, consumer information, what you would suggest to us as we look at not only defining what predatory lending is, so that we can clearly state that it is illegal and existing laws need to be enforced aggressively, and we need to make sure the resources are there to do that. But we all understand that more consumer awareness and education is very important. And that is why your being here today is so important and the Chairman's focus on this issue is so important.

I would also say on the side that I am pleased and appreciate that Freddie Mac is coming to Detroit to help us focus in September on the whole question of community awareness and education through an effort that they do which is called Don't Borrow Trouble. We are appreciative in their leadership in this, as well as the support and involvement of Fannie Mae in efforts as well.

But I am wondering if any of you would like to comment on what kind of information would be helpful to you to have on the front end? Did any of you receive information in writing about the terms, the costs, anything comparing what you were paying? For instance, Ms. Mackey, your current—the loan before all of this happened versus the new loan and the points and fees and costs and so on? Did you receive any information in writing? And if not, what would you suggest as being something that we should focus on in terms of public information?

Ms. MACKEY. I received a good-faith estimate, which I think is something that is required from American Equity Mortgage, before the final paperwork. I did not see any paperwork other than that until the final paperwork that I went in to sign. And everything had been increased significantly at that time.

Senator STABENOW. I am not sure I understood correctly. Did you have paperwork that said something different for the exact same——

Ms. MACKEY. I am sorry. I had this bug in my ear.

Senator STABENOW. That is okay. You received information on the front end. What exactly did they give you information about? What were the numbers? What were the terms that they shared with you?

Ms. MACKEY. They went over the rates that I already had and they gave me the suggested interest rate or estimated interest rate, which was 11-something. The monthly payment would be probably around $900 and something.

At that time, my income was about, take-home was about $1,800 a month. So $900 sounded like a whole lot. But sounded do-able if I was not going to have all of these other debts to take care of.

All the information on that good-faith estimate, and I am sorry I do not have it right before me, the figures were all significantly lower. The costs, the points, whatever, all were lower than the final paperwork.

I would like to see something that could be put in the hands of the borrower by the lender in advance that was the final paperwork, final numbers. An estimate is wonderful, but when they up everything by several hundred dollars or more, it does not really do much good. And you get there and you think, oh my gosh, what have I done? And you are embarrassed and you do not know.

I sat there thinking, I really should just walk out of here. But I cannot do that. It is silly to even think that way. But I think if I had something to look over at home before I went in to sign those papers, it would have given me a better opportunity.

I could have taken it to someone, although I do not know that I would, because I did not want to—now I am talking about it all. But at that point—what I am doing now is not for me. But at that point, I did not want anybody to know what I had done.

Senator STABENOW. Thank you. And so, you were given a piece of paper that said the payment would be around $900.

Ms. MACKEY. Yes.

Senator STABENOW. Instead, it was $1,103.

Ms. MACKEY. Yes.

Senator STABENOW. And a different interest rate.

Ms. MACKEY. Correct.

Senator STABENOW. And so, you walked in assuming one thing and found out something else.

Ms. MACKEY. And you know, Senator Stabenow, it was several days after I went home with this paperwork and looked it over thoroughly on my own, that I discovered that my main reason for getting this, one of my credit card debts had not been paid. And when I called the young man who did the work, he said we could not pay everything and give you what you wanted for the improvements on your condo. But they could charge me over $8,000 in fees.

You are talking about equity stripping. I had the difference between $150,000 and $74,000, what is that? $75,000? And now I may have $50,000 equity in my home, if I am lucky.

I just think that there has to be more education. And it is not just the responsibility of the Committee or the industry, but it is also our responsibility to avail ourselves of that information.

And that again was my own fault for not doing that because I know that there is information out there. But it is that embarrassment situation again, which is—I am not embarrassed any more. I have learned.

Senator STABENOW. Well, thank you so much.

Chairman SARBANES. Senator Dodd.

Senator DODD. Thank you, Mr. Chairman. Again, I think that this has been tremendously helpful to have all four of you share your testimony.

I realize, something you just said, Ms. Mackey, was very worthwhile because in all of this, obviously, there are some other sources of responsibility here. But you properly point out, if nothing else, we hope people watching this or listening to this will take note of what you just said.

The important thing is to always check and ask other people. There are people you can go to in most communities that will help you find out whether what you are being offered is—my mother used to say, if it sounds too good to be true—remember that?

Ms. MACKEY. It usually is.

Senator DODD. It usually is, yes. And when you hear these radio ads and so forth and they are offering to make your life easy, offering you more money at less cost, that is usually a good signal.

Ms. MACKEY. I understand that. And I was at a point where I was very, almost desperate to get this taken care of.

Senator DODD. Yes, I understand that.

Ms. MACKEY. So, I lost all good sense.

Senator STABENOW. Would my friend yield for just one moment?

I would just want to add that in this particular situation, Ms. Mackey got information ahead of time, saying, it would be a $900 payment and it changed at closing. So, I would just add that even when we ask ahead of time, if it is changed, there is a problem.

Senator DODD. No, I agree. But my point is, again, for people listening out there, or who are watching this, who have not yet done this, but who are being approached by people, your testimony here is a good warning. It does not offer you any immediate relief, obviously, but maybe just by being here, you may be saving some people from the same kind of tragedy.

You have been through basically a financial mugging. That is what this is. You were mugged. It is almost like walking down the street and being mugged. Now it took longer and it was more subtle and it was cute. But it is as much as if someone had held you up, in my view.

Senator Reed made a very good point. There are some of us who have strongly objected to this so-called bankruptcy reform bill. One of the reasons that the bill has not become law today is because there are a couple of States in this country where affluent homeowners do not want their homes subject to bankruptcy laws—the Homestead Exemption. And Ms. Podelco, if you just moved to Palm Beach and bought yourself a nice big condo, you might not be in this trouble today.

[Laughter.]

I do not know if that was possible for you in West Virginia. But it is somewhat ironic in a way that we are talking about so-called reforms here, where people want to prohibit the discharge of credit card responsibility and make it more difficult for people who get caught in difficult situations to be able to get themselves out of it. But that is an aside that I raise to you here today.

Let me just ask you, because one thing was common in all of your stories here. They all have a poignancy to them. But it just seemed to me in every case, with some variations on it—Mr. Satriano, you have something next to you there. What is that?

Mr. SATRIANO. It is just a picture of my house.

Senator DODD. Why not get it the right side up?

[Laughter.]

There we go. That is your home?

Mr. SATRIANO. Yes.

Senator DODD. How long had you been in that house?

Mr. SATRIANO. My wife grew up in there.

Senator DODD. Your father-in-law built that house?

Mr. SATRIANO. Right. 1947.

Senator DODD. Well, the one thing I saw as I was listening to you talk about it here is that the solicitors in every case withheld information, it seems to me, in every case. And correct me if I am wrong, but you had very important information withheld from you as the solicitations were being made. And important information about the terms of the loan, you were directly misled in every single case. Is that true?

Mr. SATRIANO. [Nods in the affirmative.]

Ms. MACKEY. [Nods in the affirmative.]

Mr. WILLIAMS. [Nods in the affirmative.]

Ms. PODELCO. [Nods in the affirmative.]

Senator DODD. You are nodding your head yes.

Ms. MACKEY. Yes.

Senator DODD. Now the marketing of this just seems to me it is fraud in your cases here. I do not know how else to describe it. The marketing techniques that were used against you were all in the case promising you a much better deal, obviously, than you had in every single case.

Again, I thank you, Mr. Chairman. I know we have other witnesses to hear from. I hope maybe some of our colleagues when we look at it—there was a piece in *The Wall Street Journal*, I think it is today's home economics—refinancing boom helps explain strength of consumer spending.

An unprecedented cashflow may prevent recession. Economists figure that all of the refinancing activity contributed nearly half of 1.2 percent annualized growth in the first quarter gross domestic product.

I mean, this is going on. There is a lot of refinancing going on all over the country. Now I am not suggesting, obviously, that the refinancing, all of it is predatory lending. But I get nervous when I see this, a lot of these solicitations going out. And as long as home prices stay up—I remember in Hartford, Connecticut a few years ago, we had the mid-1980's. And there was this tremendous inflation in values of homes. And then we had the real estate market crash. And people had mortgages on their homes that vastly exceeded the value of these homes.

I have an uneasy feeling that we may be entering a period like that. And we are going to find that not just people like yourselves sitting here that have been through and dealt with unscrupulous lenders out there that have taken advantage of you by withholding information and lying to you, basically, deceiving you, that we may find a more compounded problem here as a result of this effort to convince people that they can refinance their homes and ought to do so, and find that these homes are not going to be worth as much as they thought they were.

Again, I thank all four of you. You are courageous people. We are grateful to you for being here.

Chairman SARBANES. Senator Corzine.

Senator CORZINE. I will be brief, Mr. Chairman.

I certainly concur that you are courageous to sit and tell us these stories, which I think accentuate a major flaw, a reprehensible flaw in our economic system. I hope we can get at some of the funda-

mental problems here with precise but important legislation as we come through this.

One thing that yells out at us is the need for financial literacy exposure. This morning I was with a group of people from the Urban League and Historic Black Colleges and Freddie Mac on a Credit Smart program that is designed to deal with getting financial literacy out in the community so that we can deal with this when you are faced with people that are smooth talking and fast talking and trying to give you something for nothing.

But I have one question. How many of you had an independent, outside participant with you as you went through this, for example, a lawyer?

For the life of me, I have never gone to a closing on a mortgage without a lawyer. And I am wondering whether any of you in the situations you had had some independent party that would challenge the efficacy of this process.

Ms. PODELCO. [Nods in the negative.]

Ms. MACKEY. [Nods in the negative.]

Mr. WILLIAMS. [Nods in the negative.]

Mr. SATRIANO. [Nods in the negative.]

Chairman SARBANES. I think the record should show that all four panelists, they did not have someone with them.

Senator CORZINE. I am not sure on all of the steps that we need to take in this process, but the idea that people who deal in the subprime market and this secondary lending have the ability to have a one-on-one relationship without someone who has the financial skills to evaluate some of these programs makes a lot of sense.

You are courageous. I appreciate very much your statements and participation and help in this process, and I look forward to us pushing aggressively forward. And I also have to identify with the bankruptcy remarks that the Senators from Connecticut and Rhode Island made. This is not a one-sided affair, as I think we heard it mostly debated on the floor of the Senate.

Chairman SARBANES. Thank you very much, Senator Corzine.

I want to tell the panel members how much we appreciate their testimony. As I said at the outset, I know it is difficult to appear in this public atmosphere to tell your personal story, but it constitutes a valuable contribution to this effort we have undertaken.

Some of my colleagues made note of it, and I think I ought to, for the completeness of the record, observe that there are a number of financial institutions that have announced recently, subsequently to when we scheduled these hearings, a number of steps that would address some of the concerns that are here today.

In particular, a number of companies have announced that they will no longer finance single premium insurance in their loans, roll it into the mortgage and then you end up paying interest over a sustained period of time. Other practices have also been changed.

Those are important steps and we welcome them. But there is more to be done, obviously, and we intend to continue to press forward with really laying out exactly what the problem is, so it is fully understood.

We want the regulators to exercise more effective control. We want tougher enforcement of existing laws, which may well need the commitment of more resources.

But there are practices going on that are not illegal under existing laws. The repeated refinancing of a loan and the stripping out of equity is technically not illegal.

And so, we need to address those problems. We need to address the education dimension which Senator Corzine talked about. And I encourage the industry itself to continue to try to establish best practices and raise the level of activity within the industry.

It is very helpful in all of this that people will come in and speak out about their own experience. I know it is, in some respects, as Ms. Mackey said, embarrassing for you, although you have passed that threshold, I gather, now.

But you have made a very substantial contribution here today and we thank you very much. We will excuse this panel and move on to our next panel.

Thank you all very much.

The Committee will take just a brief pause while we move this panel out and bring the other panel on.

[Pause.]

Chairman SARBANES. I want to welcome the second panel. I know you have been waiting quite a while.

On this panel we have: Tom Miller, the long-time Attorney General of Iowa, and the Chairman of the Predatory Lending Working Group of the National Association of State Attorneys General; Steve Prough, the Chairman of Ameriquest Mortgage Company, one of the larger subprime lenders in the country. And Ameriquest has developed a program, with a number of civil rights and community organizations, which we are looking forward to hearing about this morning; Charles Calomiris, professor of finance at the Columbia Business School and the Codirector of the Project on Financial Deregulation at the American Enterprise Institute; and Martin Eakes, who is the President and CEO of the Self-Help Credit Union in North Carolina. Mr. Eakes has, as I think we all know, been a leader in the effort to fight predatory practices, both in his home State of North Carolina and nationally. And of course, North Carolina has taken a number of very important initiatives that I think are worthy of attention. We welcome all of you.

Gentlemen, we are running late this morning. I think what we will do is we will include your full statements in the record. I very much appreciate the obvious effort and time and thought that was devoted to preparing these statements. They are quite comprehensive and they will be of enormous help.

If you could summarize your statements in 8 to 10 minutes, we would appreciate that. And then we will go to a question period. Attorney General Miller, why don't we start with you? We are pleased to welcome you before the Committee, and I might note that many years ago, in his younger life, Attorney General Miller worked as a Vista volunteer in Baltimore, Maryland. We were pleased to have him there and we are pleased to have him here today before the Committee.

Mr. Miller.

STATEMENT OF THOMAS J. MILLER
ATTORNEY GENERAL, THE STATE OF IOWA

Mr. MILLER. Thank you, Mr. Chairman.

You might add that I was also a very enthusiastic volunteer in your campaign.

Chairman SARBANES. I did not want to make it political.

[Laughter.]

Mr. MILLER. I will try and summarize as you suggested. In a way, a summary is made easy because of what happened before. The testimony that we heard before was compelling. It was strong. It was complete. And it tells the story. It tells the story because it did not happen to just those four individuals. It happens to many people throughout the country.

Even in a place like Iowa. I met 2 days ago with three very similar people to the four you heard this morning, very similar stories and very sad stories. Indeed, the conduct is bad enough and it is being done often enough throughout the country, that I believe it is truly a national scandal.

I think you summarized the elements that are used by various people against low income people to do this in America and I will just mention them briefly. And keep in mind that it is the combination of these tricks and these gimmicks and these charges that accomplishes the draining of their equity and the loss of their house.

First of all, as was mentioned, it is the points and related charges that can add up to thousands of dollars, often 5 to 10 percent and more. Then it is the credit insurance. And there is absolutely no reason for this insurance. Let us look at this.

A low income person that is trying, struggling to buy a house, going to an equity loan, a second mortgage, in terms of what they need and what they would choose, would they choose insurance payments at a large level? It just does not make sense. It is pure exploitation. And I am pleased, as you mentioned, that three companies have decided not to use that.

One of the people we talked to earlier this week had paid $10,000 for a single premium credit insurance. And then they were going to pay $66,000 in interest. So $76,000 for a product that they do not need, would not choose, given their other needs.

The interest rate is higher, sometimes even getting into the high-teens and into the 20 percent. And one thing that was alluded to by the earlier speakers that I want to point out is a whole group of people that are involved in this. And they are called bird dogs. They are independent brokers or they are home improvement people that often do very fraudulent home improvement. And they are out looking for these people.

They are out looking for the four people that you saw this morning, the three people that I saw on Tuesday. And they have various ways of finding them. And they do find them. And all of this is below the radar screen. They will lie about everything. It reminds me a little bit about telemarketing fraud that we fought a few years ago. When people got on the phone, those telemarketing fraud operators, they would lie about everything to close that deal. These bird dogs do exactly the same thing.

Another abusive practice is the balloon payment. Because of everything that these people are being charged and the interest

rate that is high in addition, people cannot pay off the loans. So what they do is they give them a 15 year balloon payment at about the same price of the loan itself. So there is no chance that they will ever pay it off.

Then there is flipping that the lady from West Virginia so eloquently laid out, the flipping from company to company to company, adding on those charges, those 10-, 20-, 30-percent charges each time—that is part of it.

And then just to make sure, once they have people hooked, that they do not get off the hook somehow by maybe a family member helping or a friend helping, there is the prepayment penalty, to hold them on onerous terms. And if they decide that they might want to go to court, it is the arbitration clause.

It is all of these things that are brought together. They are a national scandal because of what they do to people. And you can tell they are the part of business plans of some of these companies.

The bird doggers that I mentioned are part of just a fraudulent operation. This is just a whole set of people and circumstances that are exactly out to abuse people in the way that is described. And of course they do it primarily with poor people, primarily with minorities, primarily with elderly, the ones that are most vulnerable in our society. As I say, I believe it is a national scandal. The question is what do we do about it?

Well, first of all, society has to recognize that this is totally unacceptable. We as a society need to push back. And that is why I think it is so important that you have called this hearing. Putting the light of day on these practices is extremely important. But of course much more has to be done.

Some things have to be done by the companies. Some very reputable companies are involved by owning some of the subsidiaries, by buying some of the loans, in some instances dealing with the bird dogs.

They have to change their companies. And I think some of them are about doing that. You mentioned on credit insurance. I talked to one other company. It is amazing, when my name showed up on the witness list, I started to get calls, Senator from one of the large companies that indicated perhaps some real constructive change.

The industry has to clean this up because what we have seen happen is totally intolerable. And any self-respecting individual or company cannot be involved with what I just described. They need to recognize that and I think they are starting to get the message.

We need enforcement. We attorney generals recognize this as a problem, a big problem. We have just recently put together a working group, as you mentioned, of attorney generals to work on this, that I lead as well as Attorney General Roy Cooper of North Carolina and Attorney General Betty Montgomery of Ohio.

It is something we are concerned about. The FTC is involved. Other law enforcement people are involved, and understanding the grievous nature of this problem and what needs to be done.

The Federal Reserve needs to act on the regulations that are proposed before them. Thirty-one States and 31 State Attorney Generals have endorsed and pushed for those regulations. I think it is very important that those reforms go forward.

Congress needs to act. They need to look at some of the features perhaps that are preemptive on States. There may be a role for States to play, a somewhat larger role, realizing that we are dealing with a national problem.

And you need to take a look at HOEPA. HOEPA has changed some things in a constructive way. But there are more things that you can do on credit insurance, on balloon payments, on the size of fees and charges, and on the ability to pay. We need to look at this from a whole range of people.

Like many problems in the public policy arena, there is no silver bullet. There is no one thing that we can do. But we can focus on it from a number of different aspects in combination. Much like they put those various combinations of bad things together to achieve the result, we can push back and make a difference.

And I appreciate what the Senator said about this being a problem that needs to be dealt with in a way that does not harm legitimate subprime credit. It is very important that low income people have the opportunity to get loans and buy houses through subprime credit that is reasonable and fair.

And companies can tell the difference. Companies can tell the difference of these elements and the kind of lending that Senator Gramm and others talked about.

It is very important that people like Senator Gramm's mom be able to buy a house like she did. But I will tell you what. If these people got a hold of her, she would not have been able to buy that house. She would either be paying yet today, 52 years later, or be out of the house.

That is what is at stake here—to preserve what is good in the credit industry, constructive credit, and to deal strongly and effectively with destructive credit, which drains the equity and the hopes and the dreams from the people of America that are affected.

Mr. Chairman, thank you for inviting me to testify and thank you for bringing this issue to the fore. It is a very important issue.

Chairman SARBANES. Thank you very much, Attorney General Miller.

Mr. Prough.

STATEMENT OF STEPHEN W. PROUGH
CHAIRMAN, AMERIQUEST MORTGAGE COMPANY
ORANGE, CALIFORNIA

Mr. PROUGH. Good morning, Mr. Chairman. My name is Steve Prough and I am Chairman of Ameriquest Mortgage Company. Ameriquest Mortgage Company is a specialty lender. We provide affordable loans to average American homeowners who have imperfect credit profiles. We are headquartered in Orange, California. We have 220 offices nationally in 33 States and we have 3,200 professionals assisting our customers to utilize their most important asset—their home—in order to obtain affordable credit to help meet their own personal needs. Virtually all of our loans are to allow homeowners to refinance and access capital. Our loan production grew to approximately $4.1 billion in originations in 2000, and we anticipate that growth will continue in 2001, resulting in approximately $5.5 billion of loan originations. Our servicing portfolio totals $8.5 billion in loans.

From the company's senior management down through our newest hires, we at Ameriquest Mortgage Company believe that borrowers are best protected against abusive lending practices when lenders adopt firm lending practices and when borrowers are given the information they need to make informed decisions in their own best interests. That is why we instill in all our employees a commitment to promoting the importance of fair lending practices and consumer awareness.

As we developed our business, we found that the financial needs of many average Americans with impaired credit were not being met at all, or at affordable prices by the home financing industry. Ameriquest sought to meet those needs by providing financing on more favorable terms and at lower cost than had historically been offered to credit impaired individuals by other lenders.

Leveraging secondary market sources and capital from Wall Street, we originate, package, and then sell our loans. As a result of the efficiency of these markets, we are able to offer lower costs to our customers. Thus, through our Wall Street financing model, we have substantially lowered the cost of financing for Ameriquest borrowers.

We help working families and individuals whose credit may be impaired for a variety of reasons. Our average customer is: 47 years old, from a suburban community, a 10 year homeowner, stable income with an average of 12 years' employment and, finally, an average income of $70,000. This is a portrait of the Ameriquest customer who has special credit needs that we have helped achieve their goals.

We at Ameriquest are very proud of our history of making loans available to borrowers who have been denied credit, but have credit needs. It should be recognized that the specialty lending industry has contributed to the highest homeownership in the Nation's history and has helped open access to capital for traditionally underserved communities. We feel very strongly that all lenders must be subject to rules that effectively prevent them from engaging in misleading or deceptive practices and from imposing unfair terms or practices. These actions are wrong. They have no place in the real estate lending industry or, for that matter, in any credit transaction whatsoever.

While we believe that it is important that lenders refrain from acting in a manner that seeks to take advantage of borrowers, we also believe that it is equally important that responsible lenders take action to adopt and implement practices specifically designed to promote fair lending and to enable borrowers to make intelligent, informed decisions about their credit needs. It is for this reason that our business philosophy is "Do The Right Thing."

Ameriquest Mortgage Company has fostered long-standing relationships with the Leadership Conference on Civil Rights, the Nation's oldest and largest civil rights coalition, the National Fair Housing Alliance, the National Association of Neighborhoods, and more recently, with the Association of Community Organizations for Reform Now—ACORN. These groups have been our allies in the cause to promote fair lending and consumer awareness. Ameriquest Mortgage Company has partnered with these committed advocates to develop and implement a set of best practices to ensure that our

borrowers receive top quality service and fair treatment and are able to obtain loans that meet their financial needs on reasonable terms and at fair prices.

In developing our set of best practices, we asked our key community group allies to help us identify their principal concerns regarding subprime lending activities. While Ameriquest had long ago addressed many of those concerns, we implemented practices and policies to address others as part of our constant effort to improve our programs to meet our customers' needs.

Ameriquest Mortgage Company provides to every customer: reasonable rates, points, and fees; full and timely disclosure of loan terms and conditions in plain English; recommended credit counseling; a full week to allow customers to evaluate whether our loan best suits their needs; a highly qualified loan servicing officer who has been trained in fair lending practices.

In addition, we: report all borrower repayment history to credit bureaus; maintain arm's-length relationship with third parties such as title companies, loan appraisers, and escrow companies.

The following practices, although legal and conducted by some, are not offered by Ameriquest: no single premium credit life insurance to borrowers; no refinancing of a loan within 24 months of its origination; no loans with mandatory arbitration clauses; no loans with balloon payments; no negative amortization loans.

Our best practices include providing each customer a one-page document, written in plain English, that clearly identifies all of the important terms of the loan using very simple phrases.

We are very concerned about the fact that you receive a big, huge bundle of information and there is no one page that this is all put on. So that is why we clearly state on one page: your interest rate is—; you have a prepayment charge of—; your total fees are—

Very simple, very straightforward. We prepare a side-by-side comparison for prospective borrowers of our initial loan quote and the final loan offering so that people can see exactly what they are getting from what we originally had offered them in order to ensure dialogue that would take place during the process.

We recommend credit counseling to all our customers by providing the 800–number for HUD-certified loan counseling. Instead of the standard three-day rescission period called for under existing law, we provide all of our customers in our retail lending network with a full week to allow them to shop for better loans. That added time allows them to determine without pressure and with the help of trained credit counselors if ours is the best loan for them. Our loan servicing associates go through a stringent training program, with a minimum of 80 hours of training. We want to ensure that in the case of every borrower, we are being sensitive to that borrower's needs.

All of our best practices empower consumers to make the right choice for them. Why do we do this? We do it because it is the right thing to do. But we also do it because we honestly believe our business benefits from our best practices. We benefit when we have fully informed borrowers who recognize that they have been treated fairly, rather than dissatisfied customers who feel that they have been taken advantage of.

There are many of us in the specialty lending sector that have been fairly and responsibly assisting traditionally underserved communities, and have helped countless, hard working families gain access to capital. I know you want us to continue to lend to this segment of America, since homeownership is one of the key elements of our society that most embodies the American Dream.

No responsible lender wishes to engage in abusive lending practices. And I am sure everyone in this room would agree that a single deceitful loan is one too many. Regulatory authorities need to use the full range of their existing enforcement powers and to devote more resources to enforcement of existing laws designed to guarantee that customers receive loans appropriate for their needs and fair terms. We at Ameriquest Mortgage Company believe that our set of best practices is designed to achieve that very result in three ways: one, our best practices prohibit certain specific kinds of abusive practices; two, our best practices provide clear and full disclosure of the critical loan terms in plain English; and three, we make credit counseling available to our borrowers and encourage them to make use of it and provide a one-week, post-approval period during which the borrower can shop our loan and evaluate, with the help of a credit counselor, whether the loan we have offered is truly a loan the borrower wants.

In short, strong enforcement of existing laws coupled with a strong set of best practices is the best tools to ensure that consumers are best served. Although we do not believe that additional laws or regulations are needed, it would be best, if there is to be action, for it to come at the Federal level, rather than adding to the existing patchwork of State and local ordinances.

Ameriquest Mortgage Company creates loans the old-fashioned way—we take the time to develop a loan for each borrower based on their individual needs. This is how I started my lending career 30 years ago, when banks were more personal and took the time to get to know their customers. It is important to recognize that this form of lending is more subjective at the individual level and requires increased personal attention from the loan officer.

We hope as this Committee considers any proposed new legislation, you are careful as you proceed to ensure that there are no unintended consequences that would have the effect of limiting access to credit for those who need it most. In that way, we ask for your support in helping us to continue to serve Middle America and reach traditionally underserved communities.

Ameriquest commends you for focusing attention on these issues. As one of the Nation's largest retail special lenders, we share your commitment to making the dream of homeownership affordable and fairly accessible for all Americans. We at Ameriquest look forward to continuing to work with you.

Thank you very much.

Chairman SARBANES. Well, thank you very much, Mr. Prough, and we appreciate, as Chairman of Ameriquest Mortgage Company, you coming across the country from California, in order to be here with us at this hearing and to give us this testimony.

I am also very appreciative of the attachment that you have to your statement setting out in considerable detail Ameriquest Mort-

gage Company's retail best practices. It is very helpful to the Committee to have that information.

Professor Calomiris.

STATEMENT OF CHARLES W. CALOMIRIS
PAUL M. MONTRONE PROFESSOR
OF FINANCE AND ECONOMICS
GRADUATE SCHOOL OF BUSINESS, COLUMBIA UNIVERSITY
NEW YORK, NEW YORK

Mr. CALOMIRIS. Thank you, Mr. Chairman. It is a pleasure and an honor to address you today on the important topic of predatory lending.

Predatory lending is a real problem. It is, however, a problem that needs to be addressed thoughtfully and deliberately, with a hard head as well as a soft heart.

Chairman SARBANES. That is what we are trying to do, yes.

Mr. CALOMIRIS. There is no doubt that people have been hurt by the predatory practices of some creditors and we have heard about that today quite a bit. But we must make sure that the cure is not worse than the disease. Unfortunately, many of the proposed or enacted municipal, State and Federal statutory responses to predatory lending would have adverse consequences and in fact already have had adverse consequences that are worse perhaps than the problems they seek to redress. Many of these initiatives would reduce the supply or have reduced the supply of credit to low income homeowners, raise their cost of credit, and restrict the menu of beneficial choices available to borrowers.

Fortunately, there is a growing consensus in favor of a balanced approach to this problem. That consensus is reflected in the viewpoints expressed by a wide variety of individuals and organizations, including Robert Litan of the Brookings Institution, Fed Governor Edward Gramlich, most of the recommendations of last year's HUD Treasury report, the voluntary standards set by the American Financial Services Association, the recent predatory lending statute passed by the State of Pennsylvania, and the recommendations and practices of many subprime lenders.

An appropriate response to predatory practices should occur, I think, in two stages. First, there should be an immediate regulatory response to strengthen enforcement of existing laws, enhance disclosure rules, provide counseling services, amend existing regulation in some ways, and limit or ban some practices. I believe that these initiatives, which I will describe in detail in a minute, will address all of the serious problems associated with predatory lending.

Second, in other areas, especially the regulation of prepayment penalties and balloons, any regulatory change, I think, should await a better understanding of the extent of remaining predatory problems that result from these features. And the best way to address those is through appropriate regulation. The Fed is currently pursuing the first systematic scientific evaluation of these areas as part of its clear intent to expand its role as the primary regulator of subprime lending. Given its authority under HOEPA, the Fed has the regulatory authority and the expertise necessary to find

the right balance between preventing abuse and permitting beneficial contractual flexibility.

I think the main role Congress should be playing at this time is to rein in actions by States and municipalities that seek to avoid established Federal preemption by effectively setting mortgage usury ceilings under the guise of consumer protection rules. Immediate Congressional action to dismantle these new undesirable barriers to individuals' access to mortgage credit would ensure that consumers throughout the country retain their basic contractual rights to borrow in the subprime market.

The problems that fall under the rubric of predatory lending are only possible today because of the beneficial democratization of consumer finance and mortgage markets in particular that has occurred over the past decade. Predatory practices are part and parcel of the increasing complexity of mortgage contracting in the high-risk, subprime mortgage area. That greater contractual complexity has two parts: One, the increased reliance on risk pricing using Fair Issac scores rather than the rationing of credit via a yes or no lending decision. And second, the use of points, credit insurance, and prepayment penalties to limit the risks lenders and borrowers bear and the costs borrowers pay.

These practices make economic sense and can bring great benefits to consumers. Most importantly, these market innovations allow mortgage lenders to gauge, price, and control risk better than before and thus allow them to tolerate greater gradations of risk among borrowers.

According to last year's HUD-Treasury report, subprime mortgage originations skyrocketed since the early 1990's, increasing by ten-fold since 1993. The dollar volume of subprime mortgages was less than 5 percent of mortgage originations in 1994, and in 1998, it was 12.5 percent. As Governor Gramlich has noted, between 1993 and 1998, mortgages extended to Hispanic-Americans and African-Americans increased the most, by 78 and 95 percent, respectively, largely due to the growth in subprime mortgage lending.

Subprime lending is risky. The reason that so many low-income and minority borrowers tend to rely on the subprime market is that, on average, these classes of borrowers tend to be riskier. It is worth bearing in mind that default risk varies tremendously in the mortgage market. The probability of default—based on Standard & Poor's credit ratings—for the highest risk class of subprime mortgage borrowers is roughly 23 percent, which is more than 1,000 times the default risk of the lowest risk class of prime mortgage borrowers.

When default risk is that great, in order for lenders to participate in the market, they must be compensated with unusually high interest rates. But, default risk is not the only risk that lenders bear. Indeed, prepayment risk is of a similar order of magnitude in the mortgage market.

In the subprime market where borrowers' creditworthiness is also highly subject to change, prepayment risk results from improvements in borrower riskiness, as well as changes in U.S. Treasury interest rates.

Borrowers in the subprime market are subject to significant risk that they could lose their homes as a result of death, disability, or

job loss of the household's breadwinners. Because single premium insurance commits the borrower to the full length of the mortgage, the monthly cost of single premium credit insurance is much lower than the cost of monthly insurance.

Single premium insurance has been much maligned here today. Mr. Miller said there is no reason to have single premium insurance. But I checked on some facts. I called up Assurant Group, which is a major provider ultimately of credit insurance in the mortgage market, and asked for a cost comparison. The monthly cost, that is, taken on a monthly basis over the life of the mortgage, the monthly present-value cost for monthly credit insurance that is paid each month, not all at once, on a 5 year mortgage, on average, is about 50 percent more expensive than the monthly cost of single premium credit insurance.

A lot of these intermediaries have left the market because the bad public relations about single premium insurance has been bad for their business. That is unfortunate, I think, and I will come back to how I think we can regulate single premium insurance without doing harm to borrowers.

The Congress recognized that substantial points, prepayment penalties, short mortgage maturities, and credit insurance, have arisen in the primary market in large part because these contractual features offer preferred means of reducing overall costs and risks to consumers. Default and prepayment risks are higher in the subprime market and therefore, mortgages are more expensive and mortgage contracts are more complex.

The goal of policymakers should be to define and address predatory practices without undermining real important opportunities in the subprime market. So what are those practices? They have already been mentioned.

According to the HUD-Treasury report, they are loan flipping, packing or excessive fee charges, lending without regard to the borrower's ability to repay, and outright fraud.

Many alleged predatory problems revolve around questions of fair disclosure and fraud prevention. But the critics of predatory lending are correct when they say inadequate disclosure and outright fraud are not the only ways borrowers may be fooled. Let me now turn to an analysis of specific proposed remedies.

First, I would recommend enhanced disclosure and new counseling opportunities for mortgage applicants. In my statement, I go through a very long list of ways to improve disclosure and counseling, but I will omit that here in the interest of time.

Credit history reporting. It is alleged that some lenders withhold favorable information about customers in order to keep and use that information privately. I think it is appropriate to require lenders not to selectively report information to credit bureaus.

Now single premium insurance. Keep in mind, roughly one in four households do not have any life insurance. And so, single premium credit insurance or monthly credit insurance can be very beneficial. To prevent abuse, though, of single premium, there should be a mandatory requirement that lenders that offer single premium insurance have to do three things. One, they must give borrowers a choice between single premium and monthly premium credit insurance. Second, they must clearly disclose that credit in-

surance, whether single premium or monthly, is optional and that the other terms of the mortgage are not related to whether the borrower chooses credit insurance. And third, they must allow borrowers to cancel their single premium credit insurance and receive a full refund of the payment within a reasonable time after closing.

What about limits on flipping? Well, I think there have been several new proposals. I agree that there needs to be some action. The Fed rule that has been proposed would prohibit refinancing of a HOEPA loan by the lender or its affiliate within the first 12 months, unless that refinancing is, "in the borrower's interest." This is a reasonable idea so long as there is a clear and reasonable safe harbor in the rule for lenders that establishes criteria under which it will be presumed that the refinancing was in the borrower's interest. For example, if a refinancing either, A, provides substantial new money or debt consolidation, B, reduces monthly payments by a certain amount or, C, reduces the duration of the loan, then any one of those features should protect the lender from any claim that the refinancing was not in the borrower's interest.

What about limits on refinancing of subsidized government or not-for-profit loans? It has been alleged that some lenders have tricked borrowers into refinancing heavily subsidized government or not-for-profit loans. Lenders that refinance these loans, I believe should face very strict tests for demonstrating that the refinancing was in the interest of the borrower.

Should we have any outright prohibitions? Well, I believe that some mortgage structures really do add little real value to the menu of consumer options and are especially prone to abuse. In my judgment, the Federal Reserve Board has properly identified payable-on-demand clauses or call provisions as examples of such contractual features that should be prohibited.

How should we deal with prepayment penalties? We should require lenders to offer loans with and without prepayment penalties. Rather than regulate prepayment penalties at this time, I would recommend requiring that HOEPA lenders offer that choice.

What about balloons? I think that, again, limits on balloons and also proposed limits on new brokers' practices may be a good idea, but I think that we should await more data before we know exactly how to shape those rules.

My final point and I know I am running out of time is dealing with usury laws. These are very bad ideas. I want to focus on the recent legislation that has been enacted and the problems that have come from it. Because of legal limits on local authorities to impose usury ceilings because of Federal preemption, explicitly, that is, they cannot explicitly impose usury ceilings, they have adopted what I would call an alternative stealth approach to usury laws. The technique is to impose unworkable risks on subprime lenders that charge rates or fees in excess of government-specified levels and thereby, drive high-interest rate lenders from the market. Several cities and States have passed or are currently debating these stealth usury laws for subprime lending.

For example, the City of Dayton, Ohio, this month passed a Draconian antipredatory lending law. This law places lenders at risk if they make high-interest loans that are, "less favorable to the borrower than could otherwise have been obtained in similar trans-

actions by like consumers within the City of Dayton." And lenders may not charge fees and/or costs that, "exceed the fees and/or costs available in similar transactions by like consumers in the City of Dayton by more than 20 percent."

In my opinion, it would be imprudent for a lender to make a loan in Dayton governed by this statute. Indeed, I believe that the statute's intent must be to eliminate high-interest loans, which is why I describe it as a stealth usury law. Immediately upon the passage of the Dayton law, Banc One announced that it was withdrawing from origination of loans that were subject to the statute. No doubt, others will exit, too. The recent 131 page antipredatory lending law passed in the District of Columbia is similarly unworkable.

What about North Carolina, which pioneered this area in 1999? As Donald Lampe points out, massive withdrawal from the subprime lending market has occurred in response to the overly zealous initiative against predatory lending by North Carolina.

Michael Staten of the Credit Research Center of Georgetown University has compiled a new database on subprime lending that permits one to track the damage, the chilling effect, of the North Carolina law on subprime lending in the State.

Staten's statistical research, which I reproduced with his permission in the appendix to my testimony, compares changes in mortgage originations in North Carolina with those of South Carolina and Virginia before and after the passage of the 1999 North Carolina law.

Staten finds that originations of subprime mortgage loans, especially first lien subprime loans, in North Carolina, plummeted after passage of the 1999 law, both absolutely and relatively to its neighbors, and that the decline was almost exclusively in the supply of loans available to low- and moderate-income borrowers, those most dependent on high-cost credit. For borrowers in the low income group, with annual incomes less than $25,000, originations were cut in half. For those in the next income class, with annual incomes between $25,000 and $49,000, originations were cut by roughly a third. The response to the North Carolina law provides clear evidence of the chilling effect of antipredatory laws on the supply of subprime mortgage loans to low-income borrowers. And in fact, was anticipated in the critical remarks that Bob Litan made about these laws.

The history of the last two decades shows that usury laws are highly counter-productive. Limits on the ability of States to regulate consumer lenders headquartered outside their State were undermined happily by the 1978 Marquette National Bank case and furthered by the 1982 passage of the Alternative Mortgage Transaction Parity Act.

I will not go into all my details in this discussion, but I want to emphasize that it would be very useful for Congress to reassert Federal preemption to prevent any more damage from taking place.

Let me conclude, for the most part, predatory lending practices can be addressed by focusing effort on better enforcing laws, improving disclosure rules, offering government finance counseling, and placing a few well thought-out limits on credit industry practices. The Fed already has the authority and the expertise to formulate those rules and is in the process of doing so based on a new

data collection effort that will permit an informed and balanced approach to regulating subprime lending.

And again, I emphasize, the main role of Congress should be to reestablish Federal preemption. And I hope also Members of Congress, and especially Members of this Committee, will speak out in defense of honest subprime lenders, of which there are many. The possible passage of State and city usury laws is not the only threat to the supply of subprime loans. There is also the possibility that bad publicity, orchestrated perhaps by well-meaning community groups, itself could force some lenders to exit the market.

Thank you, Mr. Chairman.

Chairman SARBANES. Well, thank you. This is a very useful statement and appendix for the Committee to have because it puts together a lot of the assertions that have been made, which I think will require very careful analysis on our part.

We are approaching this issue with a hard head and we would be interested to see how this analysis withstands a hard head analysis, how this statement withstands a hard head analysis. So, it is helpful to have it all put together the way you have done it and I want to thank you because, obviously, a good deal of effort has gone into it.

Mr. CALOMIRIS. Thank you, Mr. Chairman.

Chairman SARBANES. Mr. Eakes.

STATEMENT OF MARTIN EAKES
PRESIDENT AND CEO, SELF-HELP ORGANIZATION
DURHAM, NORTH CAROLINA

Mr. EAKES. Thank you, Mr. Chairman.

I too in the last couple of weeks since my name has been on this list have been called by numerous lenders telling me that they are giving up single premium credit insurance, hoping that I would not mention their names in this hearing, including one as late as yesterday. I come to you today in two roles.

The first is in my role as CEO of Self-Help, which is an $800 million community development financial institution. That makes us the largest nonprofit community-development lending organization in the Nation, which is also about the size of one large bank branch, to put it into perspective. Self-Help has been making subprime mortgage loans for 17 years. We are probably one of the oldest, still-remaining, subprime mortgage lenders. We have provided $1.6 billion of financing to 23,000 families across the country. We charge about one-half of 1 percent higher rate than a conventional-rate mortgage. We have had virtually no defaults whatsoever in 17 years. If you have a 23 percent default, I can almost assure you, it is the result of lending with fraud in that process. Subprime lending can be done right. We agree that there are good subprime lenders. We hope that we are one.

I come to you, second, as a spokesperson for an organization that started in North Carolina, called the Coalition for Responsible Lending. The coalition that formed in North Carolina was a really remarkable event for anyone who watches politics among financial institutions. This coalition started in early 1999 and started with 120 CEO's of financial institutions who came together to ask for a

law to be passed in order that they could squeeze the bad apples out of the lending industry in North Carolina.

Let me ask you on this Committee, how many times have you had credit unions and every bank in the country come together and ask you to pass a bill that would regulate them as well as everyone else? Ever?

Chairman SARBANES. We are working at that right now.

Mr. EAKES. We are working at that.

[Laughter.]

We ended up with a coalition that had 88 organizations that represented over 3 million people in the membership of those organizations in North Carolina. North Carolina only has 5 million adult voters in the State. This group included all the credit unions, every thrift, every bank, the Mortgage Bankers Association, the Mortgage Brokers Association, the realtors, the NAACP, civil rights groups, housing groups, AARP and seniors groups—every single organization that had something to say about mortgage lending in the State of North Carolina came together to pass what was not a perfect bill, it was a compromise bill among all those parties. And we passed a bill. The bill in North Carolina in 1999 passed both the Senate and the House virtually unanimously. We had one vote against in the Senate and two in the House out of 120 members.

Let me tell you what the philosophy of the North Carolina bill was, which shows you why there was such an encompassing consensus. We started with two key principles. The first principle was that this bill would add no additional disclosures whatsoever. The industry representatives and the consumer representatives agreed that real estate closings now have 30 plus documents to sign and go through.

I am a real estate attorney. I have closed hundreds, if not thousands, of real estate loans. And I am not sure that I can understand every little piece of fine print in those 30 forms. I assure you that no ordinary real person can read those documents and understand them. It is also unfair to say that education or disclosure will solve the problem. I will give you an example.

My father, who was this ornery—some people think I am ornery and hard to get along with. I used to be nicer. My father was at least twice as mean as I am. He ran a business, contracting business. No one could take advantage of him until the last 6 months of his life when he was bedridden with cancer. And then, all of a sudden, he had people calling him, saying, can you refinance your house? And even my father, mean, technically competent, a business person, could fall prey to a lender who approached him in his own house.

The second principle that we had was that we would place no cap on the interest rate on mortgages. Now this was somewhat controversial. We did that for an explicit reason. We said, by putting no cap on the interest rate, there can be no rationing of legitimate subprime credit in the State of North Carolina.

Instead, we focused on all the hidden elements of pricing in a mortgage loan. And we said, we are going to try to prohibit those and force the price into the interest rate, the one factor that most borrowers understand best. It has been said that it is hard to define predatory lending. Well, in North Carolina, whether you like

what we did or did not do, that is precisely what we did. We identified six practices that we thought were the essence of predatory lending.

In the North Carolina bill, we dealt with only four of them. That is all we could do in the first bill. But what we did in legislation was precisely define these four predatory lending practices in legal, legislative language, and enact them into law. The following four practices are what we focused on in the North Carolina bill.

First, we put a threshold limit on upfront fees. It is simply a problem, as we heard from the woman from West Virginia, when you have upfront fees, you can never get them back. The moment you sign the document, you may have lost your entire life savings in less than one second of signing your name. Instead, what the North Carolina bill said was, no financing of fees if the amount of fees is greater than 5 percent. Now, in all honesty, 5 percent fee to originate a mortgage is a very large number. The standard amount paid for a conventional, middle-class mortgage that most of us would go and obtain is 1.1 percent. That is the standard across the country.

So 5 percent is a pretty extreme compromise. It is not something I went home and was proud of after the bill was passed. And we said 5 percent of fees, not counting lawyer fees, not counting appraisals, any of the third-party fees that you normally pay at a mortgage closing, that is a limit beyond which there are some protections in the North Carolina law. And I guess I would call that a stealth usury provision if you want to say that charging more than 5 percent fees is a good thing.

Second, we focused on the practice of flipping. The reason that this was so poignant for us in North Carolina is that we had done research—you may know this—but President Carter came to Charlotte. We have one of the most active Habitat For Humanity networks in North Carolina of any State. We found researching loan by loan at courthouses that more than 10 to 15 percent of all Habitat for Humanity borrowers who had $40,000, zero-percent first mortgages from Habitat, had been refinanced into 14 percent finance company mortgages. Now what does that tell you?

That 10 to 15 percent could not have been acting rationally in the way that in academia we assume is a fully functioning perfect market. Moreover, it shows that if lenders will take advantage of 10 to 15 percent of people who have zero percent mortgages and refinance them into 14 percent mortgages, what do you think that says about the people who have those measly 7½ and 8 percent mortgages. They are certainly fair game for flipping. We passed a prohibition for all home loans in North Carolina that says you may not flip, refinance a home loan, unless there is a net tangible benefit to the borrower.

Third, we prohibited prepayment penalties on all mortgage loans. Well, that is nothing new. In North Carolina, we had that prohibition already since 1973. In fact, 31 States across the country have limitations prohibiting or restricting prepayment penalties on mortgages currently. This one really drives me crazy.

We tell poor people that it is your goal and your message is to get out of debt. That is what we charge people with. And yet, for the average African-American family with a $150,000 loan on a

home, the average prepayment penalty is about 5 percent. To pay off that debt, get out of debt, or refinance to another borrower, is 5 percent of $150,000, $7,500. That is more than the median net wealth of African-American families in this country. So in one second, when you sign up for this mortgage, you can put at risk an entire lifetime savings of wealth for the average median African-American family in this country.

And four, we prohibited in North Carolina the financing of credit insurance on all home loans in North Carolina. Before predatory lending, I was a nicer human being. But as I listened to Professor Calomiris, I hope in the question and answer session you will let me come back and maybe engage him in a little academic questioning on those terms.

To say that monthly pay insurance costs 50 percent more than single premium insurance is the worst kind of analytic mistake or intellectual dishonesty that I can imagine. Every analyst who has looked at single premium insurance finds it more expensive, which it is. I will give you an example.

If I came to you and said, you pay for your electric bill on a monthly basis every month for the next 5 years and you pay it with no interest. Instead, I give you the option to finance all 60 months of your electric payment into a loan at the front end and pay the interest on it over the next 5 years. And a typical case would come to, say, $7,000 or $8,000 of interest. At the end of the 5 years, you still owe all of the electric payments because you have not paid anything off. Everyone who has analyzed single premium credit insurance will tell you that it costs twice as much as monthly pay, no matter how you run the assumptions, no matter what you do.

The predatory lenders use this tactic with a borrower the same way it is used in public—to say that your monthly cost will be lower because all you are paying is the interest. But the cost for the single premium credit insurance, like financing your electric payments, is still 100 percent, 99 percent due at the end of 5 years.

I used to not lose my temper, but this is really driving me nuts. Let me tell you how I came to this work.

For 17 years, I worked and was a preacher preaching that we needed to get access to credit, particularly for African-American homeowners. Access to credit was my watchword.

In the last 2 years, it has turned totally on its head and I no longer worry about whether there is access to credit. It is now the terms of credit. And where there were sometimes lenders who were starving communities from getting credit they needed, the problem now is that many lenders are actually eating those communities. They are eating the equity of these families.

I had a borrower who came into my office and he told me this story which I really did not believe. I said, bring me your paperwork for your loan, which he did. We sat down. He showed me his loan. He had gotten a refinance loan from the Associates in 1989. It refinanced a Wachovia Veterans Administration loan and it was a $29,000 loan. On his paperwork, it showed that he had $15,000 of charges added into the loan for what was a $29,000 refinance. So, he had $44,000 of total debt. He paid on that loan for 10 years until he came to see me in early 1999. He told me that he had three different times tried to pay the loan and that the Associates,

recently purchased by Citigroup, would not allow him to pay off the loan and refinance it.

I said, I am a lawyer. I know that cannot be true. That is illegal. I do not believe it. As I got ready to call the company on his behalf, he sat down and tears welled up in his eyes and he said, let me tell you one more thing. The reason that this house means so much to me is not just the shelter, that it is the house I have lived in, but I lost my wife 3 years ago and I have a 9-year-old daughter. And this house is the only connection that my 9-year-old daughter will ever have with her mother. And I am sitting here, oh, God.

And I call the company and the woman on the phone says, "I am not going to give you the pay-off quote." Well, there are people who have worked with me for 18 years who have never really seen me get mad. But at that point, I really lost it and I told her—she said,"You are just a competing lender. Why should I give you the pay-off quote?" You are just going to refinance them.

And I told her, if it takes me the rest of my life, I will sue you to hell and back and we will get this person out from under your thumb. And we will refinance this loan if I lose every penny of it. I do not care any more.

And we did. We refinanced it. We litigated. We reduced the loan in half. And that was the beginning, my first knowledge of the Associates, which many people knew was the rogue company in predatory lending. There are a lot. But that one is just a horrible company. That was the beginning for me of this coalition that started in North Carolina.

I have since traveled around the country and I have said that I will spend every penny that Self-Help owns, I will spend every penny that I own until we stop this practice of basically stealing people's homes in the guise of lending. A couple more stories and I will end and then we can have some questions.

I got called as an expert witness by the banking commissioner in North Carolina who was trying to remove the license of a lender. The story was this. The lender has made 5,000 loans in North Carolina. This can only happen in the South. He had advertised on the radio that this is a good Christian company. Please come here and we will take care of you. He did take care of them. The average fees—he would not close a loan for less than 11 points on the front end for any of those loans. The person who was the principal of this business had met his other senior management in prison for trafficking cocaine.

What came out in the hearing, and I am on the witness stand and his lawyer is cross-examining me, saying, why are you picking on this company? We are not nearly as bad as three others he named. The problem in North Carolina we found was unbelievable.

We found that between 10,000 and 20,000 families in North Carolina were losing the equity in their homes or losing their homes outright every year. For me, personally, this was really an affront. I had spent 18 years at that point helping families own homes. And what I found was one or two lenders—I do not have to look at the average for the industry—but one or two lenders who are undoing in a month's time every possible step of good that Self-Help had done with its 23,000 loans over 18 years. It stopped being

an academic issue for me at that point, although I think I would be pleased to argue it on academic terms.

There are things that Congress needs to do. We need to repeal the Parity Act in its entirety. We need to strengthen HOEPA.

But I will stop there. Thank you.

Chairman SARBANES. Thank you very much, Mr. Eakes.

I am going to ask a few questions. I hope that no one on the panel is under an immediate time pressure.

I want to go to this single premium credit life insurance and the assertion that it is cheaper than paying it by the month. I just have great difficulty with that analysis. First of all, the mortgage is usually for 30 years. The single premium is for 5 years. Correct, in most instances?

Mr. CALOMIRIS. That is not what I am talking about, Senator.

Chairman SARBANES. Are you talking about a 30 year single premium?

Mr. CALOMIRIS. No.

Chairman SARBANES. No one does a 30 year single premium because the cost of that premium would be so huge, that it just would not fly.

Mr. CALOMIRIS. I am talking about a 5 year single premium.

Chairman SARBANES. That is right. And then they get to the end of the 5 years and then they refinance, and then they throw in another 5 year single premium. Is that right? Is that what happens in almost every instance?

Mr. CALOMIRIS. I do not think anyone knows what happens in almost every instance, Mr. Chairman. But I think we can agree on some basic arithmetic principles. I hope we can.

First of all, we are talking about a stream of cashflows, whether you talk about the monthly premium or the single premium. And then the question is, if it is monthly premium, you have to decide what discount rate do you discount those cashflows to arrive at a present value because the right comparison, I think you will agree, is that you want to ask whether the present value of monthly premium insurance or the present value of single premium insurance is larger. If you discount, which is the correct way to do it, at the interest rate that is charged in the loan, because that is the borrower's discount rate, you arrive at a calculation that single premium is half as costly.

Whether you are financing that single premium up front or paying it up front, it is equivalent. It does not matter. The fact that you are only paying the interest and then 5 years from now, you still have to continue paying the interest because you have not repaid the balance on the money you borrowed to pay the single premium insurance, is irrelevant to the computation. I think what we are really having a problem with here is what I would call basic finance arithmetic. And I think that is unfortunate.

Chairman SARBANES. Well, Martin, do you want to address that?

Mr. EAKES. I would love to get into basic finance arithmetic with someone because now you are really on my turf. I have been a lender for almost 20 years. There is no way that you can have a cashflow that includes interest and discount it back at any interest rate and have that come out to be lower than something that has no interest whatsoever.

It does not matter. You still have the terminal amount that is the full amount of the premium. It does not matter. I am absolutely certain that this is an analytic bad mistake in every way it can be.

Chairman SARBANES. My perception of it is that it is like trying to walk up the down escalator. You just keep losing ground.

Let me give you an example from one company. They had a $50,000, 15 year mortgage loan with a single premium life insurance policy costing $1,900 that was in force for 5 years. At the end of the 5 years, the homeowner still owed about $1,600 on the original insurance premium. So then he refinances. He takes out another policy. So there is another $1,900 that is thrown into the loan. Now it is $3,500 that has been pulled out of him. We do not really go after the protections of the insurance if they pay it on a monthly basis. But that is outside of being folded into the loan and then paying interest on that large charge. Then the person ends up losing their home because you have packed all these fees into it.

Mr. MILLER. Senator, if I could just make a couple of practical points, too. Think about the income level of the people we are talking about.

Chairman SARBANES. I want to get to that, too, in a minute on the balloon payment, yes.

Mr. MILLER. In this context. All the demands on their financial resources. Life insurance would not naturally be high on their list. It would not fit in, except for what the lenders are doing.

And think, too, to finance insurance, would that be something they would want to put their home in jeopardy for and put that in the mortgage? No. It just does not make sense from the consumer's point of view. It is only in there for the lenders. And indeed, in my view, it is a litmus test of whether a lender is in good or bad faith.

They are out to drain the consumer, if they are selling single premium credit life insurance. It is just very clear to me where they are headed.

Mr. CALOMIRIS. Mr. Chairman, if I could just interject.

Chairman SARBANES. Certainly.

Mr. CALOMIRIS. What I am proposing, of course, is not to leave things as they are. I am proposing some pretty big changes. I am proposing that the lender has to offer both products—single premium and monthly premium—that the lender has to fully disclose what is the cash that I am going to get back? What is the monthly payment I am going to have to make in totality? All the charges. And then let the borrower choose.

And make it also clear that this is entirely optional because a lot of the complaints have been that people did not understand it was optional, that all of the other terms in the loan do not change.

Somebody has to explain to me why, when somebody is being given a choice that is clearly spelled out, and we are going to make sure that the disclosure is right, and they decide that they would prefer what I would regard, in some cases, at least, and from what I understand, on average, cheaper insurance over the life of that 5 years, somebody has to explain to me why, because a Senator or an activist or an attorney general believes that is not the right choice, why they, with counseling, on their own, with all information, cannot do it?

Mr. MILLER. Charles, were you here this morning? Did you hear what was going on?

Mr. CALOMIRIS. I was here this morning.

Mr. MILLER. And do you have any sense of the power and influence of the industry making these loans and running them through? Yours is an academic approach. What we really need to do is deal with the real people that we saw this morning, and in that setting, to set up these complicated disclosures just does not make any sense in the real world.

Mr. EAKES. This is a product that never benefits the consumer. Never. Not a single case. That is why it is so easy. And if we have a trained economist who cannot get it right, how do we expect a borrower to get it right? When you offer a choice between something that in every case costs you the extra interest, every single case, it makes it a false choice.

And so the borrower, yes, they can be deceived into choosing it because the predatory lender focuses on the monthly payment. And they say, this example of a $100,000 loan with $10,000 of up front credit insurance, if you pay for that interest only, it would be $133 a month, which is what financing it as single premium is. If you pay for it on a monthly basis, your monthly payment will be $167.

So, he is right. It does, on the monthly basis, cost a little bit less. But at the end, you still owe $9,900 of the single premium credit insurance. To offer a choice of something that, in every single case, is worse for the borrower, is merely a deception. How can we possibly have the consumer understand that. Put it in the interest rate if the lender needs that compensation. This is ridiculous.

Chairman SARBANES. Let me ask this question.

How is a borrower in the subprime market who almost by definition is right at the limit of their ability to handle the matter, going to handle a balloon payment at the end of the mortgage period?

Is that not, to a large extent, building up a huge risk of default, or perhaps more likely which keeps happening, a refinancing when they get to that point, again in which a lot of fees are packed into the loan and we get the sort of process that was laid out here this morning where the equity is being stripped out of this loan? Does anyone want to address that?

Mr. CALOMIRIS. When I was younger, I borrowed balloon loans because the interest rates are lower because, by keeping maturity lower, typically, in a loan, risk is lower—and then I rolled it over with the same bank.

Chairman SARBANES. And what were your earning prospects when you did that?

Mr. CALOMIRIS. I do not know. I was in my early 20's. I was a graduate student at the time. I suppose that if you were optimistic about my career ability, you would say they were pretty good.

Chairman SARBANES. They were pretty good. Now suppose you were 70 years old and you were living on Social Security.

What is the rationale for the balloon payment in that case? That is your income. You are at the end of your working life. That is your income. And you take out a subprime loan. They slap on this balloon payment. Now what is the rationale there?

Mr. CALOMIRIS. Again, balloon payments tend to reduce interest cost, so they can be beneficial. In my statement, of course, I recog-

nize that you may want to limit balloons in some cases. And, in fact, I argue that was one of the things that I hope the Fed will look at. But I do not believe we want to rashly decide whether a 1 year balloon or a 3 year balloon or a 5 year or 7 year, is the right route.

Chairman SARBANES. We are not going to decide anything rashly.

Mr. CALOMIRIS. Right.

Chairman SARBANES. Let me make that very clear. Nothing will be decided rashly.

Mr. CALOMIRIS. Balloon payments reduce interest costs and that is the main benefit anyone derives from them. If there is rollover risk, as I think you are suggesting there can be in some cases, or if people are tricked and do not understand that they are facing a balloon, then I think there is a real issue. But let us again not throw the baby out with the bathwater.

But if I can just make one other comment about flipping. Again, I have specific ideas about how you can prevent flipping. The problem with the North Carolina law, and the reason that it is had such a chilling effect on subprime lending already in North Carolina is that it does not give anybody safe harbor.

If you are going to say people cannot flip, that is fine. I am all for it. But let us define what flipping is in a very clear way, because if we do not define what it is, the legal risk that comes from being potentially sued for having flipped puts a chilling effect on lending. Let us go after flipping. But let us not go after it in a vague way, which is what the North Carolina law does. And that is why I think it is had such a negative effect.

Chairman SARBANES. Well, Mr. Eakes, Professor Calomiris to some extent, took out after North Carolina.

Mr. EAKES. Yes, I think he called me out to a duel, right?

Chairman SARBANES. So, you are entitled to some response to it, if you choose to make it.

Mr. EAKES. Let me respond and maybe I will ask a question.

The data that is cited is from a study paid for by industry that looked at nine lenders. Nine lenders. That is the study. What it shows is that there has been a drop in lending, which I have not seen before today, that says that North Carolina dropped in the third quarter of 1999 and the fourth quarter and the first two quarters of 2000. That was the data that I saw in that study.

I wish that data were correct. I really do, because it would show that the goal that we had in North Carolina—Mr. Calomiris may or may not know this—but of the four practices that I mentioned, only one of them had gone into effect as of the third quarter of 1999 and that is the flipping. So that had to be what would show a reduction in originations, by 25 and 50 percent.

I wish that number were right because when we passed the bill, the goal of the North Carolina legislation was to reduce flipping. And the way you reduce flipping is have less loans originate. That data would show that gap.

Here is what I would like to ask, is whether Mr. Calomiris knows of any other events that were active in North Carolina during the third quarter of 1999? Are you aware of any other environmental changes?

Mr. MILLER. Was there a hurricane?

Mr. EAKES. We had in North Carolina, on September 15, 1999, the largest flood in the history of North Carolina ever recorded. It took 15,000 units directly down the river. As many as 100,000 families were dislocated. September 15, 1999. They could not have borrowed money if the predatory lenders had come to them in a boat.

[Laughter.]

So, his assessment—I wish it were right. I wish that really had seen a, "chilling effect because the only provision that we had in effect was the antiflipping."

That is what we wanted to do, was to reduce the number of flips. But, unfortunately, I am afraid—I actually have heard this. It is remarkable. I travel around the country and I hear the North Carolina bill—first, I heard that every lobbyist who supported it lost their job. Totally false.

Chairman SARBANES. Mr. Prough, I want to put a couple of questions to you. You have been very patient.

Mr. PROUGH. Yes, sir. Well, I would have liked to have participated in the conversation on credit life and balloons, but since we do not offer those products, there was no need.

Chairman SARBANES. Yes. Ameriquest does not engage in those practices. Correct?

Mr. PROUGH. Never. We never have.

Chairman SARBANES. I have the impression by establishing this high level of performance, you have been able to make it succeed. But I am concerned about—I want to ask this question, which may not be fully applicable to you because you have really made it work. But if lenders try to follow that course, would they be at a competitive disadvantage with respect to others in the industry?

Let me put it this way. I guess they would be missing out on the opportunity to make some fast money. Now they choose to do that. But they are passing up such an opportunity, are they not?

Mr. PROUGH. Everybody runs their own business model, Senator.

Our approach is that by using the secondary market, using Wall Street, and bundling our loans, we are able to create efficiencies and create our profits through moving loans that way. And that way, we can pass that cost savings on to the consumer.

Some of these other products just do not fit for that model because you are adding costs to the loan which eventually then have to be financed through Wall Street. That causes complications. We prefer to keep it very simple, very straightforward, and do exactly what the customer expects us to do, provide home financing.

Chairman SARBANES. Well, it is a very interesting model and we appreciate your coming here today to tell us about it. No question.

I am going to draw this to a close.

Mr. CALOMIRIS. May I just make one comment, Mr. Chairman?

Chairman SARBANES. Certainly.

Mr. CALOMIRIS. Because I did not get a chance to respond.

Chairman SARBANES. I do not want you to go away feeling that. We try to be eminently fair here. Yes.

Mr. CALOMIRIS. I mean respond on one fact.

Chairman SARBANES. Yes.

Mr. CALOMIRIS. The evidence that I presented in the appendix showed that the decline in subprime lending occurred only in some income classes. So it seems a little strange to say it was the result

of a flood, because then you would have to believe that the flood only affected people with incomes below $50,000.

Chairman SARBANES. But the subprime lending occurs primarily in certain income classes, does it not?

Mr. CALOMIRIS. The point, Mr. Chairman, is that I have it for the different income classes, only subprime lending. I am not looking at all lending. Just subprime. The point is that it only affected people who are really subject to these particular rules. And I did note that was phased in over 2000 and the data are about 2000, not about the end of 1999. I just want to emphasize that we do not have all the facts here before us. I do not claim that we do.

Chairman SARBANES. You want to get out from under the flood, I take it. Is that it?

Mr. CALOMIRIS. Exactly.

[Laughter.]

As I say, that dog is not going to hunt.

Mr. EAKES. If I could just—and I promise I will be quick.

Chairman SARBANES. Yes, I have to draw this to a close.

Mr. EAKES. The poor people, where they own homes, happens to often be in low-lying land that ends up being flood plain.

Rich people do not live in flood areas. And so it is extremely reasonable that you would have families in the lower income brackets who are homeowners who are subject to these loans.

I really wish I could bring—you are at Columbia? I would love to bring him just for a few days to actually see how the marketplace works, both in floods and out of floods, because he does not get it right now.

[Laughter.]

Chairman SARBANES. Mr. Prough, you sat quietly through all of this. Is there any comment you want to add before I draw this to a close?

Mr. PROUGH. No, sir.

[Laughter.]

Chairman SARBANES. No wonder you all have been so successful.

[Laughter.]

Well, I want to thank this panel very much. I am sure we will be back to you about one thing or another as we proceed to explore this matter. Again, I want to thank you for your helpful testimony and for the obvious careful thought that went into the statements.

The hearing now stands adjourned.

[Whereupon, at 1:10 p.m., the hearing was adjourned.]

[Prepared statements, response to written questions, and additional materials supplied for the record follow:]

PREPARED STATEMENT OF SENATOR PAUL S. SARBANES

Today is the first of two hearings on "Predatory Mortgage Lending: the Problem, Impact, and Responses." This morning we will hear first, from a number of families that have been victimized by predatory lenders. Then, later this morning and tomorrow, an array of public interest and community advocates, industry representatives, and legal and academic experts will have the opportunity to discuss the broader problem and the impact predatory mortgage lending can have on both families and communities.

Homeownership is the American Dream. It is the opportunity for all Americans to put down roots and start creating equity for themselves and their families. Homeownership has been the path to building wealth for generations of Americans; it has been the key to ensuring stable communities, good schools, and safe streets.

Predatory lender play on these hopes and dreams to cynically cheat people of their wealth. These lenders target lower income, minority, elderly, and, often, unsophisticated homeowners for their abusive practices. It is a contemptible practice.

Let me briefly describe how predatory lenders and brokers operate. They target people with a lot of equity in their homes, many of whom may already be feeling the pinch of growing consumer and credit card debts; they underwrite the property often without regard to the ability of the borrower to pay the loan back. They make their money by charging extremely high origination fees, and by "packing" other products into the loan, including upfront premiums for credit life, disability, and unemployment insurance, and others, for which they get significant commissions but for which homeowners continue to pay for years beyond the terms of the policies.

The premiums for these products get financed into the loan, greatly increasing the loan's total balance amount. As a result, and because of the high interest rates being charged, the borrower is likely to find himself in extreme financial difficulty.

As the trouble mounts, the predatory lender will offer to refinance the loan. Unfortunately, another characteristic of these loans is that they have high prepayment penalties. So, by the time the refinancing occurs, with all the fees repeated and the prepayment penalty included, the lender or broker makes a lot of money from the transaction, and the owner has been stripped of his or her equity and, oftentimes, his home.

Nearly every banking regulator has recognized this as an increasing problem. Taken as a whole, predatory lending practices represent a frontal assault on homeowners all over America.

I want to make clear that these hearings are aimed at predatory practices. There are people who may have had some credit problems who still need access to affordable mortgage credit. They may only be able to get mortgage loans in the subprime market, which charges higher interest rates. Clearly, to get the credit they will have to pay somewhat higher rates because of the greater risk they represent.

But these families should not be charged more than the increased risk justifies. These families should not be stripped of their home equity through financing of extremely high fees, credit insurance, or prepayment penalties. They should not be forced into constant refinancings, losing more and more of the wealth they have taken a lifetime to build to a new set of fees, with each transaction. They should not be stripped of their legal rights by mandatory arbitration clauses that block their ability to go to court to vindicate their protections under the law.

Some people argue that there is no such thing as predatory lending because it is a practice that is hard to define. I think the best response to this was given by Federal Reserve Board Governor Edward Gramlich, who said earlier this year:

> "Predatory lending takes its place alongside other concepts, none of which are terribly precise safety and soundness, unfair and deceptive practices, patterns, and practices of certain types of lending. The fact that we cannot get a precise definition should not stop us. It does not mean this is not a problem."

Others, recognizing that abuses do exist, contend that they are already illegal. According to this reasoning, the proper response is improved enforcement.

Of course, I support increased enforcement. The FTC, to its credit, has been active in bringing cases against predatory lenders for deceptive and misleading practices. However, because it is so difficult to bring such cases, the FTC further suggested last year a number of increased enforcement tools that would help to crack down on predators. I hope we will get an opportunity to discuss these proposals as the hearings progress.

I also support actions by regulators to utilize authority under existing law to expand protections against predatory lending. That is why I sent a letter, signed by a number of my colleagues on the Committee, strongly supporting the Federal Reserve Board's proposed regulation to strengthen the consumer protections under cur-

rent law. I also note that the Federal Trade Commission voted 5 to 0 last year in support of many of the provisions of the proposed regulation.

Campaigns to increase financial literacy and industry best practices must also be a part of any effort to combat this problem. Many industry groups have contributed time and resources to educational campaigns of this type, or developed practices and guidelines, and I applaud and welcome this as an integral part of a comprehensive response to the problem of predatory lending.

But neither stronger enforcement, nor literacy campaigns are enough. Too many of the practices we will hear outlined this morning and in tomorrow's hearing, while extremely harmful and abusive, are legal. And while we must aggressively pursue financial education, we must also recognize that education takes time to be effective, and thousands of people are being hurt every day. At his recent confirmation hearing, Fed Governor Roger Ferguson summed it up well when he said that "legislation, careful regulation, and education are all components of the response to these emerging consumer concerns."

Again, I want to reiterate, subprime lending is an important and legitimate part of the credit markets. But such lending must be consistent with and supportive of the efforts to increase homeownership, build wealth, and strengthen communities. In the face of so much evidence and so much pain, we must work together to address this crisis. Before taking your testimony, let me express my appreciation to all of you for your willingness to leave your homes and come to Washington to speak publically about your misfortunes. I know it must be very difficult. In my view, you ought to be proud that you are contributing to a process that I hope will lead to some action to put an end to the kinds of practices that have caused each of you such heartache and trouble.

PREPARED STATEMENT OF SENATOR WAYNE ALLARD

I would like to thank Chairman Sarbanes for holding this hearing. This is an important topic, and I am glad that this Committee will have an opportunity to examine it more closely. I know that predatory lending is an issue that Chairman Sarbanes has followed very closely, as the so-called "flipping" form of predatory lending has been a particular problem in Baltimore.

In the various Housing and Transportation Subcommittee hearings over the last 3 years, predatory lending came up on several occasions. It is an abhorrent practice, and as Ranking Member of the Subcommittee I am particularly concerned about predatory lending that involves FHA loans. The fraud perpetrated in those cases not only victimizes the individual family, but also robs the taxpayers, who are responsible for backing the loan through FHA.

During my years as Chairman, and now as Ranking Member of the Housing Subcommittee, I have seen firsthand how important homeownership is to Americans, after all, it is the American Dream. It is reprehensible that a small number of individuals prey upon those hopes and dreams, turning the dream into a nightmare.

I am pleased that this Committee will have an opportunity to examine some of the issues surrounding predatory lending. While we hear a great deal about predatory lending, much of what we know seems to come from anecdotes. I believe it is important that we examine the problem in a careful, reasoned way. In this manner we can first get a clear idea of exactly what constitutes predatory lending, and how great the scope of the problem is. Next, we can consider whether current laws are adequate or whether we need additional laws.

I particularly wish to focus on the matter of enforcement. While predatory lending is obviously occurring under the current laws, it may very well be that the current laws are adequate, but simply not well enforced. Similarly, any additional laws that this Committee may pass would be of little value if they are not enforced.

As important as it is to curb predatory lending, any actions considered by Congress, the States, or regulatory bodies must be made with caution. While predatory lending is by its nature deceptive and fraudulent and should be stopped, there is certainly room for a legitimate subprime lending market. Subprime lending expands homeownership opportunities for those families that may have experienced credit problems or who have not had an opportunity to establish credit. The subprime market gives them access to financing that allows them to experience the dream of homeownership.

Without access to this market, far fewer people would own a home. It is no coincidence that subprime lending has greatly expanded as the country is experiencing record homeownership rates. If we are not careful with any legislation, we could end up hurting the very people that we are trying to help.

We also cannot lose sight of the fact that laws cannot solve all problems. Because there will always be those who disregard the laws, we must also find ways to promote personal protection and responsibility. I believe that we need to find a better way to educate and empower consumers. I believe that knowledge can be a very powerful weapon, and this is particularly true for financial matters. Survey after survey has found that Americans lack basic financial knowledge. This lack of information can lead to financial disaster. Better consumer and financial knowledge will leave consumers better protected—regardless of what the laws may be.

Again, I would like to thank the Chairman for holding this hearing. While today's cases are genuine tragedies, I hope that we will be able to learn from their situations to help stem predatory lending in America. I thank the witnesses for being willing to come forward to share their stories. I look forward to your testimony.

PREPARED STATEMENT OF SENATOR JIM BUNNING

Mr. Chairman, I would like to thank you for holding this hearing, and I would like to thank our witnesses for testifying today and tomorrow.

Nobody is in favor of "Predatory" lending. We have all heard the horror stories of unscrupulous people preying on the elderly, going through an entire neighborhood and negotiating home improvement loans. These same individuals then strip the equity from these homes, usually without even doing the repairs. There is a word for these practices, and it is fraud. These practices should not and cannot be tolerated. The perpetrators of these practices should be prosecuted to the fullest extent of the law.

But we must not throw the baby out with the bath water. Sixty-eight percent of Americans own their own homes. While I do not know the exact statistics, I am willing to bet not all of that 68 percent were candidates for the prime rate. I am pretty sure many of them did not qualify for prime.

So then, how are these people, who are not rich, or may have missed a payment or two in their lifetime able to afford homes? The answer, of course, is the subprime market.

The subprime market has been the tool for many Americans to achieve the American Dream of owning their own home. Many of our largest and most reputable financial institutions are a part of the subprime industry. I believe this is a good thing, and a viable subprime market is good for our country.

We need to punish the bad actors. When fraud is committed, the perpetrators should be punished and punished severely. But we also should encourage the good actors. Citibank and Chase, to name two, have put into practice new guidelines to help eliminate abuses or even the possibility of abuses. Companies taking these steps should be commended.

When we try to eliminate abuse, we must make sure we do not kill the subprime market. We must not drive out the reputable institutions that make home ownership possible to so many who otherwise would not be able to achieve that dream.

Thank you Mr. Chairman.

PREPARED STATEMENT OF THOMAS J. MILLER

ATTORNEY GENERAL, THE STATE OF IOWA

JULY 26, 2001

Introduction

I would like to thank you, Mr. Chairman, and the Committee for giving me the chance to speak on this critically important issue. This is one of the most important challenges among the issues within this Committee's jurisdiction, and I welcome the opportunity to participate in the public discussion.

Homeownership is "the American Dream," and America is rightfully proud of its record in the number of Americans who have achieved that.[1] The mortgage market we normally think of, and are proud of, is "productive credit"—a wealth-building credit that millions of Americans have used to make an investment in their lives and their childrens' futures: the market that has helped those 66 percent of Ameri-

[1] Homeownership reached a record level of 66 percent in 1998. Arthur B. Kennickell, et al., *Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances,* 86 Fed. Res. Bull. 1, 15–18 (2000).

cans buy their homes; keep those homes in good repair; help finance the kids' education, and for some, helped them start a small business. But make no mistake: what we are talking about today is a threat to that dream and a very different mortgage market. Today, we are talking about asset-depletion. This is "destructive debt," with devastating consequences to both the individual homeowners and to their communities. We are talking about people who are being convinced to "spend" the homes they already own or are buying, often for little or nothing in return.[2] Tens of thousands of Americans, elderly Americans and African-Americans disproportionately among them, are seeing what for many is their only source of accumulated wealth—the equity in their homes—siphoned off. Too often, the home itself is lost.[3] Then what? How do they—particularly the elderly—start over?

Please keep this in mind when you hear the caution that legislative action will "dry up credit." Drying up productive credit would be of grave concern; drying up destructive debt is sound economic and public policy.[4]

In the previous panel, some of those affected by this conduct shared their experiences with you. Earlier this week, some Iowans shared their experiences with me. Their stories were typical, but the suffering caused by these practices is keenly felt by each of these individuals. One consumer who has paid nearly $18,000 for 4 years would have had her original $9,000 mortgage paid off by now, had she not been delivered into one of these loans by an unscrupulous contractor. The lender who worked with the contractor to make the home improvement loan refinanced that mortgage with the $27,000 home improvement cost. But the contractor's payment was little more than a very large broker's fee, for he did incomplete and shoddy work, and then disappeared. The lender's promises to make it right were all words for 4 years, while they took her money. In the other cases, the homeowners I visited with were not looking for loans, but they have credit cards from an issuer who also has a home equity lending business. They were barraged by cross-marketing telemarketers, and convinced that it would be a sound move to refinance. Indeed a sound move—for the lender who charged $6,900 in fees on $57,000 of proceeds. (The fees, of course, were financed.) These families are the faces behind these lenders' sales training motto: "These loans are sold, not bought."[5] These families are the faces behind the sordid fact that predatory lending happens because people trusted; and because these lenders and the middlemen who deliver the borrowers to them do not deserve their trust. These lives have been turned upside down by a business philosophy run amuck: a philosophy of total extraction when there is equity at hand.

I know that my counterparts in North Carolina heard similar stories, which is why Former Attorney General, now Governor Easley and Attorney General Cooper as well, have been so instrumental in North Carolina's pioneering reform legislation. This problem is about these people—in Iowa, West Virginia, Pennsylvania, North Carolina—and all over this country; this is not about abstract market theories. And it is a problem that Congress has a pivotal role in curbing.

In some of our States, we are finding other types of predatory practices that are preying on the vulnerable by appealing to—and subverting—their dreams of buying a home. Some cities are seeing a resurgence of property flipping. In some areas of my State, we are seeing abusive practices in the sale of homes on contracts. In fact, it appears that such contracts may be taking their place along with brokers and home improvement contractors as another "feeder" system into the high-cost mortgage market.[6]

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[2] Part of the problem with the subprime market generally is it is not offering what many people need. Overwhelmingly, it offers refinance and consolidation loans—irrespective of whether that is wanted, warranted, or wise. See section I–C, below.

[3] See Alan White and Cathy Lesser Mansfield, *Subprime Mortgage Foreclosures: Mounting Defaults Draining Home Ownership,* (testimony at HUD predatory lending hearings, May 12, 2000), indicating 72,000 families were in or near foreclosure.

While the foreclosures are devastating for the families, the impact on the lenders is less clear. First, there is a distinction to be made between delinquencies/defaults and actual credit loss. Second, as we note below, some of this risk to the lender is self-made. See Section II–A , below. See also Appendix B, page 1, in which insurance padding added $76,000 to the cost of the loan, raised the monthly payment nearly $100, and all by itself, created a $54,000 balloon payable after the borrower would have paid over $204,000.

[4] We should also keep in mind that this prediction has been made of most consumer protection and fair lending legislation in my memory—from the original Truth in Lending up through HOEPA. And it has never happened.

[5] See Gene A. Marsh, "The Hard Sell in Consumer Credit: How the Folks in Marketing Can Put You in Court," 52 Cons. Fin. Law Qtrly Rep. 295, 298 (Summer, 1998) (quoting from a sales training manual: another instruction—"sell eligible applicants to his maximum worth or high credit.")

[6] As is discussed below, many homeowners do not select the lenders they use, but are delivered to those lenders by middlemen. In the case of some of the abusive land contracts, a contract

My office has made predatory lending a priority—both in the home equity mortgage lending context and in the contract sales abuses. In addition to investigations, we are considering adopting administrative regulations to address some of the areas within the scope of our jurisdiction, and are working with a broad-based coalition on education and financial literacy programs. But today I am here to talk to this Committee solely about the home equity mortgage lending problem, because that is where Congressional action is key. HOEPA has been a benefit, but improvements are needed. Federal preemption is hindering States' ability to address these problems on their own. The measures which have been introduced or passed at the State and municipal levels dramatically demonstrate the growing awareness of the serious impact on both individuals and communities of predatory lending, and the desire for meaningful reform.[7]

What Is Predatory Lending and How Does It Happen?

The Context: The Larger Subprime Marketplace

Predatory lending is, at its core, a mindset that differs significantly from that operating in the marketplace in which most of us in this room participate. It is a marketplace in which the operative principle is: "take as much as you think you can get away with, however you can, from whomever you think is a likely mark." This is not Adam Smith's marketplace.

Today's *prime* market is highly competitive. Interest rates are low, and points and fees are relatively so. Competition is facilitated by widespread advertisement of rates and points. Newspapers weekly carry a list of terms available in the region and nationwide, and lenders advertise their rates. The effectiveness of this price competition is demonstrated by the fact that the range of prime rates is very narrow, and has been for years. But in the subprime mortgage market, there is little price competition: there are virtually no advertisements or other publicity about the prices of loans, and it is difficult for anyone seeking price information to get it. Marketing in the subprime market, when terms are mentioned at all, tends to focus on "low-monthly payments." This marketing is, at best, misleading, given the products being sold, and is often simply an outright lie.

I do not mean to imply that all subprime lending is predatory lending, nor does my use of statistics about the subprime generally so imply. However, most of the abuses do occur *within* the subprime market. We must understand the operations and characteristics of that marketplace in order to recognize how and why the abuses within it occur, and to try to address those problems.

- Interest rates in the subprime market are high and rising. During a 5 year period when the median conventional rates ranged from 7–8 percent, the median subprime rate was 10–12 percent. But that 5 year period saw two disturbing trends. First, the distribution around that median has changed—with the number of loans on the high side of that median rising. Second, rates have increased, with the top rates creeping up from a thinly populated 17-plus percent to nearly 20 percent.[8]

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seller will sell a home to an unsophisticated borrower at a greatly inflated price on a 2–5 year balloon, telling the buyer that their contract payments will help establish a credit record. The hitch is that it is likely to be difficult, if not impossible, to get conventional mortgage financing when the balloon comes due because the inflated sales price would make the loan-to-value ratio too high for a conventional market. The result? Another way of steering the less sophisticated home buyer into the high-cost refinancing market.

[7] See section III–B, below on how preemption has hampered the ability of States to deal with the kind of predatory lending practices we are talking about in these hearings.

[8] A graph of the distribution of loans around the median rate shifted from a bell-curve distribution in 1995 to a "twin peaks" distribution around the median in 1999, indicating greater segmentation within the subprime market, and shows the "rate creep" on the high side of the distribution. See Cathy Lesser Mansfield, *The Road to Subprime "HEL" Was Paved With Good Congressional Intentions,* 51 So. Car. L. Rev. 473, p. 578, Graph 2; p. 586, Graph 6 (2000).

Percent of loans in securitized subprime pools sold on Wall Street:

above 12 percent in 1995 was 30 percent; and 1999 was 44 percent;
above 15 percent in 1995 was 3 percent; and 1999 was 8 percent;
above 17 percent in 1995 was .02 percent; and 1999 was 1.5 percent.

See *id.*, p. 577 Table 1.

Collecting price data on subprime lending is extraordinarily difficult, as the author of this article, one of my constituents, Professor Mansfield of Drake University law school, reported to the House Committee on Banking and Financial Services a year ago. (May 24, 2000). As noted above, unlike the prime market, there is no advertising information about rates and points in the subprime market available to most consumers. Furthermore, that information is not reported for any regulatory purposes. It is not information required by the Home Mortgage Disclo-

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- Points and fees in the subprime market, while down from the 10–15 percent frequently seen prior to the enactment of HOEPA (with its 8 percent points-and-fees trigger), are still high, in the 5–7.9 percent range, while the typical cost in the prime market is 1–3 percent.
- Subprime loans are disproportionately likely to have prepayment penalties, making it expensive to get out of these loans, and sometimes trapping the borrower in an overly expensive loan. (Seventy–seventy-six percent, compared to less than 2 percent in the prime market.)[9]
- Single-premium credit insurance, virtually nonexistent in the prime mortgage market, has been estimated to be as much as 50 percent of subprime loans, though accurate statistics are not available. (The penetration rate varies considerably, depending upon the provider. Some subprime lenders market it heavily, others very little.)[10]

The demographics of the subprime marketplace are significant. Thirty-five percent of borrowers taking out subprime loans are over 55 years old, while only 21 percent of prime borrowers are in that age group.[11] (This despite the fact that many of the elderly are likely to have owned their homes outright before getting into this market.) The share of African-Americans in the subprime market is double their share in the prime market.[12]

My co-panelist, Martin Eakes and his colleagues have estimated that the cost of abuses in these four areas cause homeowners to lose $9.1 billion of their equity annually, an average of $4,600 per family per year.[13] When I look at that figure in the context of who is most likely to be hurt by those abuses, my concern mounts.[14] Others will be talking to this Committee about the fact that predatory lending is at the intersection of civil rights and consumer protection, so I will only say that, for what may be the first time, our civil rights and consumer protection divisions in Attorneys General offices around the country are beginning to work together on this common problem.

The most common explanation offered by lenders for the high prices in the subprime market is that these are risky borrowers, and that the higher rates are priced for the higher risk. But that is far too simplistic. Neutral researchers have found that risk does not fully explain the pricing, and that there is good reason to question the efficiency of subprime lending.[15] That core mindset I mentioned earlier

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sure Act (HMDA). These statistics relate solely to pools of loans packaged as securities, where interest rate information is required by SEC rules for prospective investors.

[9] Figures cited in U.S. Department of Treasury Comment on Regulation Z (HOEPA) Proposed Rulemaking, Docket No. R–1090 (January 19, 2001), at page 7.

[10] Estimate courtesy of the Coalition for Responsible Lending. Recently, three major lenders, Citigroup, Household, and American General, announced they will stop selling single-premium credit insurance.

[11] Howard Lax, Michael Manti, Paul Raca, Peter Zorn, *Subprime Lending: An Investigation of Economic Efficiency,* p. 9 (unpublished paper, February 25, 2000).

[12] Twelve percent of subprime loans are taken out by African-Americans. Subprime loans are 51 percent of home loans in predominately African-American neighborhoods, compared with 9 percent in white neighborhoods. *Blacks in upper-income neighborhoods* were twice as likely to be in the subprime market as borrowers in *low-income white neighborhoods.* HUD, Unequal Burden: Income and Racial Disparities in Subprime Lending in America.

The Zorn, et. al study also notes that lower income borrowers are also twice as likely to be in the subprime market "despite the fact that FICO scores are not strongly correlated with income." p. 9. The Woodstock Institute study also found that the market segmentation "is considerably stronger by race than by income. Daniel Immergluck and Marti Wiles, Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development, p. iii (Woodstock Institute, November 1, 1999.)

With the aid of a Community Lending Partnership Initiative grant, the Rural Housing Institute is gathering information on lending in Iowa. Preliminary data indicates a similar picture of racial disparities in Iowa, though the researchers are awaiting the results of the 2000 Census income data to see whether the correlation in Iowa is similarly more correlated to race than income.

[13] The per family figure was found in Coalition for Responsible Lending Issue Paper, "Quantifying the Economic Cost of Predatory Lending." (March 9, 2001). Mr. Eakes' testimony today may reflect revised figures.

[14] According to 1990 census, the median net worth for an African-American family was $4,400. Comparing that to Mr. Eakes estimate of $4,600 per family loss is, to put it mildly, sobering.

[15] Howard Lax, Michael Manti, Paul Raca, Peter Zorn, Subprime Lending: An Investigation of Economic Efficiency, p. 3–4 (unpublished, February 25, 2000). While risk does play a key role, "borrowers' demographic characteristics, knowledge, and financial sophistication also play a statistically and practically significant role in determining whether they end up with subprime mortgages." *Id.* p. 3.

leads to opportunistic pricing, not pricing that is calibrated to provide a reasonable return, given the actual risk involved.

Moreover, the essence of predatory lending is to push the loan to the very edge of the borrower's capacity to handle it, meaning these loans *create their own* risk. We cannot accept statistics about delinquencies and foreclosure rates in the subprime market without also considering how the predatory practices—reckless underwriting, push marketing, and a philosophy of profit maximization—create a self-fulfilling prophecy.[16] And even with comparatively high rates of foreclosures, many lenders continue to be profitable.

How and Why It Happens?

If neither risk nor legitimate market forces explain the high prices and disadvantageous terms found so frequently in the subprime market, then what does explain it?

"*Push marketing:*" The notion of consumers shopping for a refinance loan or a home improvement loan, comparing prices and terms, is out of place in a sizeable portion of this market. Frequently, these are loans in search of a borrower, not the other way around, as was the case with the Iowa borrowers I spoke with this week. Consumers who buy household goods with a relatively small installment sales contract are moved up the "food chain" to a mortgage loan by the lender to whom the retailer assigned the contract; door-to-door contractors come by unsolicited with offers to arrange manageable financing for home improvements; telemarketers offer to "lower monthly payments" and direct mail solicitations make false representations about savings on consolidation loans. Another aspect of push marketing is "upselling." ("Upselling" a loan is to loan more money than the borrower needs, wants, or asked for.)

"*Unfair and deceptive, even downright fraudulent sales practices:*" In addition to deceptive advertisements, the sales pitches and explanations given to the borrowers mislead consumers about high prices and disadvantageous terms (or obscure them) and misrepresent benefits. Some of these tactics could confuse almost anyone, but when the consumer is unsophisticated in financial matters, as is frequently the case, the tactics can be quite fruitful.

While Federal and State laws require disclosures, for a variety of reasons, these laws have not proven adequate against these tactics.

Reverse competition: Price competition is distorted when lenders compete for referrals from the middlemen, primarily brokers and contractors. When the middleman gets to take the spread from an "upcharge"[17] on the interest rate or points, it should come as no surprise to anyone that some will steer their customers to the lenders offering them the best compensation. (Reverse competition is also a factor with credit insurance because of commission incentives and other profit-sharing programs.) It should also come as no surprise that the people who lack relevant education, are inexperienced or have a real or perceived lack of alternatives, are the ones to whom this is most likely to happen.

Even without rate upcharges, the brokers, who may have an agreement with the borrower, often take a fee on a percentage-basis, so they have an incentive to steer the borrower to a lender likely to inflate the principal, by upselling, fee-padding, or both. These are self-feeding fees. A 5 percent fee from a borrower who needs—and wants—just $5,000 for a roof repair is only $250. But if the broker turns that into

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[16] It is beyond the scope of my comments to discuss the relationship between risk and pricing. But it is important that policymakers look not just at delinquency and foreclosure rates without also looking at actual losses and revenues.

[17] An "upcharge" is when the loan is written at a rate higher than the underwriting rate. For example, an evaluation of the collateral, the borrower's income and debt-to-income ratio, and credit history indicates the borrower qualifies for a 11.5 percent interest rate. But the broker has discretion to write the note at 14 percent, and the broker gets extra compensation from that rate spread. He may get it all, or there may be a sharing arrangement with the lender, for example, the broker gets first 1 percent, and they split the other 1.5 percent. The Eleventh Circuit has recently found that a referral fee would violate RESPA. *Culpepper* v. *Irwin Mtg. Corp.,* 253 F. 3d 1324 (2001).

A recent review of yield-spread premiums in the prime market found that they added an average cost of over $1,100 on each transaction in which they were charged. The author found that the most likely explanation for the added cost was not added value, nor added services. Rather, it is a system which lends itself to price discrimination: extra broker-compensation can be extracted from less sophisticated consumers, while it can be waived for the few who are savvy about the complex pricing practices in today's mortgage market. *See* Report of Howell E. Jackson, Household International Professor of Law, Harvard Law School, pp. 72 , 81 (July 9, 2001), submitted as expert witness' report in *Glover* v. *Standard Federal Bank,* Civ. No. 97–2068 (D. Minn.)

a refinance loan, of $40,000, further padded with another $10,000 of financed points, fees, and insurance premiums, his 5 percent, now $2,500, looks a lot better.

This divided loyalty of the people in direct contact with the homeowner is particularly problematic given the complexity of any financing transaction, considerably greater in the mortgage context than in other consumer credit. As with most other transactions in our increasingly complex society, these borrowers rely on the good faith and honesty of the "specialist" to help provide full, accurate, and complete information and explanations. Unfortunately, much predatory lending is a function of misplaced trust.

These characteristics help explain why the market forces of standard economic theory do not sufficiently work in this market. There are too many distorting forces. Factor in the demographics of the larger subprime marketplace in which these players operate, and we can better understand how and why it happens.

Definition

Having looked at the context in which predatory lending occurs, we come to the question of definition. I know that some have expressed concern over the absence of a bright line definition. I do not see this as a hurdle, and I believe that Attorneys General are in a position to offer reassurance on this point. There is a real question as to whether a bright line definition is necessary, or even appropriate. All 50 States and the United States have laws which employ a broad standard of conduct: a prohibition against "deceptive practices," or "unfair and deceptive practices."[18] Attorneys General have enforcement authority for these laws, and so are in a position to assure this Committee that American business can and has prospered with broad, fairness-based laws to protect the integrity of the marketplace. Indeed, a good case can be made that they have helped American business thrive, because these laws protect the honest, responsible, and efficient businesses as much as they protect consumers, for unfair and deceptive practices are anticompetitive.

While statutes or regulations often elaborate on that broad language with specific lists of *illustrative* acts and practices, it has never been seriously advanced that illustrations can or should be an exhaustive enumeration, and that anything outside that bright line was therefore acceptable irrespective of the context. There is a simple reason for this, and it has been recognized for centuries: the human imagination is a wondrous thing, and its capacity to invent new scams, new permutations on old scams, and new ways to sell those scams is infinite. For that reason, it is not possible, nor is it probably wise, to require a bright line definition.

Several models for defining the problem have been used. One model relates to general principles of unfairness and deception. The Washington State Department of Financial Institution defines it simply as "the use of deceptive or fraudulent sales practices in the origination of a loan secured by real estate."[19] The Massachusetts Attorney General's office has promulgated regulations pursuant to its authority to regulate unfair and deceptive acts and practices to address some of these practices.[20] Improving on the HOEPA model has been the basis for other responses within the States, most notably North Carolina's legislation.[21] (In enacting HOEPA, Congress recognized that it was a floor, and States could enact more protective legislation.[22])

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[18] See Section III, below, for a discussion of the adequacy of these laws to address predatory mortgage lending.

[19] See, Comments from John Bley, Director of Financial Institutions, State of Washington, on Responsible Alternative Mortgage Lending to OTS (July 3, 2000). (I note that some abuses also occur in the servicing and collection of these loans, so limiting a statutory definition to the origination stage only would leave gaps.) Mr. Bley's letter notes that the HUD/Treasury definition, quoted in his letter, is similar: "Predatory lending—whether undertaken by creditors, brokers, or even home improvement contractors—involves engaging in deception or fraud, manipulating the borrower through aggressive sales tactics, or taking unfair advantage of a borrower's lack of understanding about loan terms. These practices are often combined with loan terms that, alone or in combination, are abusive or make the borrower more vulnerable to abusive practices."

[20] 940 C.M.R. § 8.00, et seq. *See also United Companies Lending Corp.* v. *Sargeant,* 20 F. Supp. 2d 192 (D. Mass. 1998).

[21] N.C. Gen. Stat. § 24–1–.1E. See also 209 C.M.R. 32.32 (Massachusetts Banking Commission); Ill. Admin. Code 38, 1050.110 et seq.; N.Y. Comp Codes & Regs. Tit. 3 § 91.1 et seq. Some cities have also crafted ordinances along these lines, Philadelphia and Dayton being two examples. While legal concerns about preemption and practical concerns about "balkanization" have been raised in response to this increasingly local response much care and thought has gone into the substantive provisions, building on the actual experience under HOEPA, and may be a good source of suggestions for improvements on HOEPA itself.

[22] "[P]rovisions of this subtitle preempt State law only where Federal and State law are inconsistent, and then only to the extent of the inconsistency. The Conferees intend to allow States to enact more protective provisions than those in this legislation." H.R. Conf. Rep. No. 652, 103d

There is considerable consensus about a constellation of practices and terms most often misused, with common threads.

The terms and practices are designed to maximize the revenue to the lenders and middlemen, which maximizes the amount of equity depleted from the borrowers' homes. As mentioned earlier, when done by means which do not show in the credit price tags, or may be concealed through confusion or obfuscation, all the better. That makes deceptive sales techniques easier, and reduces the chances for any real competition to work.

Among those practices:

- Upselling the basic loan (includes inappropriate refinancing and debt consolidation). The homeowner may need (and want) only a relatively small loan, for example, $3,000 for a new furnace. But those loans tend not to be made. Instead these loans are turned into the "cash-out" refinancing loan, that refinances the first mortgage or consolidation loans (usually consolidating unsecured debts along with a refinance of the existing first mortgage). In the most egregious cases, 0 percent Habitat for Humanity loans, or low-interest, deferred payment rehabilitation loans have been refinanced into high rate loans which stretch the limits of the homeowner's income. But even refinancing a 9–10 percent mortgage into a 14 percent mortgage just to, get the $3,000 for that furnace is rarely justifiable. Like other practices, this has a self-feeding effect. A 5 percent brokers fee; or 5 points will be much more remunerative on a $50,000 loan than on a $3,000 loan. Since these fees are financed in this market, they, in turn, make the principal larger, making a 14 percent rate worth more dollars. For the homeowner, of course, that is all more equity lost.[23]
- Upcharging on rates and points (includes yield spread premiums and steering). The corrosive impact of yield spread premiums generally was described above in connection with the discussion of reverse competition. (See note 17.) The problem is exacerbated in the subprime market, where the much greater range of interest rates[24] makes greater upcharges possible, and the demographics of the subprime market as a whole lends itself to the type of opportunistic pricing that Professor Jackson posed as the likely explanation.
- Excessive fees and points/padded costs. Since the fees and charges are financed as part of the loan principal, and since some of them are percentage-based fees, this kind of loan padding creates a self-feeding cost loop (an example is described earlier in the discussion of upselling), which makes this a very efficient practice for extracting more equity out of the homes.
- Financing single-premium credit insurance. Appendix B is a good example of how effective single-premium credit insurance is as a tool for a predatory lender to strip equity from a borrower's home. It is also a good example of how well it lends itself to manipulation and deceptive sales tactics. Appendix B shows that adding a $10,000 insurance premium (of which the lender keeps approximately 35–40 percent as commission) over the life of the loan, will cost the borrower an extra $76,000 in lost equity over the life of the loan. Even if the borrower prepays (or more likely refinances) at 5 years, the credit insurance adds $9,400 to the payoff. And the lender's estimated commission from the premium was double the amount of revenue the lender got from the three points charged on that loan.[25]
- Prepayment penalties. Prepayment penalties trap borrowers in the high cost loans. They are especially troublesome, since borrowers are often told that they

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Cong. Sess. 147, 162 (1994), 1994 U.S. C.C.A.N. 1992. That has not prevented preemption challenges, however. The Illinois DFI regulations have been challenged by the Illinois Association of Mortgage Brokers, alleging that they are preempted by the Alternative Mortgage Transaction Parity Act.

[23] While most of these loans are more than amply secured by the home, well within usual loan-to-value ranges, some lenders are upselling loans into the high LTV range, which bumps the loan into a higher rate. Some lenders do this by "loan-splitting," dividing a loan into a large loan for the first 80–90 percent if the home's equity, at, for example, 13–14 percent, and a smaller loan for the rest of the equity (or exceeding the equity) at 16–21 percent. These loans are often made by "upselling," not because the borrower sought a high LTV loan. The practice seems to involve getting inflated "made-to-order" appraisals, then upselling the loan based on the phony "appreciation." As with some of the other tactics, like stiff prepayment penalties, these loans marry the homeowner to this lender. The homeowner cannot refinance with a market-rate lender.

[24] See text accompanying note 8.

[25] See Appendix B, p. 2 line 5. Compare columns 5 and 6. This is not a hypothetical example. It is a loan made to an Iowa couple.

need not worry about the high payments, because these loans are a bridge, that can be refinanced after a couple of years of good payment history.[26]

- Flipping. Flipping is the repeated refinancing of the consumer's loan. It is especially useful for equity-stripping when used by lenders who frontload high fees (points, truncated credit insurance,[27] and so forth). The old fees are pyramided into the new principal, and new fees get added. My staff has seen loans in which nearly 50 percent of the loan principal simply reflected pyramided fees from serial refinancing.
- Balloons. While HOEPA did succeed in reducing the incidence of 1 and 2 year balloons, what we are seeing now is long-term balloon loans which seem to be offered solely to enable the lender, broker, or contractor to sell the loan based on the low monthly payment. We are seeing 15, and even 20 year balloon loans. The Iowa couple whose loan is discussed in Appendix B borrowed $68,000 (including a $10,000 insurance premium). Over the next 20 years of scheduled payments, they would pay $204,584, and then they would still owe a $54,300 balloon.

Unfair and deceptive sales practices in sales of the credit: In addition to misleading advertisements, the sales pitches and explanations given to the borrowers mislead consumers about high prices and disadvantageous terms (or obscure them) and misrepresent benefits. Again, just a few examples:

- While Federal and State laws require disclosures, for a variety of reasons, these laws have not proven adequate against these tactics. Techniques such as "mixing and matching" the numbers from the note and the TIL disclosure low-ball both the loan amount (disguising high fees and points), and the interest rate, thus completely pervert the basic concept of truth in lending.[28]
- When door-to-door contractors arrange financing with these high-cost lenders (often with lenders who use the opportunity to upsell the credit into a refinancing or consolidation loan), it appears to be common to manipulate the cancellation rights so that the consumer believes he must proceed with a loan which costs too much.[29]

Some of the front-line personnel selling these loans even use the lack of transparency about credit scores to convince people that they could not get a lower-cost loan, either from this lender or anywhere else. As one lawyer who has worked for a decade with elderly victims put it, when the broker gets through, the homeowners feel lucky if anyone would give them a dime.[30]

Ability to pay: These lenders pay less attention to the ability of the homeowner to sustain the loan over the long haul. The old standard underwriting motto of "the 3–C's: capacity, collateral, and creditworthiness" is shortened to "1–C"—collateral. Capacity is, at best, a secondary consideration. Creditworthiness, as mentioned above, becomes an instrument for deceptive sales practices in individual cases.

A recent example from Iowa: A 72 and 64 year old couple were approached by a door-to-door contractor, who sold them on the need for repairs to their home, and offered to make arrangements for the loan. The work was to cost approximately $6,500. The contractor brought in a broker, who arranged for a refinance plus the

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[26] This is another instance which demonstrates the limits of disclosures. A recent loan we saw has an "Alternative Mortgage Transactions Parity Act Prepayment Charge Disclosure," which explains that State law is preempted, and provides an example of how their formula would apply to a $100,000 loan. It is doubtful the example would score on any literacy scale below upper college-level.

[27] Truncated credit insurance is insurance sold for a term less than the loan term in the example in Attachment B, page 1, the loan premium financed in the 20 year balloon note purchased a 7 year policy. That frontloads the premium, so if the loan was refinanced at 5 years, over 90 percent of the premium would have been "earned," and rolled over into the new loan principal—but without any insurance coverage from that extra $9,400 in the new loan.

[28] This was the technique at issue in the FAMCO cases, see Section III, below.

[29] The practice is a variation of "spiking." ("Spiking" means to start work or otherwise proceed during the cooling off period, which leads the consumer to believe they cannot cancel, "because work has begun.") By trying to separate the sale of the home improvement from the financing for it, the borrowers' right to cancel under either the State door-to-door sales act or the TIL are subverted. This practice, which appears to be common, is described more fully in National Consumer Law Center, Truth in Lending § 6.8.4.2, esp. 6.8.4.2.2 (4th Ed. 1999.)

[30] Oral presentation of an AARP lawyer at a conference on predatory mortgage lending in Des Moines, Iowa, June 1999.

It is a fertile area for misrepresentations. When looking at mortgage lending in the prime market, the Boston Federal Reserve Bank found that approximately 80 percent of applicants had some ding on their credit record which would have, looked at in isolation, justified a denial.

The recent move by Fair Isaac to bring transparency to credit scores may help, but it will more likely be a help in the prime market than in the subprime market. Again, a knowledgeable broker or contractor-cum-broker would assure that the consumer knew that, but the reverse competition effect may impede that.

cash out for the contractor. (The broker took a 5 percent fee on the upsold loan ($1,800) plus what appears to be a yield-spread premium amounting to another $1,440. Now the payments on their mortgage, (including taxes and insurance) are $546. That is nearly 60 percent of their income: It leaves them $389 a month for food, car and health insurance, medical expenses, gasoline and other car expenses, utilities, and everything else. This terrific deal the broker arranged was a 30 year mortgage. The loan amount was $36,000, and the settlement charges almost $3,900 (though not all in HOEPA trigger fees). The APR is 14.7 percent.[31]

The consequence of all this? "Risk" becomes a self-fulfilling prophecy. Home ownership is threatened, not encouraged.

It is not an insurmountable challenge to bring this experience to bear in crafting legislation and regulation, as our experience with illustrative provisions in UDAP statutes and regulations, and in HOEPA itself, show.[32]

What Can Be Done Now?

State Attorneys General have used our State Unfair and Deceptive Acts and Practices (UDAP) laws against predatory mortgage lenders, including most notably, First Alliance Mortgage Company (FAMCO).[33] FAMCO demonstrates that lenders can be in technical compliance with disclosure laws like Truth in Lending and RESPA, yet nonetheless engage in widespread deception. When regulators did routine examinations, they would see very expensive loans, but no violations of any "bright line" disclosure laws. The problem was that FAMCO employees were rigorously trained as to how to disguise their 20 point charges through a sales script full of tricky and misleading information designed to mislead consumers into thinking that the charges were much lower than they were. This sales script was dubbed "The Monster Track." Attorneys General in Minnesota, Massachusetts, Illinois, Florida, California, New York, and Arizona have taken action against the company, along with the Department of Financial Institutions in Washington State. (In the wake of all the litigation and enforcement actions, the company filed bankruptcy.)

(States which either opted-out of Federal preemption of State limitations on points or reenacted them may have effectively prevented companies like FAMCO from doing business in their State. Iowa opted-out of the Federal preemption on first lien points and rates, and kept a two-point limit in place. While there is no concrete proof that this point-cap is why FAMCO did not do business in Iowa, it seems a reasonable assumption.)

But our UDAP laws, and our offices are by no means as much as is needed for this growing problem.

Impediments to Enforcement of Existing Laws

Some of the predatory lending practices certainly do fall afoul of existing laws. But there are important loopholes in those laws, and there are also serious impediments to enforcement of those laws against predatory lenders.

- Public enforcement

Resource limitations: One of the most significant impediments to public enforcement of existing applicable laws is insufficient resources. While State and Federal agencies have many dedicated public servants working to protect consumers and the integrity of the marketplace, in the past 15 or so years we have seen an ever-growing shortfall in the personnel when compared to the workload. The number of credit providers, the volume of lending, and the amount of problem lending have all exploded at the same time that the resources available to examine, monitor, investigate them, and enforce the laws have declined in absolute numbers. The resulting relative disparity is even greater. The experience in my State is probably not atypical. The number of licensed nondepository providers of household credit has roughly tripled in, the past 15 years, and the volume of lending has risen accordingly. (And not all out-of-State lenders operating through mail, telephone, or the Internet are licensed.) Three entire new categories of licensees have been created during those years. Yet, the staff necessary to examine these licensees and undertake any inves-

[31] The homeowners tried to exercise their right to cancel. But the lender claims they never got the notice, and the contractor told them not to worry about those payments, they would lower them . . . .

[32] A good example is the FTC Credit Practices Rule, 16 C.F.R. 444, which prohibited certain practices common in the consumer finance industry as unfair or deceptive. At the time it was under consideration, opponents predicted it would "dry up credit to those who need it the most." It did not. (Indeed, it was predicted that HOEPA would "dry up credit to those who need it the most." It has not.)

[33] FAMCO's practices were the subject of a *New York Times* article, Diana B. Henriques, "Mortgaged Lives," NYT, A1 (March 15, 2000).

tigations and enforcement actions have decreased. This is undoubtedly true at the Federal level, as well as the State level.

This disparity between need and supply in the Attorneys General offices is exacerbated by the fact that credit is only one of many areas for which we have some responsibility. For example, telecommunications deregulation and the explosion in e-commerce have resulted both in expanded areas of concern for us, and an expanded volume of complaints from our citizens.

Holes in coverage: Some State UDAP statutes do not include credit as a "good or service" to which the Act applies, or lenders may be exempted from the list of covered entities.[34] Some State statutes prohibit "deceptive" practices, but not unfair practices. In my State, we have no private right of action for our UDAP statute, magnifying the impact of the problem of inadequate resources for public enforcement. Other claims which might apply to a creditors' practices may be beyond the jurisdictional authority given to public agencies.

The silent victim: There is also a threshold problem of detection. Most of the people whose homes are being drained of their equity do not complain. Like most Americans, they are unfamiliar with applicable laws and so are unaware that the lender may have crossed the bounds; many people are embarrassed, or simply feel that it is yet one more of life's unfortunate turns. Coupled with the "clean paper" on many of these loans, this silence means activity goes undetected—at least until it is too late for many. As mentioned above, regulatory examinations of the records in the lenders' offices (even if there was sufficient person-power), often do not reveal the problems.

- Private enforcement

Mandatory arbitration: We have always recognized that the public resources for enforcement would never be adequate to assure full compliance. Thus, the concept that consumers can vindicate these rights themselves is built into many of the statutes which apply to these transactions. Under these statutes, as well as common law, these actions may be brought in our courts, where impartial judges and juries representing the community at large can assess the evidence and apply the law. Some of these statutes help assure that the right is not a phantom one, by providing for attorney's fees and costs as part of the remedy against the wrong-doer. Critically, the legal system offers an open and efficient system for addressing systemic abuses—abuses that Governmental enforcement alone could not address.

But private enforcement faces a serious threat today. Mandatory arbitration clauses which deny consumers that right to access to impartial judges and juries of their peers are increasingly prevalent. This denies all of us the open system necessary to assure that systemic problems are exposed and addressed. This is not the forum to discuss in detail the way the concept of arbitration has been subverted from its premise and promise into a mechanism used by one party to a contract—the one that is holding all the cards—to avoid any meaningful accountability for their own misconduct. These are not, as arbitration was envisioned, simple consensual agreements to choose a different forum in which to resolve differences cheaply and quickly; these are intended to insulate the ones who insist upon them from the consequences of their improper actions. While not unique to predatory mortgage lending, this rapidly growing practice in consumer transactions is a serious threat to effective use of existing laws to address predatory lending, as well as to enforcement of any further legislative or regulatory efforts to curb it. It is within Congress' power to remove this barrier.[35]

Preemption

Federal laws which, by statute or by regulatory action, preempt State laws, have played a role in the growth of predatory mortgage lending.[36] Unlike some examples of Federal preemption, preemption in the credit arena did not replace multiple State standards with a single Federal standard. In important areas, it replaced State standards with no real standards at all.

With commerce increasingly crossing borders, the industry asks that it not be subjected to "balkanized" State laws, and now, even municipal ordinances. But the in-

[34] The theory for exempting lenders is generally that other regulators are monitoring the conduct of the entity. Yet, the regulator may not have the jurisdictional authority to address unfair and deceptive acts and practices generally.

[35] The European Union recognizes the problems inherent in mandatory arbitration in consumer transactions, and includes it among contract terms that are presumptively unfair. See European Union Commission Recommendation No. 98/257/EC on the Principles Applicable to the Bodies Responsible for the Out-of-Court Settlement of Consumer Disputes, and Council Directive 93/13/EC of April 5, 1993 on Unfair Terms in Consumer Contracts.

[36] See, for example Mansfield, The Road to Subprime "HEL," note 8, above.

dustry and Congress should recognize that these efforts are born of concern for what is happening *now* to people and to their communities, and of frustration at inaction in Congress.

Congress did, on a bipartisan basis, enact HOEPA, which has helped, but needs to be improved. However, Congress has not done anything about the vacuum (and the uncertainty) left by preemption. Some Federal regulatory agencies have made the problem even worse since then, through broad (arguably overbroad) interpretations of Federal law. For example, the 1996 expansive reading of the Alternative Mortgage Transactions Parity Act (AMTPA) to preempt State laws on prepayment penalties has contributed to the problems we are talking about today. Over a year ago, the OTS asked whether that Act and interpretations under it had contributed to the problem, and 45 States submitted comments saying "yes." But nothing has come of that.[37] In the meantime, regulators in Virginia and Illinois have been sued by industry trade associations on grounds that AMTPA preempts their rules.[38]

What More Needs To Be Done?

It is simply not the case that existing laws are adequate. In an imperfect market, there must be ground rules. These are some suggestions.

Federal Reserve Board: HOEPA Regulation

Thirty-one States submitted comments to the Federal Reserve Board urging it to adopt the HOEPA rules as proposed, without being weakened in any respect. Our comments emphasized the importance of including single-premium credit insurance among the trigger fees. (A copy of the comments is submitted as Appendix A.)

Other Legislative Recommendations

In addition to closing the enforcement and substantive loopholes created by mandatory arbitration and preemption, HOEPA could be improved in light of the lessons we have learned from almost 6 years of experience with it. Some of the suggested reforms include:

- Improve the "asset-based lending" prohibition. Since this is the key issue in predatory lending, it is vital that it be effectual and enforceable. As it stands, it is neither. The "pattern and practice" requirement should be eliminated from the provision prohibiting making unaffordable loans.[39] The concept of "suitability," borrowed from the securities field, might be incorporated.
- Prohibiting the financing of single-premium credit insurance in HOEPA loans, as HUD and the FRB have recommended.
- Remove the Federal preemption hurdle to State enforcement of laws prohibiting prepayment penalties, or, at a minimum, prohibit prepayment penalties in HOEPA loans. The current HOEPA provision on prepayment penalties, as a practical matter, is so convoluted as to be virtually unenforceable.
- Improve the balloon payment provisions. While we no longer see 1 and 2 year balloons, we now see 15 and 20 year balloons, whose sole purpose is to enable the lender or broker to low-ball the cost by selling on "low monthly payments." And without prepayment penalties, there is no real reason for balloon loans: if a consumer is planning on selling in 5 years, they can prepay the loan in any event.
- Limit the amount of upfront fees and points which can be financed.

My colleagues and other State and local officials are seeing more and more of the hardship and havoc that results from these practices. We are committed to trying to address them as best we can within the limits of our jurisdiction and our resources. Federal preemption is part of what is limiting our ability to respond. Congress has a signal role here, for this is a national problem.

I would like to offer my continuing assistance to this Committee, and I know that my colleagues will, as well.

Thank you for giving me this opportunity to share my views with you.

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[37] It is also possible that AMTPA has contributed to the prevalence of the "exploding ARM" by predatory lenders, as the existence of a variable rate is one of the triggers for AMTPA coverage. 12 U.S.C. § 3802. Although we are focused today on mortgage lending, we are also concerned about overbroad preemption interpretations by the OCC affecting our ability to address problems in other areas, such as payday lending, and, now, perhaps even car loans.

[38] *Illinois Assoc. of Mortgage Brokers* v. *Office of Banks and Real Estate,* (N.D. Ill, filed July 3, 2001); *National Home Equity Mortgage Association* v. *Face,* 239 F. 3d 633 (4th Cir. 2001), cert. Filed June 7, 2001.

[39] It is not a violation to make unaffordable loans, it is only a violation to engage in a "pattern and practice of doing so," a difficult enforcement challenge. *See Newton* v. *United Companies,* 24 F. Supp. 2d 444 (E.D. Pa 1998).

APPENDIX A

Comments of Attorneys General of Thirty-One States*
to the Federal Reserve Board on Proposed Amendments
to HOEPA Rules

March 9, 2001

* In addition to those listed on the Comments, the Attorneys General of Arkansas and South Carolina joined by separate letter to the FRB.

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March 9, 2001

COMMENTS OF ATTORNEYS GENERAL OF

Arizona, California, Colorado, Connecticut, District of Columbia, Florida, Hawaii, Illinois, Iowa, Kansas, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Montana, Nevada, New Mexico, New York, North Carolina, N. Mariana Islands, Oregon, Pennsylvania, Tennessee, Vermont, Washington, and West Virginia

Federal Reserve Board Proposed HOEPA Rules
Regulation Z, 12 CFR Part 226, Docket No. R-1090
65 Federal Register 81438 (December 26, 2000)

The following comments are submitted by the undersigned Attorneys General in support of the Federal Reserve Board's proposed changes to those portions of Regulation Z regarding mortgage transactions subject to the Home Ownership and Equity Protection Act (HOEPA), 15 U.S.C. § 1639.

SUMMARY

Predatory mortgage lending is a major concern of the Attorneys General. We commend the effort that the Board and its staff made in conducting the public hearings in an effort to determine how HOEPA has worked in its first five years, and how it can be improved. We strongly support the proposals to broaden the scope of mortgage loans subject to HOEPA, and to strengthen some of its protections. We believe that they will help assure that HOEPA will play an even greater role in curbing the abuses in the mortgage marketplace which cause so much hardship to families, and so much harm to communities through consequent higher foreclosures.

As some of us have seen too often, the abusive lending practices cited by the Board -- including credit insurance "packing," unjustifiably high interest rates, loan "flipping," oppressive balloon payment provisions, equity-based lending without regard to the borrower's ability to repay, and structuring oppressive loans as open-end credit to avoid HOEPA's provisions -- are all too common in certain segments of the home credit marketplace. Although most lenders engage in responsible lending practices, a small but significant percentage of lenders make highly abusive loans that strip the hard-earned equity from the homes of vulnerable citizens. The combination of the recent explosive growth in subprime lending, the relative paucity of regulation of non-bank creditors, and the unsophisticated nature of many subprime borrowers, all have contributed to an environment that is ripe for abuse.

We believe that the Board's proposed amendments, in particular the proposal to include single-premium credit insurance as a HOEPA trigger fee, are major steps forward in addressing this national problem. Our comments will focus on a few of what we view as the most key proposals.

SPECIFIC PROPOSALS

1. Include Single-Premium Credit Insurance Charges in the HOEPA 8% "Fees and Points" Trigger: § 226.32(b)(1)(iv)

We strongly urge the Board to adhere to its proposal that single-premium credit insurance charges count toward the HOEPA fees trigger on a *per se* basis. As originally enacted, Congress did not by statute define single-premium credit insurance charges as a fee which counts toward HOEPA's 8% "fees and points" trigger. Recognizing the potential that some lenders may try to evade the HOEPA label by packing loans with other types of charges not identified in the statute, Congress gave the Board the authority to add other types of charges as it deems appropriate. 15 U.S.C. § 1601(aa)(4)(D). Credit insurance premiums were among the charges specifically mentioned by Congress as warranting Board consideration under that provision. 65 Fed. Reg. at 814442.

Some of our consumer protection offices have seen evidence that lenders "pack" single premium credit insurance into the borrower's loan by including it without the borrower's prior request. Some borrowers believe that the insurance is required (when it is not); most do not understand the product's actual costs with long term financing. Additionally, we note that the loss-ratios for this product have traditionally been very low -- usually less than 40% -- indicating further that consumers are overcharged and that lenders profit substantially from sales commissions.[1]

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[1] The market distortions involved in the sale of credit insurance are too well documented to warrant our repeating them in detail in this letter. Abuses in credit insurance have been the subject of Congressional attention as far back as 1955.

This insurance has been the focus of both state and federal attention recently. The North Carolina General Assembly prohibited the financing of single premium insurance in mortgage loans made after July 1, 2000. In addition, Fannie Mae and Freddie Mac have announced that they will no longer purchase mortgage loans containing single premium credit insurance. The U.S. Department of Treasury and HUD also have publicly condemned the practice, and the Joint FRB/HUD Report suggested that Congress should consider prohibiting financing single-premium insurance in HOEPA loans.

There is no available database which would permit a study of the credit insurance penetration rates on mortgage loans, of the cost of the insurance, nor of the extra equity that the financed single-premiums strip out of people's homes. We did have the opportunity to review microcosmic pool subprime loans in one community, and found the credit insurance information telling. Nearly half had single-premium credit insurance. In six of the eight loans with credit insurance, *the single-premium insurance charges comprised 10.6% to 16.5% of the amount financed on these loans*. The charges ranged from a low of $918 to a high of $10,227, with an average premium of $4081. Insurance premiums comprising more than 10% of the loan amount are not unusual. The equity-stripping effect is compounded by the fact that these premiums are financed over the life of these high-rate loans, (10 to 30 years), although the term of the insurance is much less, typically 5 - 7 years.[2] (A more detailed analysis of these issues, as exemplified in our small sample, is found in Attachment A, below.)

The supplementary information notes that the industry expressed a fear that creditors "might cease offering single-premium credit insurance to avoid HOEPA's coverage." We submit that the Board need not be concerned about such an outcome. First, all the financial incentives for creditors built into credit insurance will remain a powerful draw, HOEPA notwithstanding. Second, the proposal would only include the single-premium charges financed as part of these loans. Creditors who are interested in offering cost-efficient coverage would be able to do so; insurance premiums

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The "reverse competition" effect which comes into play when it is the selling creditor which selects the group policy it will sell to its borrowers has long been a criticism of this product. See, e.g. Cope v. Aetna Finance Co., 412 F.2d 635, 640 n. 14 (1st Cir. 1969); Spears v. Colonial Bank of Alabama, 514 So. 2d 814, 819 (Ala. 1987); New York Insurance Adm. Code, Reg. 27A – 11 NYCRR 185.0. Marketing abuses have also long been of concern to Attorneys General. See note 6, *infra*.

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The argument sometimes made is that consumers find it more convenient to spread out the premium over the life of the loan, which is unconvincing. Very few consumers understand the financial impact of financing a 5-year insurance over 20 years at 15% interest. In one of the loans examined in the Attachment, the insurance premiums alone turned the mortgage from a fully amortizing loan to a 20-year balloon. The consumer had merely been told that the insurance would cost "$40 extra a month." That figure represented the $10,000+ cost of the premium over 240 months without financing it at 15%. In truth, the insurance alone created the balloon payment of over $54,000, and raised the monthly payments by over $90/mo during the preceding 239 months.

sold on a monthly basis would not be affected. This is the more common method of offering insurance in the prime mortgage market, and it is generally cheaper coverage.

Accordingly, the state Attorneys General strongly support the Board's proposed amendment to include single premium credit insurance as part of the HOEPA points and fees calculation. We also urge the Board to adopt the proposed amendment in its current form, without any changes whatsoever that would weaken its effect. The Supplementary Information asks for comment on whether these insurance products should count toward the HOEPA trigger only when the insurance is overtly required.[3] We urge against a "sometimes in, sometimes out" test for several reasons.

* *To facilitate identification of HOEPA loans, and hence compliance and enforcement:* To the maximum extent possible, it should be possible for anyone looking at a loan to determine from the face of the documents whether a transaction is a HOEPA loan or not. When underlying facts behind a given transaction determine whether any given charge is a HOEPA charge or not, compliance will be hit-or-miss, and enforcement will be impeded. While TIL disclosures have boiler-plate disclosures about the voluntariness of the purchase, whether any given purchase is actually voluntary or not is a question of fact -- as it should be if the test is to be meaningful.[4] One of the hurdles to HOEPA enforcement has been the fact that on the "sometimes-in, sometimes-out" charges, the information necessary to know whether a charge is countable or not is available to the lender, but not to a regulator or private attorney trying to evaluate the case. A clear-cut rule, easy for lenders to comply with; easy for assignees to evaluate; and easy to evaluate for public or private enforcement is preferable, and will ultimately result in greater compliance and lower compliance costs.

* *The statutory "voluntariness" standard for §226.4 has not deterred the marketing abuses, and, in fact may encourage them.[5] The current HOEPA exclusion has created additional incentives, and the Board can and should eliminate these incentives by making insurance premiums per se part of the fees and points trigger.*

The purpose of HOEPA was to reduce the incidence of unnecessarily high-cost mortgages which jeopardize people's homes. It provides *substantive* protections against abusive practices in lending which have been documented in much litigation, and in many hearings around the country.

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[3] For disclosure purposes, Reg. Z, 226.4(d), provides that "voluntary" insurance premiums may be excluded from the finance charge.

[4] OSC § 226. 4(d)-5; *see also* OSC § 226.4(b)(7) and (8), codifying the Board's historic position, *see, e.g* FRB Staff Letter No. 1270 (Dec. 20, 1977). *See also* Hager v. American General Fin., 37 F. Supp. 778 (S.D. W.Va. 1999); Slovak v. American General Fin., 1998 WL 830656 (E.D. Pa. 1998); Kaminski v. Shawmut Credit Union, 494 F. Supp. 723 (D. Mass. 1980); Matter of Tower Loan of Mississippi, FTC Dkt. # 9241 (complaint filed July 5, 1990) (consent order).

[5] See Attachment A.

The " voluntariness" standard in the TIL *disclosure* rules has not prevented those abuses. In fact, credit insurance packing has been the subject of enforcement action by Attorneys General on a number of occasions.[6] The "voluntariness" standard would remain an ineffectual deterrent if adopted as part of the HOEPA trigger

By eliminating at least one incentive for aggressive selling of overpriced single-premium products, the Board would further the goals of HOEPA. It may be one small step toward making credit insurance what it was intended – simple risk protection for both sides of a contract, with costs reasonably related to the benefits – rather than "the tail that wags the dog."[7]

The Supplementary Information mentioned another option suggested by the industry: excluding insurance provided the consumer could cancel it and obtain a full refund. Such cancellation policies are not uncommon now, either by state law or contract. But, as with the voluntariness standard, the cancellation right has been wholly insufficient either to avoid the marketing abuses or to reduce the pricing distortions.

2. Lower APR trigger: § 226.32(a)(1)(i)

We support the proposal to lower the margin on the APR threshold from 10% to 8%. There is little reason to assume that the availability of credit would be impaired by this change in margin. The Supplementary Information cites the OTS estimate that it would expand the HOEPA segment of the subprime market from 1% to approximately 5%.[8] The growth in the subprime industry since HOEPA took effect in 1995 suggests that fears that HOEPA has an adverse impact on the availability of credit are unfounded.[9] There is no reason to suppose that a different HOEPA trigger would change that .

Further, if HOEPA helps reduce the availability of destructive, predatory lending, then strengthening HOEPA will help achieve a goal that everyone shares. As the Board itself recognizes,

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[6] E.g. Attorneys General in Arizona, California, Iowa, Wisconsin have taken action in insurance packing cases. For a listing of some insurance packing cases, *see, e.g.* National Consumer Law Center, *The Cost of Credit: Regulation and Legal Challenges* §§ 8.5.4 and 8.7.4, text accompanying notes 642 -646

[7] John Fonseca, *Handling Consumer Credit Cases*, Chap. 12 (3rd ed. 1986).

[8] 65 Fed. Reg. 81438, 81441 (December 26, 2000).

[9] See estimates collected in Cathy Lesser Mansfield, *The Road to Subprime "HEL" Was Paved With Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market,* 51 So. Car. L. Rev. 473, 527 - 531 (2000), citing estimates that the number of subprime loans increased by 890% between 1993 and 1998, and that subprime lenders tripled their market share between 1995 and 1997.

no one benefits from "access" to unfair or predatory credit.

3. Anti-flipping proposals: §§ 226.34 (a)(3) and (b)(1)

Some of our consumer protection offices are all too familiar with the abusive practice of "flipping" loans. "Flipping" refers to the repeated refinancing of borrowers' loans in order to generate additional fee income, or to keep borrowers perpetually "maxed out" on their equity (thereby preventing them from refinancing with another lender on more favorable terms) -- both of which are severely detrimental to borrowers.

The proposed amendments contain two provisions addressing the problem of flipping. The first proposed amendment prohibits the creditor or assignee (or an affiliate) that is holding a HOEPA loan from refinancing it within the first twelve months unless the refinancing is in the borrower's interest. (Proposed § 226.34(a)(3)) The second proposed amendment prohibits creditors in the first five years of a zero interest rate or other low-cost loan from replacing that loan with a higher-rate loan, unless the refinancing is in the borrower's interest. (Proposed § 226.34(b)(1))

The state Attorneys General believe that loan flipping is a significant problem, especially in the lower reaches of the subprime market where borrowers often do not fully understand the costs of repeated lender-induced refinancing. In particular, we believe that creditors' refinancing of borrowers holding zero interest rate (such as Habitat for Humanity) loans or other low cost loans with high interest rate loans is an especially pernicious practice. We welcome these proposals as the minimum necessary to begin to address this practice, and a step in the right direction.

We believe the Board's proposal is a strong step in the right direction. Some clarification may be helpful. In both of the anti-flipping provisions, (proposed §§ 226.34(a)(3), and (b)(1)), the proposals would prohibit refinancings within a specified time limit "unless it is in the borrower's interest." It is quite easy to construct some minimal rationalized benefit. For example, in theory, refinancing a balloon loan to an amortizing loan might be considered "in the borrower's interest." However, some lenders have written balloon loans specifically in order to solicit the borrowers a short-time later to offer to refinance and "get rid of that balloon," just for an opportunity to book two high-fee loans in a short time. Or a refinance to get a lower rate may be considered to be "in the borrower's interest." However, that lower rate may be a teaser rate in which the payments will balloon to unaffordable payments at the end of a one or two-year teaser period, a type of predatory loan that has been a serious problem in many of our states. If the language were to be clarified to require that the refinancing be in the borrower's "best interest," that would signal that it is not sufficient just to find a minimal rationalization for the refinancing. We appreciate that some might argue that this does not provide "bright line guidance," but such limitations on exploitation have long been a part of the law without in any way undermining business. Such a test is similar to the concept of "suitability" in the securities context, a standard which has not impeded the ability of the securities field to serve its customers, and has arguably served to enhance the public's trust in the

industry.

4. *Increased scrutiny of borrowers ability to repay.* Under section 129(h) of the Truth in Lending Act, a creditor may not engage in a pattern or practice of making HOEPA loans based on the equity in the borrower's home without regard to the consumer's repayment ability. The Board has proposed several amendments strengthening or clarifying this provision.

Proposed section 226.34(a)(4)(ii) would be added to require that creditors generally document and verify consumers' current or expected income, current obligations, and employment to the extent applicable. If a creditor engages in a pattern or practice of making loans without documenting and verifying consumers' repayment ability, there would be a presumption that the creditor has violated the rule.

Another proposed amendment provides that, in adjustable rate transactions where the creditor sets the initial interest rate and the rate is later adjusted, in considering the borrowers' ability to repay, the creditor would be required to consider increases to the consumer's payments assuming the maximum possible increases in rates in the shortest possible time frame. (Proposed comment 226.34(a)(4)(i)-3)

The state Attorneys General support these changes. Some of our offices have observed many instances where borrowers have received adjustable rate mortgages with introductory low "teaser" rates, which quickly "explode" into high rates. Because the higher rates (and concomitantly higher monthly payments) are often devastating to borrowers, it is vital that creditors be required to consider the full range of payments a borrower may be required to pay in considering the borrower's actual ability to repay. Similarly, some of our offices have also witnessed numerous instances in which brokers and lenders accept scant or no substantiation of a borrower's ability to repay, leading to the borrowers' eventual default and lender's foreclosure when the borrower is unable to make the monthly payments on the loan. In order to make HOEPA's prohibition on equity-based lending an effective one, lenders and brokers must be required to verify and document a borrower's actual income.

5. *Prohibition on structuring loans as open-end credit to evade HOEPA. § 226.34(b)(2)* HOEPA covers only closed-end loans. Thus, as observed by the Board, if a consumer obtains a home-secured open-end line of credit with an APR or points and fees above HOEPA's rate and fee triggers, the loan is not subject to HOEPA's disclosure requirements or limitations.

The FTC and various consumer representatives reported cases to the Board in which creditors are using open-end credit lines to evade HOEPA. In some of those instances, consumers applied for a closed-end home-secured loan but learned for the first time at closing that the loan documents were structured as open-end credit, with credit limits far in excess of the amount requested. In other instances, creditors have documented loans as open-end "revolving" credit, even if there was no

expectation of repeat transactions under a reusable line of credit.

In an effort to address this issue, the Board has proposed an amendment prohibiting the structuring of a home-secured loan as an open-end plan to evade the requirements of HOEPA, if the credit does not meet the definition of "open-end credit" set forth in TILA.

Further, in its comments, the Board has solicited comment on the need and feasibility of rules to prevent evasions of HOEPA in other circumstances. In particular, the Board has asked whether there should be a rebuttable presumption that a creditor intended to evade HOEPA, in violation of the law, if a consumer applies for a closed-end home-secured loan but receives an open-end line of credit that is priced above HOEPA's triggers.

The state Attorneys General strongly support the proposed amendment because we firmly believe that creditors should not be allowed to structure closed-end loans as open-end transactions in order to escape HOEPA's consumer protections.[10] Additionally, we strongly support the establishment of a rebuttable presumption that a creditor intended to evade HOEPA if a consumer applies for a closed-end home loan but received an open-end line of credit priced above HOEPA's triggers.

6 Balloon Payments:

The Board had been urged to use its authority to prohibit balloons entirely in all HOEPA loans, expanding the current prohibition in loans under 61 months. The board did not make such a proposal, as it did not believe it had been given "evidence of a particular problem related to longer term balloon notes."

With note interest rates up to 18%, monthly payments to fully amortize mortgage loans in 15 years are undoubtedly enough to keep many consumers from entering into high-cost mortgages. In order to make a monthly payment low enough to be "saleable," more of the high-cost mortgages are now 15- year balloons. Further, it seems likely that the availability of the balloon contributes to the ease with which these loans are packed on the front end. Without a balloon, a loan packed with upfront costs and insurance premiums would raise the monthly payment sufficiently in many cases to create "market resistance."[11] But the financial hit from these "barely amortizing" long-term loans is astounding, as two of the HOEPA balloons from our sample (Attachment A) show.

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[10] As the Board is aware from the letter a number of us sent to the Board in 1997, our offices have long been concerned with the way that spurious open-end credit has been used to facilitate deceptive sales practices and undermine informed credit decisions, particularly in the door-to-door context. (See 62 Fed. Reg. 64769 (Dec. 7, 1997).

[11] In many cases, the long-term payments simply pay off the financed fees and the interest on them.

	Amt. Fin'd	Term	Total of 179 Monthly Payments	+Balloon
# 3	$64,643	15 yrs	$109,027	$59,322
# 4	$23,542	15 yrs	$ 62,779	$23,168

Figures such as these are consistent with the 15-year balloons we have seen on other HOEPA loans from other lenders. These "barely amortizing" long-term balloons in practice help make the borrowers captive to these lenders, as refinancing out of the high-cost mortgage is difficult. We urge the Board to prohibit balloons in HOEPA loans.

Conclusion

As the chief law enforcement officers of our states, we are gratified by and strongly endorse the Board's initiative in taking measures to combat predatory lending, which has caused substantial harm to many citizens in our states. We urge the Board to adopt the proposed amendments in their current form, in particular, those outlined above.

We greatly appreciate the opportunity to express our views on this matter. We look forward to working with the Board in mutual efforts to address the serious problem of predatory lending. Please feel free to contact any one of us directly, or NAAG's Consumer Protection Counsel, Sarah Reznek, at (202) 326-6016.

Sincerely,

[SIGNATURE FACSIMILES OMITTED]

[1] Of the states listed, Hawaii is not represented by its Attorney General. Hawaii is represented by its Office of Consumer Protection, an agency which is not a part of the state Attorney General's Office, but which is statutorily authorized to represent the State of Hawaii in consumer protection actions. For the sake of simplicity, the entire group will be referred to as the "Attorneys General," and such designation as it pertains to Hawaii, refers to the Executive Director of the State of Hawaii Office of Consumer Protection.

ATTACHMENT A

CREDIT INSURANCE PREMIUMS IN SUBPRIME MORTGAGE LENDING: ONE COMMUNITY'S EXPERIENCE

Reverse incentives have been distorting the sale of credit insurance for decades, but HOEPA added a new incentive. As a representative of one major credit insurance company explained to a lenders' trade association conference, a "full package" of insurance products can, for the creditor's yield purposes, turn a 12% loan into an 18% loan. But that won't show up in the borrower's price tag, because of the general TIL rules excluding "voluntary" credit insurance. Reg. Z, § 226.4(d). That alone is good incentive, but on a high cost-mortgage, than can be the difference between a branded HOEPA loan and a non-HOEPA loan, since the premiums do not count toward the fees and points trigger under HOEPA rules, either. There may be a number of reasons why creditors wish to avoid overtly making HOEPA loans: not wishing to give the early disclosures; wishing to include otherwise prohibited terms, or perhaps, concerned about the ability to sell the loans on the secondary market, given the enhanced holder liability. Switching from the ten point loans that we used to see from major national subprime lenders in pre-HOEPA days to insurance can protect revenues while avoiding the HOEPA label.

We do not have the resources to do a study of the penetration rates on mortgage loans, and of the level of costs, nor of the level at which the equity in borrowers' homes are securing just those excessively-priced credit insurance premiums. We are also not aware of any easily available database from which such a study could be conducted. However, we recently had an opportunity to review 17 mortgage loans made primarily in one county by one of the largest subprime mortgage lenders in the country.[12] The credit insurance picture is striking.

Number of loans:	17 (representing 14 single or joint borrowers)[13]
HOEPA loans:	7
Non-HOEPA	9

[12] Documents on sixteen of the loans were provided by a neighborhood organization following a public meeting which Governor Gramlich attended in Des Moines, Iowa in the fall of 2000. The seventeenth , from the same lender, came to our attention through a consumer complaint.

[13] These documents indicate the company engages in "loan-splitting," or writing two separate loan transactions for what is really a single loan. Apparently it does so in order to make high LTV loans. One loan is written for up to 95% LTV, the second loan is written, in theory, for the remainder of the equity up to 110%, though one set of these loans appears closer to 140% - 200% LTV.

Indeterminable [14] 1

Credit Insurance Penetration Rate
HOEPA 4 of 7
non-HOEPA 4 of 9

Cost of Insurance in Insured Mortgages

Type of Loan		Principal / (Amt. Fin'd)	Insurance premium	Premium as % of Amt. Fin'd	APR	Coverage compared to Loan term
HOEPA 1 - 4	1	$13,036 / ($12,296)	$2,036	16.5%	17.62%	unk/20 yrs
	2	$11,295 / ($10,685)	$1,284	12.0%	18.098%	7 / 10 yrs
	3	$73,159 / ($64,643)	$1,159	1.8%	11.066%	1 / 15 yrs
	4	$24,686 / ($23,542)	$2,686	11.4%	17.693%	7 yr/ 15 yr
Non-HOEPA 5 - 8	5	$68,593 ' ($65,998)	$10,227[15]	15.5%	15.417%	7 yr / 15 yr
	6	$60,682 / ($58,130)	$ 8,982	15.5%	14.143%	unk / 15 yr
	7	$52,554 / ($50,271)	$5,354	10.6%	12.993%	7 yr / 15 yr
	8	$ 34,598 / (32,441)	$ 918	2.8%	14.237%	2 yr / 15 yr
	Ave.	**$42,325 / ($39,625)**	**$4,081**	**10.76%**	**15.16%**	***5.2 yr / 14 yr** *on 6 loans

[14] For this loan, we had only a HUD-1, which does not give us the APR. However, it was a loan under $25,000, and all the other loans of that size from this lender had APRs over 17%, so it is probable that it was also a HOEPA loan.

[15] This is the lower of two inconsistent figures given on the TIL authorization and the HUD-1. It is note-worthy that this is a **20-year balloon note**. After $204,539 in 239 monthly payments, a $54,327 balloon is scheduled. Without this $10,000 in financed, single-premium insurance, these borrowers would save $100 a month for 20 years, and NOT have a balloon at the end of the road. In effect, 20 years of $855/mo payments would reduce the principal on this loan as written by little more than the amount of the insurance premiums alone.

All of these loans would be HOEPA loans if these insurance premiums were part of the HOEPA trigger fees. Even the comparatively small $918 premium on loan # 8, when added to its other fees and points, would take loan over the 8% HOEPA fees and points trigger.

The Joint Report notes reports that the economic incentives are great enough that insurance applications may be falsified in order to collect the various forms of revenue from the insurance.[16] We had access to full files on only two of the 14 borrowers whose loans were represented among the seventeen contracts. Discouragingly, both involved the sale of insurance to borrowers ineligible or unlikely to benefit from the insurance, and in both cases, the premiums comprised more than 10% of the loan amounts. While those borrowers had requested the insurance, the lender wrote in more than $16,850 premiums in the aggregate, rather than explaining that the security the homeowners thought they were paying these extraordinary amounts for were largely illusory, as they arguably are legally bound to do.[17]

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[16] Board of Governors / HUD Joint Report to the Congress Concerning Reform to the Truth in Lending Act and the Real Estate Settlement Procedures Act 66, note 100 (July, 1998).

[17] See National Consumer Law Center, *The Cost of Credit: Regulation and Legal Challenges* §§ 8.5.5, 8.7.2 - 8.7.4. One of the borrowers (whose loan was split to make a high LTV loan), states she informed the loan originator of her preexisting condition when she filled out the application. She states he asked if she was planning on surgery or "anything drastic" in the future, and when she responded negatively, he instructed her to write "no" in response to the question about existing conditions. On the second loan, joint credit life was written for over $7000, though one of the spouses income on the application is clearly listed as social security disability. It appears that the nature of the disability is such that she would have been ineligible for coverage.

APPENDIX B

Single Premium Credit Insurance: A Tool for Equity-Skimming

The first page shows the impact of financing single-premium insurance in a high-cost loan. It is a real loan, made to an Iowa couple. See NAAG Comments to the Federal Reserve Board on Proposed Amendments to HOEPA Regulations, Attachment A, (Appendix A to this testimony.) The loan on the next page is loan # 5 on the chart in that Attachment (p. 12).

The second page shows how selling truncated single-premium credit insurance front-loads the premium cost, so that even if the borrow prepays, or refinances, they will still be paying most of the premium. The chart uses the same loans from the NAAG Comment letter, and calculates how much of the premium would have been deemed "earned" at a five-year prepayment. It also compares the estimated lender commissions on those premiums to the amount of points charged on the loans. The credit insurance enables the lender to maintain revenues, while appearing to reduce the points.

IMPACT OF SINGLE PREMIUM CREDIT INSURANCE IN A SUBPRIME MORTGAGE:

	WITH CREDIT INSURANCE	WITHOUT CREDIT INSURANCE
Principal	$ 68,593	$ 58, 366
Note Rate	14.79%	14.79%
Payments	239@$856 + 1 @ $54,327	240@$759.52
Total of Payments	$258,866	$182,280

Cost Difference: Over $96 per month
Plus entire $54,327 balloon

Total Cost Difference Over Loan Life: ***$76,586***
$66,359 of which is extra interest

Principal reduced by amount of insurance premium at month 210.
Policy lapsed at month 84.

******

How was the price explained to consumer?

$40 per month

How did the loan officer come up with that?

$10,000 ÷ 240 months = $41.67 / month

INSURANCE PREMIUMS AND EARLY PAY-OFFS

Type of Loan		Insurance premium (principal)	Amount of principal pd at 5 yrs *	Amount of insurance "earned" at 5 years **	Amount of creditor comm.*** (Est =40%)	Points & Proc. Fees
HOEPA 1 - 4	1					
	2	$1284 (of $11,285)	$3441	$1176	$ 514	$ 600 (5 pts)
	3	$1159 (of $73,159)	$2809*	$1159 (1 yr ins)	$ 464	$8352 (11.4 pts – includes buy-down)
Non-HOEPA 5 - 8	4	$2686 (of $24,686)	$ 217*	$2460	$1074	$1080 (4.4 pts)
	5	$10,227 (of $68,593)	$ 916*	$9368	$4091	$2040 (3 pts)
	6					
	7	$5,354 (of $52,554)	$8503	$4904	$2142	$2088 (4 pts)
	8	$ 918 (of $34,598)	$ 631*	$ 918 (2 yr ins)	$ 367	$1900 (5.5 pts)

* Balloon loan

** Rebates are calculated by the Rule of 78s, using the term of the truncated insurance (rather than the loan term) to derive the rebate factor. All insurance, except as noted, is for a 7-year term. Rebate factor for payoff at month 60 on 7-year premium is .0840.

*** ESTIMATES: See chart on producer commissions for ABIG, which is the insurer on at least two of these loans, p. 5. See also aggregate national data, p. 6.

On loans 1 and 6, the documents obtained did not specify the term for the insurance.

ORIGINAL PREPARED STATEMENT OF CHARLES W. CALOMIRIS

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JULY 26, 2001

Mr. Chairman, it is a pleasure and an honor to address you today on the important topic of predatory lending.

Predatory lending is a real problem. It is, however, a problem that needs to be addressed thoughtfully and deliberately, with a hard head as well as a soft heart. There is no doubt that people have been hurt by the predatory practices of some creditors, but we must make sure that the cure is not worse than the disease. Unfortunately, many of the proposed or enacted municipal, State, and Federal statutory responses to predatory lending would have adverse consequences that are worse than the problems they seek to redress. Many of these initiatives would reduce the supply of credit to low-income homeowners, raise their cost of credit, and restrict the menu of beneficial choices available to borrowers.

Fortunately, there is a growing consensus in favor of a balanced approach to the problem. That consensus is reflected in the viewpoints expressed by a wide variety of individuals and organizations, including Robert Litan of the Brookings Institution, Fed Governor Edward Gramlich, most of the recommendations of last year's HUD-Treasury Report, the voluntary standards set by the American Financial Services Association (AFSA), the recent predatory lending statute passed by the State of Pennsylvania, and the recommendations and practices of many subprime mortgage lenders (including, most notably, Household). In my comments, I will describe and defend that balanced approach, and offer some specific recommendations for Congress and for financial regulators.

To summarize my recommendations at the outset, I believe that an appropriate response to predatory practices should occur in two stages: First, there should be an immediate regulatory response to strengthen enforcement of existing laws, enhance disclosure rules and provide counseling services, amend existing regulation, and limit or ban some practices. I believe that these initiatives, described in detail below, will address all of the serious problems associated with predatory lending.

In other areas—especially the regulation of prepayment penalties and balloon payments—any regulatory change should await a better understanding of the extent of remaining predatory problems that result from these features, and the best ways to address them through appropriate regulations. The Fed is currently pursuing the first systematic scientific evaluation of these areas, as part of its clear intent to expand its role as the primary regulator of subprime lending, given its authority under HOEPA. The Fed has the regulatory authority and the expertise necessary to find the right balance between preventing abuse and permitting beneficial contractual flexibility.

Congress, and other legislative bodies, should not rush to judgment ahead of the facts and before the Fed has had a chance to address these more complex problems, and in so doing, end up throwing away the proverbial baby of subprime lending along with the bathwater of predatory practices.

I think the main role Congress should play at this time is to rein in actions by States and municipalities that seek to avoid established Federal preemption by effectively setting mortgage usury ceilings under the guise of consumer protection rules. Immediate Congressional action to dismantle these new undesirable barriers to individuals' access to mortgage credit would ensure that consumers throughout the country retain their basic contractual rights to borrow in the subprime market.

My detailed comments divide into four parts: (1) a background discussion of subprime lending, (2) an attempt to define predatory practices, (3) a point-by-point evaluation of proposed or enacted remedies for predatory practices, and (4) a concluding section.

Subprime Lending, the Democratization of Finance, and Financial Innovation

The problems that fall under the rubric of predatory lending are only possible today because of the beneficial "democratization" of consumer credit markets, and mortgage markets in particular, that has occurred over the past decade. Predatory practices are part and parcel of the increasing complexity of mortgage contracts in the high-risk (subprime) mortgage area. That greater contractual complexity has two parts: (1) the increased reliance on risk pricing using Fair, Isaac & Co. (FICO) scores rather than the rationing of credit via yes or no lending decisions, and (2) the use of points, insurance, and prepayment penalties to limit the risks lenders and borrowers bear and the costs borrowers pay.

These practices make economic sense and can bring great benefits to consumers. Most importantly, these market innovations allow mortgage lenders to gauge, price, and control risk better than before, and thus allow them to tolerate greater gradations of risk among borrowers.

According to last year's HUD-Treasury report, subprime mortgage originations have skyrocketed since the early 1990's, increasing by tenfold since 1993. The dollar volume of subprime mortgages was less than 5 percent of all mortgage originations in 1994, but by 1998 had risen to 12.5 percent. As Fed Governor Edward Gramlich (2000) has noted, between 1993 and 1998, mortgages extended to Hispanic-Americans and African-Americans increased the most, by 78 and 95 percent, respectively, largely due to the growth in subprime mortgage lending.

Subprime loans are extended primarily by nondepository institutions. The new market in consumer credit, and subprime credit in particular, is highly competitive and involves a wide range of intermediaries. Research by economists at the Federal Reserve Board indicates that the reliance on nondepository intermediaries reflects a greater tolerance for lending risk by intermediaries that do not have to subject their loan portfolios to examination by Government supervisors (Carey et al. 1998).

Subprime lending is risky. The reason that so many low-income and minority borrowers rely on the subprime market is that, on average, these are riskier groups of borrowers. It is worth bearing in mind that default risk varies tremendously in the mortgage market. The probability of default for the highest risk class of subprime mortgage borrowers is roughly 23 percent, which is *more than one thousand times* the default risk of the lowest risk class of prime mortgage borrowers.

When default risk is this great, in order for lenders to participate in the market, they must be compensated with unusually high interest rates. For example, even if a lender were risk-neutral (indifferent to the variance of payoffs from a bundle of loans) a lender bearing a 20 percent risk of default, and expecting to lose 50 percent on a foreclosed loan (net of foreclosure costs) should charge at least the relevant Treasury rate (given the maturity of the loan) plus 10 percent. On second trust mortgages, loan losses may be as high as 100 percent. In that case, the risk-neutral default premium would be 20 percent. Added to these risk-neutral premia would be a risk premium to compensate for the high variance of returns on risky loans (to the extent that default risk is nondiversifiable), as well as premia to pay for the costs of gathering information about borrowers, and the costs of maintaining lending facilities and staff. These premia would be charged either in the form of higher interest rates or the present value equivalent of points paid in advance.

Default risk, however, is not the only risk that lenders bear. Indeed, prepayment risk is of a similar order of magnitude in the mortgage market. To understand prepayment risk, consider a 15 year amortized subprime mortgage loan of $50,000 with a 10 percent interest rate over the Treasury rate, zero points and no prepayment penalty. If the Treasury rate falls, say by 1 percent, assume that the borrower will choose to refinance the mortgage without penalty, and assume that this decline in the Treasury rate actually happens 1 year after the mortgage is originated.

If the interest rate on the mortgage was set with the expectation that the loan would last for 15 years, and if the cost of originating and servicing the loan was spread over that length of time, then the prepayment of the loan will result in a loss to the lender. An additional loss to the lender results from the reduction in the value of its net worth as the result of losing the revenue from the mortgage when it is prepaid (if the lender's cost of funds does not decline by the same degree as its return on assets after the prepayment).

In the competitive mortgage market, lenders will have to protect against this loss in one of several ways: First, lenders could charge a prepayment fee to discourage prepayment, and thus limit the losses that prepayment would entail. Second, the lender could "frontload" the cost of the mortgage by charging points and reducing the interest rate on the loan. This is a commitment device that reduces the incentive of the borrower to refinance when interest rates fall, since the cost of a new mortgage (points and interest) would have to compete against a lower annual interest cost from the original loan. A third possibility would be avoiding prepayment penalties and points and simply charging a higher interest rate on the mortgage to compensate for prepayment risk.

In a competitive mortgage market, the present value of the cost to the borrower of these three alternatives is equivalent. If all three alternatives were available, each borrower would decide which of these three alternatives was most desirable, based on the borrower's risk preferences.

The first two alternatives amount to the decision to lock in a lower cost of funds rather than begin with a higher cost of funds and hope that the cost will decline as the result of prepayment. In essence, the first two choices amount to buying an

insurance policy compared to the third, where the borrower instead prefers to retain the option to prepay (effectively "betting" that interest rates will fall).

If regulation were to limit prepayment penalties, by this logic, those wishing to lock in low mortgage costs would choose a mortgage that frontloads costs through points as an alternative to choosing a mortgage with a prepayment penalty.

Loan maturity is another important choice for the borrower. The borrower who wishes to bet on declining interest rates can avoid much of the cost of the third alternative mentioned above (that is, paying the prepayment risk premium) by keeping the mortgage maturity short-term (for example, by agreeing to a balloon payment of principal in, say, 3 years). Doing so can substantially reduce the annual cost of the mortgage.

In the subprime market, where borrowers' creditworthiness is also highly subject to change, prepayment risk results from improvements in borrower riskiness as well as changes in U.S. Treasury interest rates. The choice of either points, prepayment penalties, or neither amounts to choosing, as before, whether to lock in a lower overall cost of mortgage finance rather than betting on the possibility of an improvement. Similarly, retaining a prepayment option, or choosing a balloon mortgage, allows the individual to "bet" on an improvement in his creditworthiness.

Borrowers in the subprime market are subject to significant risk that they could lose their homes as the result of death, disability, or job loss of the household's breadwinner(s). Some households will want to insure against this eventuality with credit insurance. Credit insurance comes in two main forms: monthly insurance (which is paid as a premium each month), or "single-premium" insurance, which is paid for the life of the mortgage in a single lump sum at the time of origination, and typically is financed as part of the mortgage. Because single-premium insurance commits the borrower to the full length of time of the mortgage (and because there is the possibility that the borrowers' risk of unemployment, death, or disability will decline after origination), the monthly cost of single-premium insurance is much lower than the cost of monthly insurance. Borrowers who want the option to be able to cancel their insurance policy (for example, to take advantage of a decline in their risk of unemployment) pay for that valuable option in the form of a higher premium per month on monthly insurance. According to Assurant Group (a major provider of credit insurance to the mortgage market), the monthly cost for monthly credit insurance on 5 year mortgages, on average, is about 50 percent more expensive than the monthly cost of single-premium credit insurance.

Economists recognize that substantial points, prepayment penalties, short mortgage maturities, and credit insurance have arisen in the subprime market, in large part, because these contractual features offer preferred means of reducing overall costs and risks to consumers. Default and prepayment risks are higher in the subprime market, and therefore, mortgages are more expensive and mortgage contracts are more complex. Clearly, there would be substantial costs borne by many borrowers from limiting the interest rates or overall charges on subprime mortgages, or from prohibiting borrowers from choosing their preferred combination of rates, points, penalties, and insurance. As Fed Governor Edward Gramlich writes:

> ". . . some [predatory lending practices] are more subtle, involving misuse of practices that can improve credit market efficiency most of the time. For example, the freedom for loan rates to rise above former usury ceilings is mostly desirable, in matching relatively risky borrowers with appropriate lenders. . . . Most of the time balloon payments make it possible for young homeowners to buy their first house and match payments with their rising income stream. . . . Most of the time the ability to refinance mortgages permits borrowers to take advantage of lower mortgage rates. . . . Often mortgage credit insurance is desirable. . . ." (Gramlich 2000, p. 2)

Any attempts to regulate the subprime market should take into account the potential costs of regulatory prohibitions. As I will argue in more detail in section 3 below, many new laws and statutory proposals are imbalanced in that they fail to take into account the costs from reducing access to complex, high-cost mortgages.

Predatory Practices

So much for the "baby"; now let me turn to the "bathwater." The use of high and multiple charges, and the many dimensions of mortgage contracts, I have argued, hold great promise for consumers, but with that greater complexity also comes greater opportunity for fraud and for mistakes by consumers who may not fully understand the contractual costs and benefits they are being offered.

That is the essential dilemma. The goal of policymakers should be to define and address predatory practices without undermining the opportunities offered by subprime lending.

According to the HUD-Treasury report, predatory practices in the subprime mortgage market fall into four categories: (1) "loan flipping" (enticing borrowers to refinance excessively, sometimes when it is not in their interest to do so, and charging high refinancing fees that strip borrower home equity), (2) excessive fees and "packing" (charging excessive amounts of fees to borrowers, allegedly because borrowers fail to understand the nature of the charges, or lack knowledge of what would constitute a fair price), (3) lending without regard to the borrower's ability to repay (that is, lending with the intent of forcing a borrower into foreclosure in order to seize the borrower's home), and (4) outright fraud.

It is worth pausing for a moment to note that, with the exception of fraud (which is already illegal) these problems are defined by (often subjective) judgments about the outcomes for borrowers (excessive refinancing, excessive fees, excessive risk of default), not by clearly definable actions by lenders that can be easily prohibited without causing collateral harm in the mortgage market.

For example, with regard to loan flipping, it may not be easy to define in an exhaustive way the combinations of changes to a mortgage contract that make a borrower better off. There are clear cases of purely adverse change (for example, across-the-board increases in rates and fees with no compensating changes in the contract), and there are clear cases of improvement, but there are also gray areas in which a mix of changes occurs, and where a judgment as to whether the position of the borrower has improved or deteriorated depends on an evaluation of the probabilities of future contingencies and a knowledge of borrower preferences.

Similarly, whether fees are excessive can often be very difficult to gauge, since the sizes of the fees vary with the creditworthiness of the borrower and with the intent of the contract. For example, points are often used as a commitment device to limit prepayment risk.

And what is the maximum "acceptable" level of default risk on a mortgage, which would constitute evidence that a mortgage had been unreasonably offered because of the borrower's inability to repay?

Many alleged predatory problems revolve around questions of fair disclosure and fraud prevention. These can be addressed to a great degree by ensuring accurate and complete disclosure of facts (making sure that the borrower is aware of the true APR, and making sure that legally mandated procedures under RESPA, TILA, and HOEPA are followed by the lender). In section 3, I will discuss a variety of proposals for strengthening disclosure rules and protections against fraud.

But the critics of predatory lending argue that inadequate disclosure and outright fraud are not the only ways in which borrowers may be fooled unfairly by lenders. For some elderly people, or people who are mentally incapacitated, predatory lending may simply constitute taking advantage of those who are mentally incapable of representing themselves when signing loan contracts. And for others, lack of familiarity with financial language or concepts may make it hard for them to judge what they are agreeing to.

Of course, this problem arises in markets all the time. When consumers purchase automobiles, those who cannot calculate present values of cashflows (when comparing various financing alternatives) may be duped into paying more for a car. And when renting a car, less savvy consumers may pay more than they should for gasoline or collision insurance. In a market economy, we rely on the time-honored common law principle of *caveat emptor* because on balance we believe that market solutions are better than Government planning, and markets cannot function if those who make choices in markets are able to reverse those choices after the fact whenever they please.

But consumer advocates rightly point out that, given the importance of the mortgage decision, a misstep by an uninformed or mentally incapacitated consumer in the mortgage market can be a life changing disaster. That concern explains why well-intentioned would-be reformers have turned their attentions to proposals to regulate mortgage products. But those proposed remedies often are excessive. Reformers advocate what amount to price controls, and prohibitions of contractual features that they deem to be onerous or unnecessary.

Some of these advocates of reform, however, seem to lack a basic understanding of the functioning of financial markets and the pricing of financial instruments. In their zeal to save borrowers from harming themselves they run the risk of causing more harm to borrowers than predatory lenders.

Other reformers seem to understand that their proposals will reduce the availability of subprime credit to the general population, but they do not care. Indeed, one gets the impression that some paternalistic community groups dislike subprime lending and feel entitled to place limits on the decisionmaking authority even of mentally competent individuals. Other critics of predatory lending may have more

sinister motives related to the kickbacks they receive for contractually agreeing to stop criticizing particular subprime lenders.

Whatever the motives of these advocates, it is easy to show that many of the extreme proposals for changing the regulation of the subprime mortgage market are misguided and would harm many consumers by limiting their access to credit on the most favorable terms available. There are better ways to target the legitimate problems of abuse.

Evaluating Proposed Reforms

Let me now turn to an analysis of each of the proposed remedies for predatory lending, which I divide into three groups: (1) those that are sensible and that should be enacted by Fed regulation, (2) those that are possibly sensible, but which might do more harm than good, and thus require more empirical study before deciding whether and how to implement them, and (3) those that are not sensible, and which would obviously do more harm than good.

SENSIBLE REFORMS THAT SHOULD BE IMPLEMENTED IMMEDIATELY BY THE FED

Under HOEPA, the Fed is entitled to regulate subprime mortgages that either have interest rates far in excess of Treasury rates (the Fed currently uses a 10 percent spread trigger, but can vary that spread between 8 percent and 12 percent) or that have total fees and points greater than either 8 percent or $451. HOEPA already specifies some contractual limits on these loans (for example, prepayment penalties are only permissible for the first 5 years of the loan, and only when the borrowers' income is greater than 50 percent of the loan payment). It is my understanding that the Fed currently has broad authority to establish additional regulatory guidelines for these loans, and is currently considering a variety of measures. Following is a list of measures that I regard as desirable.

Disclosure and Counseling

Disclosure requirements always add to consumers' loan costs, but in my judgment, some additional disclosure requirements would be appropriate for the loans regulated under HOEPA. I would recommend a mandatory disclosure statement like the one proposed in section 3(a) of Senate bill S. 2415 (April 12, 2000), which alerts borrowers to the risks of subprime mortgage borrowing. It is also desirable to make counseling available to potential borrowers on HOEPA loans, and to require lenders to disclose that such counseling is available (as proposed in the HUD-Treasury report). The HUD-Treasury report also recommends amendments to RESPA and TILA that would facilitate comparison shopping and make timely information about the costs of credit and settlement easier for consumers to understand and more reliable. I also favor the HUD-Treasury suggestions of imposing an accuracy standard on permissible violations from the Good Faith Estimate required under RESPA, requiring lenders to disclose credit scores to borrowers (I note that these scores have since been made available by Fair Isaac Co. to borrowers via the Internet), and expanding penalties on lenders for inadequate or inaccurate disclosures. The use of "testers" to verify disclosure practices would likely prove very effective as an enforcement tool to ensure that lenders do not target some classes of individuals with inadequate disclosure. I also agree with the suggested requirement that lenders notify borrowers of their intent to foreclose far enough in advance that borrowers have the opportunity to arrange alternative financing (a feature of the new Pennsylvania statute) as a means of discouraging unnecessary foreclosure. Finally, I would recommend that, for HOEPA loans where borrowers' monthly payments exceed 50 percent of their monthly income, the lender should be required to make an additional disclosure that informs the borrower of the estimated high probability (using a recognized model, like that of Fair Isaac Co.) that the borrower may lose his or her home because of inadequate ability to pay debt service.

Credit History Reporting

It is alleged that some lenders withhold favorable information about customers in order to keep information about improvements in customer creditworthiness private, and thus limit competition. It is appropriate to require lenders not to selectively report information to credit bureaus.

Single-Premium Insurance

Roughly one in four households do not have any life insurance, according to Household (2001). Clearly, credit insurance can be of enormous value to subprime borrowers, and single-premium insurance can be a desirable means for reducing the risk of losing one's home at low cost. To prevent abuse of this product, there should be a mandatory requirement that lenders that offer single-premium insurance (1) must give borrowers a choice between single-premium and monthly premium credit

insurance, (2) must clearly disclose that credit insurance is optional and that the other terms of the mortgage are not related to whether the borrower chooses credit insurance, and (3) must allow borrowers to cancel their single-premium insurance and receive a full refund of the payment within a reasonable time after closing (say, within 30 days, as in the Pennsylvania statute).

Limits on Flipping

Several new laws and proposals, including a proposed rule by the Federal Reserve Board, would limit refinancing to address the problem of loan flipping. The Fed rule would prohibit refinancing of a HOEPA loan by the lender or its affiliate within the first 12 months unless that refinancing is "in the borrower's interest." This is a reasonable idea so long as there is a clear and reasonable safe harbor in the rule for lenders that establishes criteria under which it will be presumed that the refinancing was in the borrower's interest. For example, if a refinancing either (a) provides substantial new money or debt consolidation, (b) reduces monthly payments by a minimum amount, or (c) reduces the duration of the loan, then any one of those features should protect the lender from any claim that the refinancing was not in the borrower's interest.

Limits on Refinancing of Subsidized Government or Not-for-Profit Loans

It has been alleged that some lenders have tricked borrowers into refinancing heavily subsidized Government or not-for-profit loans at market (or above market) rates. Lenders that refinance such loans should face very strict tests for demonstrating that the refinancing was in the interest of the borrower.

Prohibition of Some Contractual Features

Some mortgage structures add little real value to the menu of consumers' options, and are especially prone to abuse. In my judgment, the Federal Reserve Board has properly identified payable-on-demand clauses or call provisions as an example of such contractual features that should be prohibited.

Require Lenders To Offer Loans With and Without Prepayment Penalties

Rather than regulate prepayment penalties further as some have proposed, I would recommend requiring that HOEPA lenders offer mortgages both with and without prepayment penalties, so that the price of the prepayment option would be clear to consumers. Then consumers could make an informed decision whether to pay for the option to prepay.

PROPOSALS THAT REQUIRE FURTHER STUDY

In addition to the aforementioned reforms, many other potentially beneficial, but also potentially costly, reforms have been proposed and should be studied to determine whether they are necessary over and above the reforms listed above, and whether on balance they would do more good than harm. The list of potentially beneficial reforms that are worthy of careful scrutiny includes:

(1) A limit on balloons (for example, requiring a minimum of a certain period of time between origination and the balloon payment) is worth exploring—although many of the proposed limits on balloons do not seem reasonable; for example both the Pennsylvania statute's 10 year limit and the HUD-Treasury report's proposed 15 year limit, seem to me far too long; but shorter-term limits on balloons (say, a 3 or 5 year minimum duration) may be desirable.

(2) The establishment of new rules on mortgage brokers' behavior (as proposed in the HUD-Treasury report) may be worthwhile, as a means of ensuring that mortgage brokerage is not employed to circumvent effective compliance; and

(3) It may be desirable, as the Fed has proposed, to lower the HOEPA interest rate threshold from 10 percent to 8 percent. The main drawback of lowering the trigger point for HOEPA, which has been noted by researchers at the Fed, and by Robert Litan, is the potential chilling effect that reporting requirements may have on the supply of credit in the subprime market. (I note in passing that I do not agree with the proposal to include all fees into the HOEPA fee trigger; fees that are optional, and not conditions for granting the mortgage—like credit insurance—should be excluded from the calculation.)

PROPOSALS THAT SHOULD BE REJECTED

Usury Laws

Under the rubric of bad ideas, I will focus on one in particular: price controls. It is a matter of elementary economics that limits on prices restrict supply. Among the ideas that should be rejected out of hand are proposals to impose Government price controls—on interest rates, points, and fees—for subprime mortgages.

Because of legal limits on local authorities to impose usury ceilings (due to Federal preemption) States and municipalities intent on discouraging high-cost mortgage lending have pursued an alternative "stealth" approach to usury laws. The technique is to impose unworkable risks on subprime lenders that charge rates or fees in excess of Government specified levels and thereby drive high-interest rate lenders from the market.

Additionally, some price control proposals are put forward by community groups like ACORN in the form of "suggested" voluntary agreements between community groups and lenders.

Several cities and States have passed, or are currently debating, stealth usury laws for subprime lending. For example, the city of Dayton, Ohio this month passed a draconian antipredatory lending law. This law places lenders at risk if they make high-interest loans that are "less favorable to the borrower than could otherwise have been obtained in similar transactions by like consumers within the City of Dayton," and lenders may not charge fees and/or costs that "exceed the fees and/or costs available in similar transactions by like consumers in the City of Dayton by more than 20 percent."

In my opinion, it would be imprudent for a lender to make a loan in Dayton governed by this statute. Indeed, I believe that the statute's intent must be to eliminate high-interest loans, which is why I describe it as a stealth usury law. Immediately upon the passage of the Dayton law, Bank One announced that it was withdrawing from origination of loans that were subject to the statute. No doubt others will exit, as well.

The recent 131 page antipredatory lending law passed in the District of Columbia is similarly unworkable. Lenders are subject to substantial penalties if they are deemed to have lent at an interest rate "substantially greater than the home borrower otherwise would have qualified for, at that lender or at another lender, had the lender based the annual percentage rate upon the home borrowers' credit scores as provided by nationally recognized credit reporting agencies," or if loan costs are "unconscionable," or if loan discount points are "not reasonably consistent with established industry customs and practices."

The District law is fundamentally flawed in several respects. First, it essentially requires lenders to charge no more than the rate indicated by the customer's credit score. That is an improper use of credit scores. Credit scores are not perfect indicators of risk; they are used as one of many—and sometimes not the primary—means of judging whether and on what terms to make a loan. Second, the DC law places the ridiculous burden on the lender of making sure, prior to lending, that his customer could not find a better deal from his competitors. Finally, the vague wording makes the legal risks of subprime lending so great that no banker would want to engage in it.

As Donald Lampe points out, massive withdrawal from the subprime lending market occurred in response to the overly zealous initiative against predatory lending by the State of North Carolina. To quote from Lampe's (2001) summary of the North Carolina experience:

> "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." (p. 4)

Michael Staten of the Credit Research Center of Georgetown University has compiled a new database on subprime lending that permits one to track the chilling effect of the North Carolina law on subprime lending in the State. The sample coverage of the database nationwide includes 39 percent of all subprime mortgage loans made by HMDA-reporting institutions in 1998.

Staten's statistical research (reproduced with permission in an appendix to this testimony) compares changes in mortgage originations in North Carolina with those in South Carolina and Virginia, before and after the passage of the North Carolina law (which was passed in July 1999 and phased in through early 2000). South Carolina and Virginia are included in these tables as controls to allow for changes over time in mortgage originations in the Upper South that were not specific to North Carolina.

As shown in the appendix, Staten finds that originations of subprime mortgage loans (especially first-lien loans) in North Carolina plummeted after passage of the 1999 law, both absolutely and relatively to its neighbors, and that the decline was almost exclusively in the supply of loans available to low- and moderate-income borrowers (those most dependent on high-cost credit). For borrowers in the low-income group (with annual incomes less than $25,000) originations were cut in half; for those in the next income class (with annual incomes between $25,000 and $49,000)

originations were cut by roughly a third. The response to the North Carolina law provides clear evidence of the chilling effect of antipredatory laws on the supply of subprime mortgage loans to low-income borrowers.

Robert Litan (2001) had anticipated this result. He wrote that:

> ". . . statutory measures at the State and local level at this point run a significant risk of unintentionally cutting off the flow of funds to creditworthy borrowers. This is a very real threat and one that should be seriously considered by policymakers at all levels of government, especially in light of the multiple, successful efforts that Federal law in particular has made to increase lending in recent years to minorities and low-income borrowers.
>
> "The more prudent course is for policymakers at all levels of government to wait for more data to be collected and reported by the Federal Reserve so that enforcement officials can better target practices that may be unlawful under existing statutes. In the meantime, Congress should provide the Federal agencies charged with enforcing existing statutes with sufficient resources to carry out their mandates, as well as to support ongoing counseling efforts to educate vulnerable consumers about the alternatives open to them in the credit market and the dangers of signing mortgages with unduly onerous terms." (p. 2)

The history of the last two decades teaches that usury laws are highly counterproductive. Limits on the ability of States to regulate consumer lenders headquartered outside their State were undermined by the 1978 Marquette National Bank case (see DeMuth, 1986). In 1982, the Federal Government further expanded consumers' access to credit by preempting State restrictions on mortgage lending by mortgage lenders headquartered within the State (the Alternative Mortgage Transaction Parity Act of 1982).

These measures were crucial contributors to the democratization of consumer finance, and particularly, mortgage finance in recent years. The Marquette case opened a flood of competition in credit card lending, which led the way to establishing a deep market in consumer credit receivables and the new techniques for credit scoring—innovations which have increased the supply and reduced the cost of consumer credit.

The 1982 Parity Act expanded the range of competition in consumer mortgage finance preempting State prohibitions on alternative mortgages originated by both depository and nondepository institutions. In particular, as I understand this law, it effectively preempts State usury laws as applied to subprime mortgages. Because mortgage lending relies on real estate as security, it can be provided more inexpensively than credit card loans or other unsecured consumer credit (Calomiris and Mason, 1998). Thus the 1982 Act provided an important benefit to consumers over and above the beneficial undermining of State usury laws after the Marquette case.

But the new stealth usury laws of North Carolina, Dayton, and Washington DC, and similar proposals elsewhere, pose a new threat. If Congress fails to restore the preemption principle in the subprime mortgage market established in 1982, then lenders will be driven out of the high-risk end of the market, and therefore, many consumers will be driven out of the mortgage market and into higher-cost, less desirable credit markets (credit cards, pawn shops, and worse).

That is not progress. Congress should do everything in its power to amend the Parity Act to clearly define stealth usury laws as usury laws, not consumer protection laws, and thus prevent any further damage to individuals' access to credit from these pernicious State and city initiatives.

Other Prohibitions

I have already argued against further regulatory or statutory limits on prepayment penalties, or prohibition of single-premium credit insurance, in favor of alternative approaches to the abuses that sometimes accompany these features.

I am also opposed to the many proposals that would prevent borrowers from agreeing to mandatory binding arbitration to resolve loan disputes. Individuals should be able to choose. If an individual wishes to commit to binding arbitration, that commitment reduces the costs to lenders of originating mortgages, and in the competitive mortgage market, that cost is passed on to consumers. Requiring consumers not to commit to binding arbitration is only good for America's trial lawyers.

Conclusion

For the most part, predatory lending practices can be addressed by focusing efforts on better enforcing laws against fraud, improving disclosure rules, offering Government-financed counseling, and placing a few well thought out limits on credit

industry practices. The Fed already has the authority and the expertise to formulate those rules and is in the process of doing so, based on a new data collection effort that will permit an informed and balanced approach to regulating subprime lending.

The main role of Congress, in my view, should be to monitor the Fed's rulemaking as it evolves, make sure that the Fed has the statutory authority that it needs to set appropriate regulations, and amend the 1982 Parity Act to reestablish Federal preemption and thus defend consumers against the ill-conceived usury laws that are now spreading throughout the country.

Members of Congress, and especially Members of this Committee, also should speak out in defense of honest subprime lenders, of which there are many. The possible passage of State and city usury statutes is not the only threat to the supply of subprime loans. There is also the possibility that bad publicity, orchestrated by community groups, itself could force some lenders to exit the market.

Some community organizations have been waging a smear campaign against subprime lenders. To the extent that zealous community groups, whether out of noble or selfish intent, succeed in smearing subprime lenders as a group, the public relations consequences will have a chilling effect on the supply of subprime credit. The first casualty will be the truth. The second casualty will be access to credit for the poor.

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Appendix To

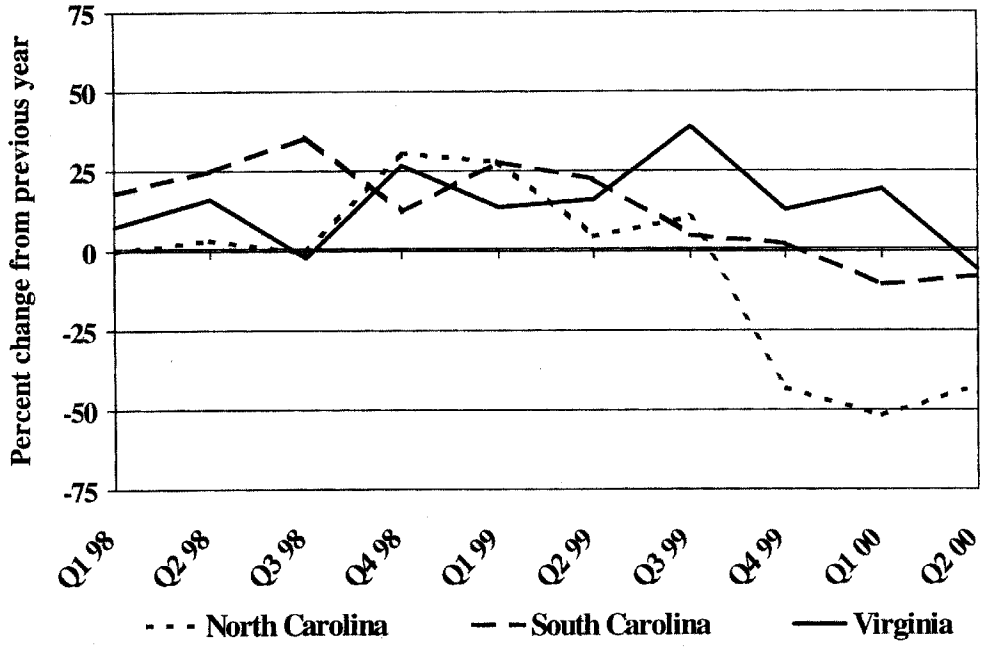
What To Do, and What Not To Do, About 'Predatory Lending'

Statement of Charles W. Calomiris

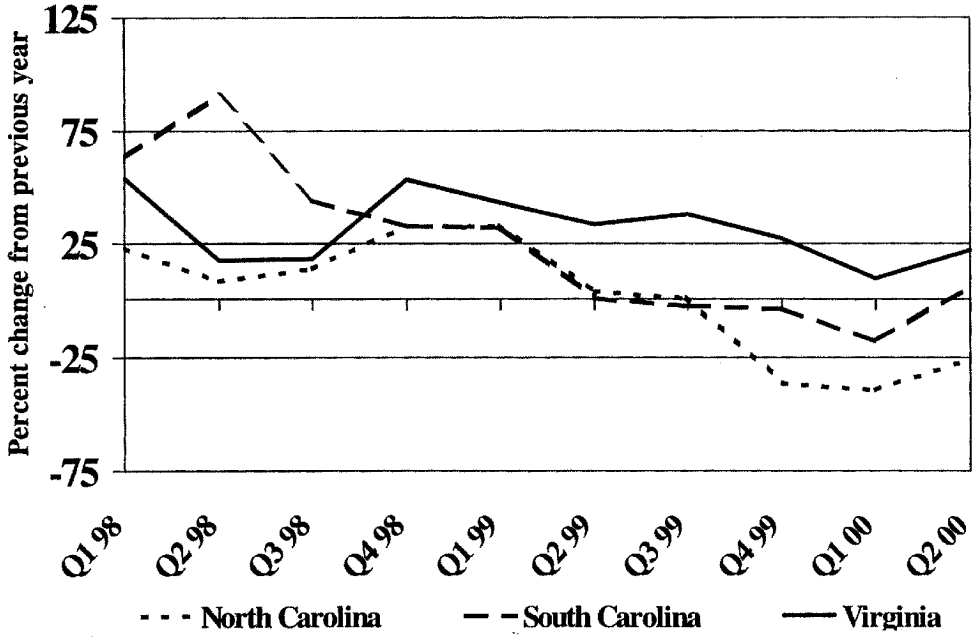
Before the Senate Banking Committee

July 26, 2001

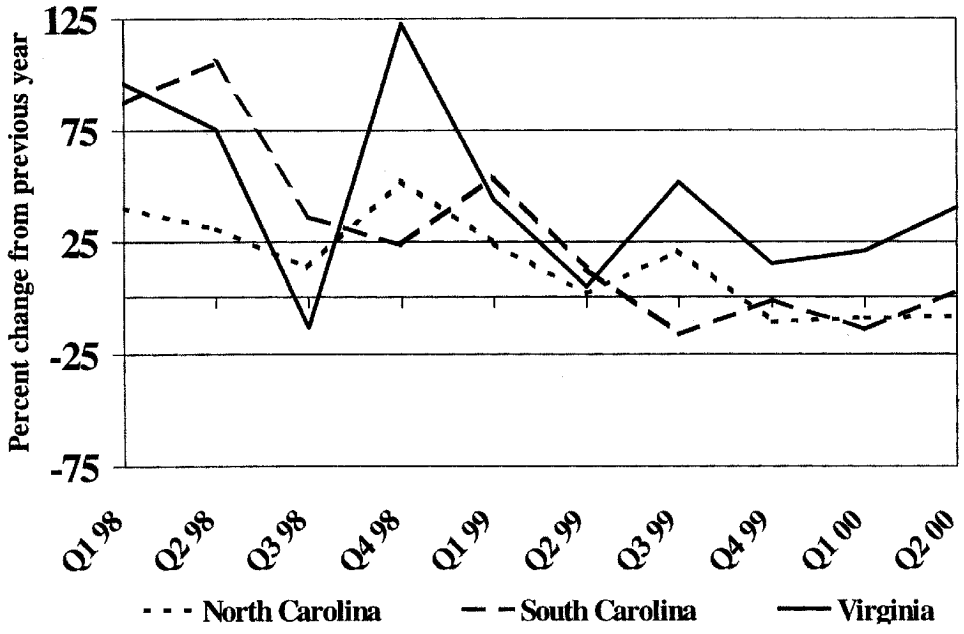
Year-over-Year Change in Originated Loans
First Liens: Borrower Income < $25,000



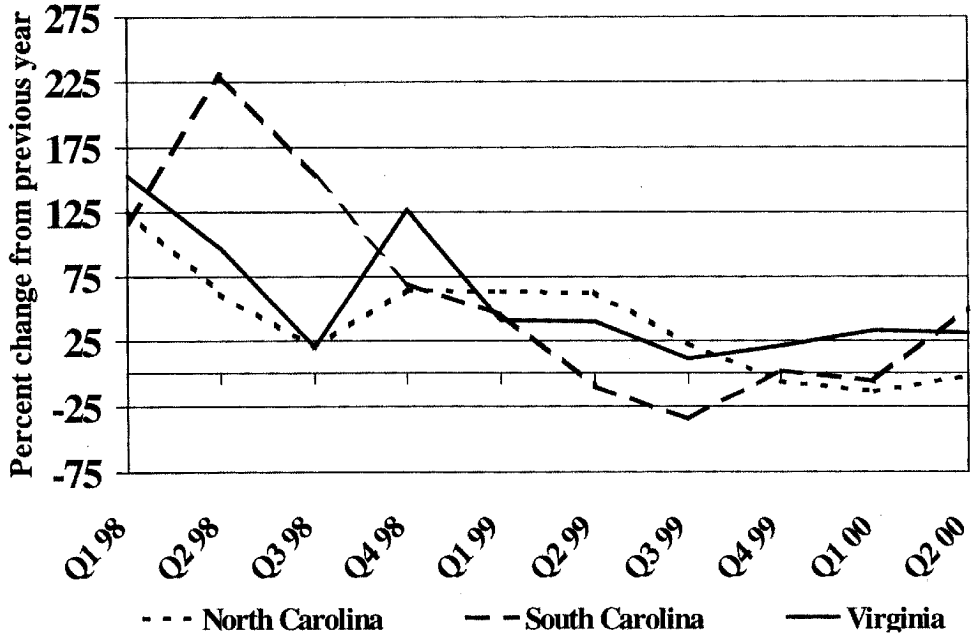
Year-over-Year Change in Originated Loans
First Liens: Borrower Income $25,000-$49,999



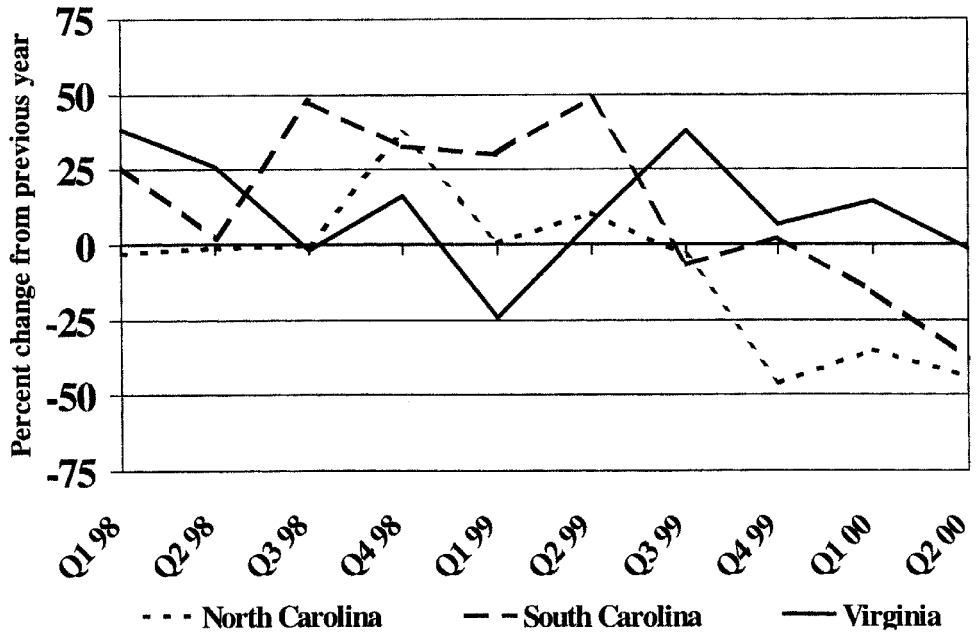
Year-over-Year Change in Originated Loans
First Liens: Borrower Income $50,000-$74,999



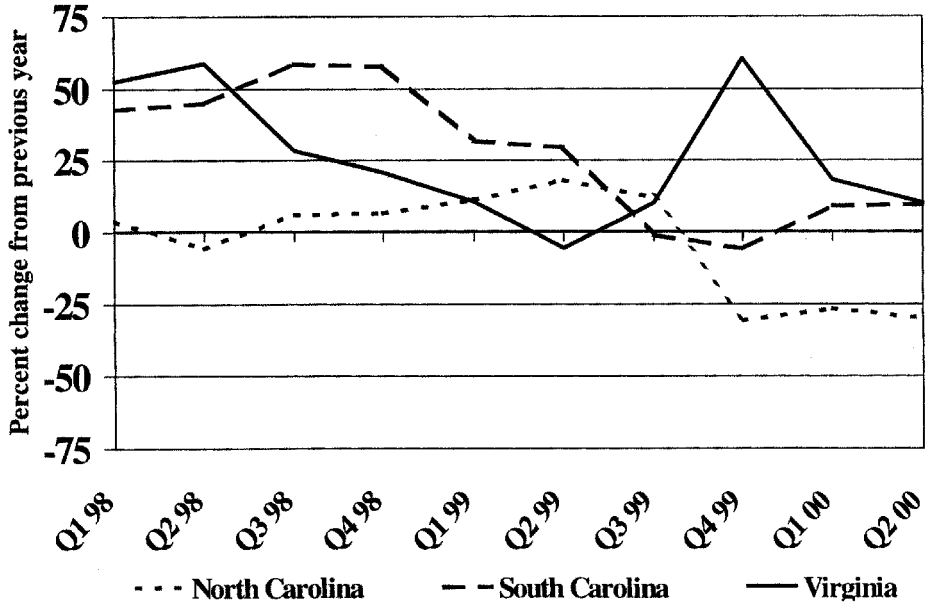
Year-over-Year Change in Originated Loans
First Liens: Borrower Income $75,000 or more



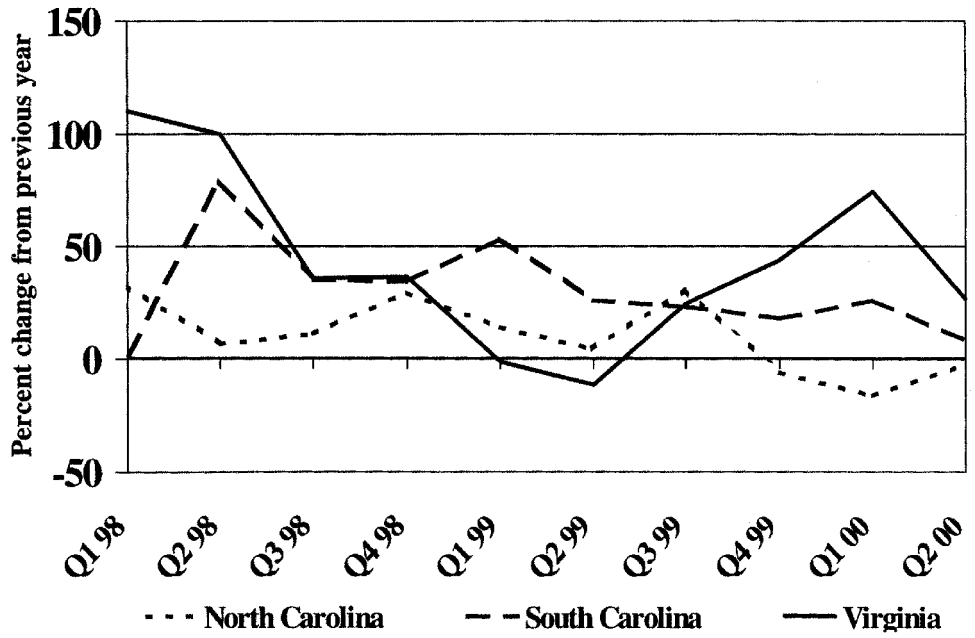
Year-over-Year Change in Originated Loans
Second Liens: Borrower Income < $25,000



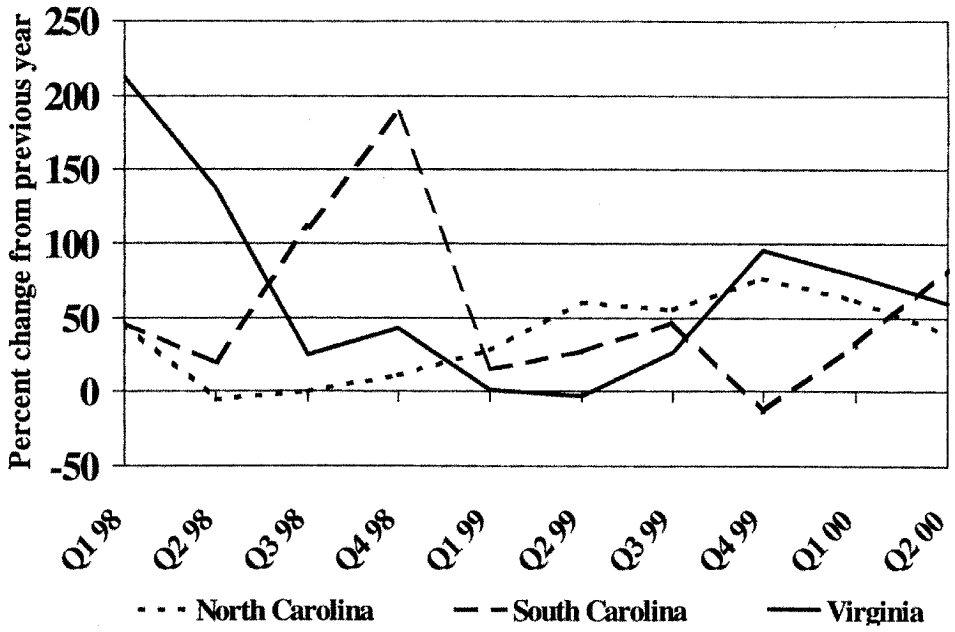
Year-over-Year Change in Originated Loans
Second Liens: Borrower Income $25,000-$49,999



Year-over-Year Change in Originated Loans
Second Liens: Borrower Income $50,000-$74,999



Year-over-Year Change in Originated Loans
Second Liens: Borrower Income $75,000 or more



American Enterprise Institute for Public Policy Research

July 27, 2001

The Honorable Paul Sarbanes
Chairman, Senate Banking Committee
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Sarbanes:

I am writing to correct an error of fact in my recent testimony before the Senate Banking Committee on predatory lending, to explain what revisions have been made in my testimony as a consequence of recognizing that error, and to ask your help in correcting the record.

In the discussion of single-premium credit insurance, I argued that the present value cost of single-premium insurance was lower than that of monthly insurance. That argument was based on my misinterpretation of the quotes I had received from Assurant Group. I want to emphasize that this was my error. I certainly do not believe that the miscommunication between Assurant and me was the result of any willful attempt on their part to mislead me. When they told me that the amortized monthly payment for a five-year mortgage insurance policy was $22 per month I believed that they meant it was amortized over five years. In fact, as you correctly guessed in your comment on my testimony, the cost figure they quoted me is paid over 30 years even though the coverage lasts only five years.

As a result of further discussions I had with several people at Assurant and elsewhere after testifying, I have altered several aspects of my testimony on the question of regulating single-premium insurance. The thrust of my recommendation remains the same – **regulate**, but do not prohibit, single-premium insurance. If properly regulated, this product may have a useful place in the industry. I know that many critics see its use as prima facie evidence of dishonesty by lenders. It is possible, however, that part of its current attraction, in spite of its high relative price, reflects the regulation of the pricing of monthly insurance. Defenders of single-premium insurance argue that the regulated price of monthly insurance is set too low, and thus only single-premium insurance is readily available for all borrowers. Thus, they argue, despite its relatively higher price, it is effectively the only game in town (this is a claim I have heard, but I have not been able to investigate this assertion). I also point out, as before, that some consumers might prefer single-premium insurance, if given a fair choice between a competitively priced version of monthly and single-premium products.

I have also altered my recommendations for regulating single-premium insurance (in section 3). I removed one recommendation and added one. Specifically, I removed the recommendation that lenders should have to offer both products. If, as some claim, monthly insurance is not profitable to offer under current regulation, it would be wrong to require lenders to offer it. I have added the recommendation that the monthly cost of single-premium should include **full amortization of principal** over the period of insurance coverage (that is, over five years rather than 30 years). That, along with the other proposed regulations, would ensure that only consumers with a real desire for the product would end up buying it.

I have also made some minor alterations elsewhere in my formal testimony, to make a few points a little clearer in the discussion of default risk on subprime mortgages, in response to comments from one of today's panelists.

I hope we can amend the record of the discussion between Mr. Eakes and myself on single-premium insurance to avoid confusion about which insurance product is cheapest under current market pricing. I am not sure what is permissible under Senate rules. My preference would be to strike the mistaken part of the testimony from the record (after discussing the matter with Mr. Eakes, of course, since that would also require striking our disagreement over the issue). I think this approach best because it will avoid confusing readers. I also think it would be appropriate to include this letter in the record, if you are willing to do so.

I will also be sending a letter to Mr. Eakes, and to the other panelists, to inform them of these changes.

My apologies for the error.

Sincerely,

Charlie

Charles W. Calomiris

Cc: Hon. Phil Gramm

REVISED PREPARED STATEMENT OF CHARLES W. CALOMIRIS

PAUL M. MONTRONE PROFESSOR OF FINANCE AND ECONOMICS
GRADUATE SCHOOL OF BUSINESS, COLUMBIA UNIVERSITY, NEW YORK, NEW YORK

JULY 27, 2001

Mr. Chairman, it is a pleasure and an honor to address you today on the important topic of predatory lending.

Predatory lending is a real problem. It is, however, a problem that needs to be addressed thoughtfully and deliberately, with a hard head as well as a soft heart. There is no doubt that people have been hurt by the predatory practices of some creditors, but we must make sure that the cure is not worse than the disease. Unfortunately, many of the proposed or enacted municipal, State, and Federal statutory responses to predatory lending would have adverse consequences that are worse than the problems they seek to redress. Many of these initiatives would reduce the supply of credit to low-income homeowners, raise their cost of credit, and restrict the menu of beneficial choices available to borrowers.

Fortunately, there is a growing consensus in favor of a balanced approach to the problem. That consensus is reflected in the viewpoints expressed by a wide variety of individuals and organizations, including Robert Litan of the Brookings Institution, Fed Governor Edward Gramlich, most of the recommendations of last year's HUD-Treasury Report, the voluntary standards set by the American Financial Services Association (AFSA), the recent predatory lending statute passed by the State of Pennsylvania, and the recommendations and practices of many subprime mortgage lenders (including, most notably, Household). In my comments, I will describe and defend that balanced approach, and offer some specific recommendations for Congress and for financial regulators.

To summarize my recommendations at the outset, I believe that an appropriate response to predatory practices should occur in two stages: First, there should be an immediate regulatory response to strengthen enforcement of existing laws, enhance disclosure rules and provide counseling services, amend existing regulation, and limit or ban some practices. I believe that these initiatives, described in detail below, will address all of the serious problems associated with predatory lending.

In other areas—especially the regulation of prepayment penalties and balloon payments—any regulatory change should await a better understanding of the extent of remaining predatory problems that result from these features, and the best ways to address them through appropriate regulations. The Fed is currently pursuing the first systematic scientific evaluation of these areas, as part of its clear intent to expand its role as the primary regulator of subprime lending, given its authority under HOEPA. The Fed has the regulatory authority and the expertise necessary to find the right balance between preventing abuse and permitting beneficial contractual flexibility.

Congress, and other legislative bodies, should not rush to judgment ahead of the facts and before the Fed has had a chance to address these more complex problems, and in so doing, end up throwing away the proverbial baby of subprime lending along with the bathwater of predatory practices.

I think the main role Congress should play at this time is to rein in actions by States and municipalities that seek to avoid established Federal preemption by effectively setting mortgage usury ceilings under the guise of consumer protection rules. Immediate Congressional action to dismantle these new undesirable barriers to individuals' access to mortgage credit would ensure that consumers throughout the country retain their basic contractual rights to borrow in the subprime market.

My detailed comments divide into four parts: (1) a background discussion of subprime lending, (2) an attempt to define predatory practices, (3) a point-by-point evaluation of proposed or enacted remedies for predatory practices, and (4) a concluding section.

Subprime Lending, the Democratization of Finance, and Financial Innovation

The problems that fall under the rubric of predatory lending are only possible today because of the beneficial "democratization" of consumer credit markets, and mortgage markets in particular, that has occurred over the past decade. Predatory practices are part and parcel of the increasing complexity of mortgage contracts in the high-risk (subprime) mortgage area. That greater contractual complexity has two parts: (1) the increased reliance on risk pricing using Fair Isaac Co. (FICO) scores rather than the rationing of credit via yes or no lending decisions, and (2) the use of points, insurance, and prepayment penalties to limit the risks lenders and borrowers bear and the costs borrowers pay.

These practices make economic sense and can bring great benefits to consumers. Most importantly, these market innovations allow mortgage lenders to gauge, price, and control risk better than before, and thus allow them to tolerate greater gradations of risk among borrowers.

According to last year's HUD-Treasury report, subprime mortgage originations have skyrocketed since the early 1990's, increasing by tenfold since 1993. The dollar volume of subprime mortgages was less than 5 percent of all mortgage originations in 1994, but by 1998 had risen to 12.5 percent. As Fed Governor Edward Gramlich (2000) has noted, between 1993 and 1998, mortgages extended to Hispanic-Americans and African-Americans increased the most, by 78 and 95 percent, respectively, largely due to the growth in subprime mortgage lending.

Subprime loans are extended primarily by nondepository institutions. The new market in consumer credit, and subprime credit in particular, is highly competitive and involves a wide range of intermediaries. Research by economists at the Federal Reserve Board indicates that the reliance on nondepository intermediaries reflects a greater tolerance for lending risk by intermediaries that do not have to subject their loan portfolios to examination by Government supervisors (Carey et al. 1998).

Subprime lending is risky. The reason that so many low-income and minority borrowers rely on the subprime market is that, on average, these are riskier groups of borrowers. It is worth bearing in mind that default risk varies tremendously in the mortgage market. According to Frank Raiter of Standard & Poor's, the probability of default (over the lifetime of the mortgage, which is typically 3 to 5 years) for the highest risk class of subprime mortgage borrowers is roughly 23 percent, which is *more than one thousand times* the default risk of the lowest risk class of prime mortgage borrowers. There is variation in default risk within the highest risk class, as well, so that some subprime mortgages have even higher risk of default.

When default risk is this great, in order for lenders to participate in the market, they must be compensated with unusually high interest rates. Consider an extreme case. For example, even if a lender were risk-neutral (indifferent to the variance of payoffs from a bundle of loans) a lender bearing a 20 percent risk of default (on average, in each year of the mortgage), and expecting to lose 50 percent on a foreclosed loan (net of foreclosure costs) should charge at least the relevant Treasury rate (given the maturity of the loan) plus 10 percent. On second-trust mortgages, loan losses may be as high as 100 percent. In that case, the risk-neutral default premium would be 20 percent. Added to these risk-neutral premia would be a risk premium to compensate for the high variance of returns on risky loans (to the extent that default risk is nondiversifiable), as well as premia to pay for the costs of gathering information about borrowers, and the costs of maintaining lending facilities and staff. These premia would be charged either in the form of higher interest rates or the present value equivalent of points paid in advance.

Default risk, however, is not the only risk that lenders bear. Indeed, prepayment risk is of a similar order of magnitude in the mortgage market. To understand prepayment risk, consider a 15 year amortized subprime mortgage loan of $50,000 with a 10 percent interest rate over the Treasury rate, zero points and no prepayment penalty. If the Treasury rate falls, say by 1 percent, assume that the borrower will choose to refinance the mortgage without penalty, and assume that this decline in the Treasury rate actually happens 1 year after the mortgage is originated.

If the interest rate on the mortgage was set with the expectation that the loan would last for 15 years, and if the cost of originating and servicing the loan was spread over that length of time, then the prepayment of the loan will result in a loss to the lender. An additional loss to the lender results from the reduction in the value of its net worth as the result of losing the revenue from the mortgage when it is prepaid (if the lender's cost of funds does not decline by the same degree as its return on assets after the prepayment).

In the competitive mortgage market, lenders will have to protect against this loss in one of several ways: First, lenders could charge a prepayment fee to discourage prepayment, and thus limit the losses that prepayment would entail. Second, the lender could "frontload" the cost of the mortgage by charging points and reducing the interest rate on the loan. This is a commitment device that reduces the incentive of the borrower to refinance when interest rates fall, since the cost of a new mortgage (points and interest) would have to compete against a lower annual interest cost from the original loan. A third possibility would be avoiding prepayment penalties and points and simply charging a higher interest rate on the mortgage to compensate for prepayment risk.

In a competitive mortgage market, the present value of the cost to the borrower of these three alternatives is equivalent. If all three alternatives were available, each borrower would decide which of these three alternatives was most desirable, based on the borrower's risk preferences.

The first two alternatives amount to the decision to lock in a lower cost of funds rather than begin with a higher cost of funds and hope that the cost will decline as the result of prepayment. In essence, the first two choices amount to buying an insurance policy compared to the third, where the borrower instead prefers to retain the option to prepay (effectively "betting" that interest rates will fall).

If regulation were to limit prepayment penalties, by this logic, those wishing to lock in low mortgage costs would choose a mortgage that frontloads costs through points as an alternative to choosing a mortgage with a prepayment penalty.

Loan maturity is another important choice for the borrower. The borrower who wishes to "bet" on declining interest rates can avoid much of the cost of the third alternative mentioned above (that is, paying the prepayment risk premium) by keeping the mortgage maturity short-term (for example, by agreeing to a balloon payment of principal in, say, 3 years). Doing so can substantially reduce the annual cost of the mortgage.

In the subprime market, where borrowers' creditworthiness is also highly subject to change, prepayment risk results from improvements in borrower riskiness as well as changes in U.S. Treasury interest rates. The choice of either points, prepayment penalties, or neither amounts to choosing, as before, whether to lock in a lower overall cost of mortgage finance rather than betting on the possibility of an improvement. Similarly, retaining a prepayment option, or choosing a balloon mortgage, allows the individual to "bet" on an improvement in his creditworthiness.

Borrowers in the subprime market are subject to significant risk that they could lose their homes as the result of death, disability, or job loss of the household's breadwinner(s), which might make them unable to make their mortgage payments. Some households will want to insure against this eventuality with credit insurance. Credit insurance comes in two main forms: monthly insurance (which is paid as a premium each month), or "single-premium" insurance, which is paid for the life of the mortgage in a single lump sum at the time of origination, and typically is financed as part of the mortgage.

Much has been said and written recently about single-premium, insurance. Single-premium insurance, it is often alleged, is a means unscrupulous lenders employ to trick borrowers into overpaying for coverage. The reason for that claim is that, in present value terms, single-premium insurance is more expensive for borrowers than monthly premium insurance.

For example, using data provided to me by Assurant Group (a major provider of credit insurance to the mortgage market), a typical single-premium policy for a 12 percent APR mortgage would have a monthly payment today of approximately $22 per month for 30 years. That policy provides coverage, however, for only the first 5 years. Its costs are amortized, however, over the entire 30 year period. A comparable 5 year average monthly cost for monthly insurance would be roughly $33, but that higher monthly payment would end after 5 years. Clearly, monthly insurance is much cheaper on a present value basis.

Defenders of single-premium insurance argue that it is sold because insurers are unwilling to supply monthly insurance in many cases because its price (which is regulated at the State level) is set too low to be profitable for issuers. Defenders also argue that single-premium insurance has some benefits that customers appreciate which would make them prefer it, even at current prices, even if both single-premium and monthly insurance were available. The former argument seems to have some merit, although I have not been able to assemble evidence to prove or disprove it. The latter argument I find hard to believe, although I do not have evidence to refute it.

In any case, while I am in favor of regulating single-premium insurance to prevent abuse (as discussed below in section 3), I am not in favor of prohibiting it, for two reasons. First, it may be that, as defenders argue, under current State price controls, it is the only economically feasible alternative. In that case, prohibiting it, without also changing State price limits, would reduce the supply of credit insurance available to consumers.

Second, if it were possible to deregulate the pricing of credit insurance, to allow the market to set prices for both kinds of insurance, and if reasonable objections to current practices of selling credit insurance could be addressed, then some consumers would prefer single-premium coverage over monthly coverage. The reason is that the market price (in present value) of single-premium coverage would probably be lower than that of monthly coverage. Because single-premium insurance commits the borrower to the full length of time of the mortgage (and because there is the possibility that the borrowers' risk of unemployment, death, or disability will decline after origination), if prices were set by a competitive market, single-premium insurance would be less expensive (in present value terms) because buyers of monthly insurance are also purchasing an implicit option. Borrowers who want the option

to be able to cancel their insurance policy (for example, to take advantage of a decline in their risk of unemployment, or upon repaying their mortgage) would prefer monthly insurance and would pay for that valuable option in the form of a higher premium per month on monthly insurance.

So, while I recognize that under current rules, single-premium insurance is priced above monthly insurance, that does not imply that buyers of single-premium insurance have been cheated, or that it should be prohibited. If we can find a way for lenders to offer both kinds of insurance in a way that enhances consumer choice, and avoids defrauding borrowers, theory suggests that this would be desirable.

In short, economists recognize that substantial points, prepayment penalties, short mortgage maturities, and credit insurance have arisen in the subprime market, in large part, because these contractual features offer preferred means of reducing overall costs and risks to consumers. Default and prepayment risks are higher in the subprime market, and therefore, mortgages are more expensive and mortgage contracts are more complex. Clearly, there would be substantial costs borne by many borrowers from limiting the interest rates or overall charges on subprime mortgages, or from prohibiting borrowers from choosing their preferred combination of rates, points, penalties, and insurance. As Fed Governor Edward Gramlich writes:

> ". . . some [predatory lending practices] are more subtle, involving misuse of practices that can improve credit market efficiency most of the time. For example, the freedom for loan rates to rise above former usury ceilings is mostly desirable, in matching relatively risky borrowers with appropriate lenders. . . . Most of the time balloon payments make it possible for young homeowners to buy their first house and match payments with their rising income stream. . . . Most of the time the ability to refinance mortgages permits borrowers to take advantage of lower mortgage rates. . . . Often mortgage credit insurance is desirable. . . ." (Gramlich 2000, p. 2)

Any attempts to regulate the subprime market should take into account the potential costs of regulatory prohibitions. As I will argue in more detail in section 3 below, many new laws and statutory proposals are imbalanced in that they fail to take into account the costs from reducing access to complex, high-cost mortgages.

Predatory Practices

So much for the "baby"; now let me turn to the "bathwater." The use of high and multiple charges, and the many dimensions of mortgage contracts, I have argued, hold great promise for consumers, but with that greater complexity also comes greater opportunity for fraud and for mistakes by consumers who may not fully understand the contractual costs and benefits they are being offered.

That is the essential dilemma. The goal of policy makers should be to define and address predatory practices without undermining the opportunities offered by subprime lending.

According to the HUD-Treasury report, predatory practices in the subprime mortgage market fall into four categories: (1) "loan flipping" (enticing borrowers to refinance excessively, sometimes when it is not in their interest to do so, and charging high refinancing fees that strip borrower home equity), (2) excessive fees and "packing" (charging excessive amounts of fees to borrowers, allegedly because borrowers fail to understand the nature of the charges, or lack knowledge of what would constitute a fair price), (3) lending without regard to the borrower's ability to repay (that is, lending with the intent of forcing a borrower into foreclosure in order to seize the borrower's home), and (4) outright fraud.

It is worth pausing for a moment to note that, with the exception of fraud (which is already illegal) these problems are defined by (often subjective) judgments about the outcomes for borrowers (excessive refinancing, excessive fees, excessive risk of default), not by clearly definable actions by lenders that can be easily prohibited without causing collateral harm in the mortgage market.

For example, with regard to loan flipping, it may not be easy to define in an exhaustive way the combinations of changes to a mortgage contract that make a borrower better off. There are clear cases of purely adverse change (for example, across-the-board increases in rates and fees with no compensating changes in the contract), and there are clear cases of improvement, but there are also gray areas in which a mix of changes occurs, and where a judgment as to whether the position of the borrower has improved or deteriorated depends on an evaluation of the probabilities of future contingencies and a knowledge of borrower preferences.

Similarly, whether fees are excessive can often be very difficult to gauge, since the sizes of the fees vary with the creditworthiness of the borrower and with the intent of the contract. For example, points are often used as a commitment device to limit prepayment risk.

And what is the maximum "acceptable" level of default risk on a mortgage, which would constitute evidence that a mortgage had been unreasonably offered because of the borrower's inability to repay?

Many alleged predatory problems revolve around questions of fair disclosure and fraud prevention. These can be addressed to a great degree by ensuring accurate and complete disclosure of facts (making sure that the borrower is aware of the true APR, and making sure that legally mandated procedures under RESPA, TILA, and HOEPA are followed by the lender). In section 3, I will discuss a variety of proposals for strengthening disclosure rules and protections against fraud.

But the critics of predatory lending argue that inadequate disclosure and outright fraud are not the only ways in which borrowers may be fooled unfairly by lenders. For some elderly people, or people who are mentally incapacitated, predatory lending may simply constitute taking advantage of those who are mentally incapable of representing themselves when signing loan contracts. And for others, lack of familiarity with financial language or concepts may make it hard for them to judge what they are agreeing to.

Of course, this problem arises in markets all the time. When consumers purchase automobiles, those who cannot calculate present values of cashflows (when comparing various financing alternatives) may be duped into paying more for a car. And when renting a car, less savvy consumers may pay more than they should for gasoline or collision insurance. In a market economy, we rely on the time-honored common law principle of *caveat emptor* because on balance we believe that market solutions are better than Government planning, and markets cannot function if those who make choices in markets are able to reverse those choices after the fact whenever they please.

But consumer advocates rightly point out that, given the importance of the mortgage decision, a misstep by an uninformed or mentally incapacitated consumer in the mortgage market can be a life changing disaster. That concern explains why well-intentioned would-be reformers have turned their attentions to proposals to regulate mortgage products. But those proposed remedies often are excessive. Reformers advocate what amount to price controls, and prohibitions of contractual features that they deem to be onerous or unnecessary.

Some of these advocates of reform, however, seem to lack a basic understanding of the functioning of financial markets and the pricing of financial instruments. In their zeal to save borrowers from harming themselves they run the risk of causing more harm to borrowers than predatory lenders.

Other reformers seem to understand that their proposals will reduce the availability of subprime credit to the general population, but they do not care. Indeed, one gets the impression that some paternalistic community groups dislike subprime lending and feel entitled to place limits on the decisionmaking authority even of mentally competent individuals. Other critics of predatory lending may have more sinister motives related to the kickbacks they receive for contractually agreeing to stop criticizing particular subprime lenders.

Whatever the motives of these advocates, it is easy to show that many of the extreme proposals for changing the regulation of the subprime mortgage market are misguided and would harm many consumers by limiting their access to credit on the most favorable terms available. There are better ways to target the legitimate problems of abuse.

Evaluating Proposed Reforms

Let me now turn to an analysis of each of the proposed remedies for predatory lending, which I divide into three groups: (1) those that are sensible and that should be enacted by Fed regulation, (2) those that are possibly sensible, but which might do more harm than good, and thus require more empirical study before deciding whether and how to implement them, and (3) those that are not sensible, and which would obviously do more harm than good.

SENSIBLE REFORMS THAT SHOULD BE IMPLEMENTED IMMEDIATELY BY THE FED

Under HOEPA, the Fed is entitled to regulate subprime mortgages that either have interest rates far in excess of Treasury rates (the Fed currently uses a 10 percent spread trigger, but can vary that spread between 8 percent and 12 percent) or that have total fees and points greater than either 8 percent or $451. HOEPA already specifies some contractual limits on these loans (for example, prepayment penalties are only permissible for the first 5 years of the loan, and only when the borrowers' income is greater than 50 percent of the loan payment). It is my understanding that the Fed currently has broad authority to establish additional regulatory guidelines for these loans, and is currently considering a variety of measures. Following is a list of measures that I regard as desirable.

Disclosure and Counseling

Disclosure requirements always add to consumers' loan costs, but in my judgment, some additional disclosure requirements would be appropriate for the loans regulated under HOEPA. I would recommend a mandatory disclosure statement like the one proposed in section 3(a) of Senate bill 2415 (April 12, 2000), which alerts borrowers to the risks of subprime mortgage borrowing. It is also desirable to make counseling available to potential borrowers on HOEPA loans, and to require lenders to disclose that such counseling is available (as proposed in the HUD-Treasury report). The HUD-Treasury report also recommends reasonable amendments to RESPA and TILA that would facilitate comparison shopping and make timely information about the costs of credit and settlement easier for consumers to understand and more reliable. I also favor the HUD-Treasury suggestions of imposing an accuracy standard on permissible deviations from the Good Faith Estimate required under RESPA, requiring lenders to disclose credit scores to borrowers (I note that these scores have since been made available by Fair Isaac Co. to borrowers via the Internet), and expanding penalties on lenders for inadequate or inaccurate disclosures. The use of "testers" to verify disclosure practices would likely prove very effective as an enforcement tool to ensure that lenders do not target some classes of individuals with inadequate disclosure. I also agree with the suggested requirement that lenders notify borrowers of their intent to foreclose far enough in advance that borrowers have the opportunity to arrange alternative financing (a feature of the new Pennsylvania statute) as a means of discouraging unnecessary foreclosure. Finally, I would recommend that, for HOEPA loans where borrowers' monthly payments exceed 50 percent of their monthly income, the lender should be required to make an additional disclosure that informs the borrower of the estimated high probability (using a recognized model, like that of Fair Isaac Co.) that the borrower may lose his or her home because of inadequate ability to pay debt service.

Credit History Reporting

It is alleged that some lenders withhold favorable information about customers in order to keep information about improvements in customer creditworthiness private, and thus limit competition. It is appropriate to require lenders not to selectively report information to credit bureaus.

Single-Premium Insurance

Roughly one in four households do not have any life insurance, according to the Life and Health Insurance Foundation (1998). Clearly, credit insurance can be of enormous value to subprime borrowers, and single-premium insurance may be, as its defenders claim, a desirable means for reducing the risk of losing one's home at low cost. To prevent abuse of this product, however, there should be a mandatory requirement that lenders that offer single-premium insurance must do three things. (1) Lenders, when computing the equivalent monthly payment on single-premium insurance in their disclosure statement, should be required to fully amortize the cost of the insurance over the period of coverage (typically 5 years) rather than over a 30 year period. That will avoid confusion on the part of borrowers about the effective cost of the insurance product. (2) Lenders should clearly disclose that credit insurance is optional and that the other terms of the mortgage are not related to whether the borrower chooses credit insurance. (3) Lenders should allow borrowers to cancel their single-premium insurance and receive a full refund of the payment within a reasonable time after closing (say, within 30 days, as in the Pennsylvania statute).

Limits on Flipping

Several new laws and proposals, including a proposed rule by the Federal Reserve Board, would limit refinancing to address the problem of loan flipping. The Fed rule would prohibit refinancing of a HOEPA loan by the lender or its affiliate within the first 12 months unless that refinancing is "in the borrower's interest." This is a reasonable idea so long as there is a clear and reasonable safe harbor in the rule for lenders that establishes criteria under which it will be presumed that the refinancing was in the borrower's interest. For example, if a refinancing either (a) provides substantial new money or debt consolidation, (b) reduces monthly payments by a minimum amount, or (c) reduces the duration of the loan, then any one of those features should protect the lender from any claim that the refinancing was not in the borrower's interest.

Limits on Refinancing of Subsidized Government or Not-for-Profit Loans

It has been alleged that some lenders have tricked borrowers into refinancing heavily subsidized Government or not-for-profit loans at market (or above market)

rates. Lenders that refinance such loans should face very strict tests for demonstrating that the refinancing was in the interest of the borrower.

Prohibition of Some Contractual Features

Some mortgage structures add little real value to the menu of consumers' options, and are especially prone to abuse. In my judgment, the Federal Reserve Board has properly identified payable-on-demand clauses or call provisions as an example of such contractual features that should be prohibited.

Require Lenders To Offer Loans With and Without Prepayment Penalties

Rather than regulate prepayment penalties further as some have proposed, I would recommend requiring that HOEPA lenders offer mortgages both with and without prepayment penalties, so that the price of the prepayment option would be clear to consumers. Then consumers could make an informed decision whether to pay for the option to prepay.

PROPOSALS THAT REQUIRE FURTHER STUDY

In addition to the aforementioned reforms, many other potentially beneficial, but also potentially costly, reforms have been proposed and should be studied to determine whether they are necessary over and above the reforms listed above, and whether on balance they would do more good than harm. The list of potentially beneficial reforms that are worthy of careful scrutiny includes:

(1) A limit on balloons (for example, requiring a minimum of a certain period of time between origination and the balloon payment) is worth exploring—although many of the proposed limits on balloons do not seem reasonable; for example both the Pennsylvania statute's 10 year limit and the HUD-Treasury report's proposed 15 year limit, seem to me far too long; but shorter-term limits on balloons (say, a 3 or 5 year minimum duration) may be desirable.

(2) The establishment of new rules on mortgage brokers' behavior (as proposed in the HUD-Treasury report) may be worthwhile, as a means of ensuring that mortgage brokerage is not employed to circumvent effective compliance; and

(3) It may be desirable, as the Fed has proposed, to lower the HOEPA interest rate threshold from 10 percent to 8 percent. The main drawback of lowering the trigger point for HOEPA, which has been noted by researchers at the Fed, and by Robert Litan, is the potential chilling effect that reporting requirements may have on the supply of credit in the subprime market. (I note in passing that I do not agree with the proposal to include all fees into the HOEPA fee trigger; fees that are optional, and not conditions for granting the mortgage—like credit insurance—should be excluded from the calculation.)

PROPOSALS THAT SHOULD BE REJECTED

Usury Laws

Under the rubric of bad ideas, I will focus on one in particular: price controls. It is a matter of elementary economics that limits on prices restrict supply. Among the ideas that should be rejected out of hand are proposals to impose Government price controls—on interest rates, points, and fees—for subprime mortgages.

Because of legal limits on local authorities to impose usury ceilings (due to Federal preemption) States and municipalities intent on discouraging high-cost mortgage lending have pursued an alternative "stealth" approach to usury laws. The technique is to impose unworkable risks on subprime lenders that charge rates or fees in excess of Government specified levels and thereby drive high-interest rate lenders from the market.

Additionally, some price control proposals are put forward by community groups like ACORN in the form of "suggested" voluntary agreements between community groups and lenders.

Several cities and States have passed, or are currently debating, stealth usury laws for subprime lending. For example, the city of Dayton, Ohio this month passed a draconian antipredatory lending law. This law places lenders at risk if they make high-interest loans that are "less favorable to the borrower than could otherwise have been obtained in similar transactions by like consumers within the City of Dayton," and lenders may not charge fees and/or costs that "exceed the fees and/or costs available in similar transactions by like consumers in the City of Dayton by more than 20 percent."

In my opinion, it would be imprudent for a lender to make a loan in Dayton governed by this statute. Indeed, I believe that the statute's intent must be to eliminate high-interest loans, which is why I describe it as a stealth usury law. Immediately upon the passage of the Dayton law, Bank One announced that it was withdrawing

from origination of loans that were subject to the statute. No doubt others will exit, as well.

The recent 131 page antipredatory lending law passed in the District of Columbia is similarly unworkable. Lenders are subject to substantial penalties if they are deemed to have lent at an interest rate "substantially greater than the home borrower otherwise would have qualified for, at that lender or at another lender, had the lender based the annual percentage rate upon the home borrowers' credit scores as provided by nationally recognized credit reporting agencies," or if loan costs are "unconscionable," or if loan discount points are "not reasonably consistent with established industry customs and practices."

The District law is fundamentally flawed in several respects. First, it essentially requires lenders to charge no more than the rate indicated by the customer's credit score. That is an improper use of credit scores. Credit scores are not perfect indicators of risk; they are used as one of many—and sometimes not the primary—means of judging whether and on what terms to make a loan. Second, the DC law places the ridiculous burden on the lender of making sure, prior to lending, that his customer could not find a better deal from his competitors. Finally, the vague wording makes the legal risks of subprime lending so great that no banker would want to engage in it.

As Donald Lampe points out, massive withdrawal from the subprime lending market occurred in response to the overly zealous initiative against predatory lending by the State of North Carolina. To quote from Lampe's (2001) summary of the North Carolina experience:

> "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." (p. 4)

Michael Staten of the Credit Research Center of Georgetown University has compiled a new database on subprime lending that permits one to track the chilling effect of the North Carolina law on subprime lending in the State. The sample coverage of the database nationwide includes 39 percent of all subprime mortgage loans made by HMDA-reporting institutions in 1998.

Staten's statistical research (reproduced with permission in an appendix to this testimony) compares changes in mortgage originations in North Carolina with those in South Carolina and Virginia, before and after the passage of the North Carolina law (which was passed in July 1999 and phased in through early 2000). South Carolina and Virginia are included in these tables as controls to allow for changes over time in mortgage originations in the Upper South that were not specific to North Carolina.

As shown in the appendix, Staten finds that originations of subprime mortgage loans (especially first-lien loans) in North Carolina plummeted after passage of the 1999 law, both absolutely and relatively to its neighbors, and that the decline was almost exclusively in the supply of loans available to low- and moderate-income borrowers (those most dependent on high-cost credit). For borrowers in the low-income group (with annual incomes less than $25,000) originations were cut in half; for those in the next income class (with annual incomes between $25,000 and $49,000) originations were cut by roughly a third. The response to the North Carolina law provides clear evidence of the chilling effect of antipredatory laws on the supply of subprime mortgage loans to low-income borrowers.

Robert Litan (2001) had anticipated this result. He wrote that:

> ". . . statutory measures at the State and local level at this point run a significant risk of unintentionally cutting off the flow of funds to creditworthy borrowers. This is a very real threat and one that should be seriously considered by policymakers at all levels of government, especially in light of the multiple, successful efforts that Federal law in particular has made to increase lending in recent years to minorities and low-income borrowers.
>
> "The more prudent course is for policymakers at all levels of government to wait for more data to be collected and reported by the Federal Reserve so that enforcement officials can better target practices that may be unlawful under existing statutes. In the meantime, Congress should provide the Federal agencies charged with enforcing existing statutes with sufficient resources to carry out their mandates, as well as to support ongoing counseling efforts to educate vulnerable consumers about the alternatives open to them in the credit market and the dangers of signing mortgages with unduly onerous terms." (p. 2)

The history of the last two decades teaches that usury laws are highly counterproductive. Limits on the ability of States to regulate consumer lenders headquartered outside their State were undermined by the 1978 Marquette National Bank case (see DeMuth, 1986). In 1982, the Federal Government further expanded consumers' access to credit by preempting State restrictions on mortgage lending by mortgage lenders headquartered within the State (the Alternative Mortgage Transaction Parity Act of 1982).

These measures were crucial contributors to the democratization of consumer finance, and particularly, mortgage finance in recent years. The Marquette case opened a flood of competition in credit card lending, which led the way to establishing a deep market in consumer credit receivables and the new techniques for credit scoring—innovations which have increased the supply and reduced the cost of consumer credit.

The 1982 Parity Act expanded the range of competition in consumer mortgage finance preempting State prohibitions on alternative mortgages originated by both depository and nondepository institutions. In particular, as I understand this law, it effectively preempts State usury laws as applied to subprime mortgages. Because mortgage lending relies on real estate as security, it can be provided more inexpensively than credit card loans or other unsecured consumer credit (Calomiris and Mason, 1998). Thus the 1982 Act provided an important benefit to consumers over and above the beneficial undermining of State usury laws after the Marquette case.

But the new stealth usury laws of North Carolina, Dayton, and Washington DC, and similar proposals elsewhere, pose a new threat. If Congress fails to restore the preemption principle in the subprime mortgage market established in 1982, then lenders will be driven out of the high-risk end of the market, and therefore, many consumers will be driven out of the mortgage market and into higher-cost, less desirable credit markets (credit cards, pawn shops, and worse).

That is not progress. Congress should do everything in its power to amend the Parity Act to clearly define stealth usury laws as usury laws, not consumer protection laws, and thus prevent any further damage to individuals' access to credit from these pernicious State and city initiatives.

Other Prohibitions

I have already argued against further regulatory or statutory limits on prepayment penalties, or prohibition of single-premium credit insurance, in favor of alternative approaches to the abuses that sometimes accompany these features.

I am also opposed to the many proposals that would prevent borrowers from agreeing to mandatory binding arbitration to resolve loan disputes. Individuals should be able to choose. If an individual wishes to commit to binding arbitration, that commitment reduces the costs to lenders of originating mortgages, and in the competitive mortgage market, that cost saving is passed on to consumers. Requiring consumers not to commit to binding arbitration is only good for America's trial lawyers.

Conclusion

For the most part, predatory lending practices can be addressed by focusing efforts on better enforcing laws against fraud, improving disclosure rules, offering Government-financed counseling, and placing a few well thought out limits on credit industry practices. The Fed already has the authority and the expertise to formulate those rules and is in the process of doing so, based on a new data collection effort that will permit an informed and balanced approach to regulating subprime lending.

The main role of Congress, in my view, should be to monitor the Fed's rulemaking as it evolves, make sure that the Fed has the statutory authority that it needs to set appropriate regulations, and amend the 1982 Parity Act to reestablish Federal preemption and thus defend consumers against the ill-conceived usury laws that are now spreading throughout the country.

Members of Congress, and especially Members of this Committee, also should speak out in defense of honest subprime lenders, of which there are many. The possible passage of State and city usury statutes is not the only threat to the supply of subprime loans. There is also the possibility that bad publicity, orchestrated by community groups, itself could force some lenders to exit the market.

Some community organizations have been waging a smear campaign against subprime lenders. To the extent that zealous community groups, whether out of noble or selfish intent, succeed in smearing subprime lenders as a group, the public relations consequences will have a chilling effect on the supply of subprime credit. The first casualty will be the truth. The second casualty will be access to credit for the poor.

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Appendix To

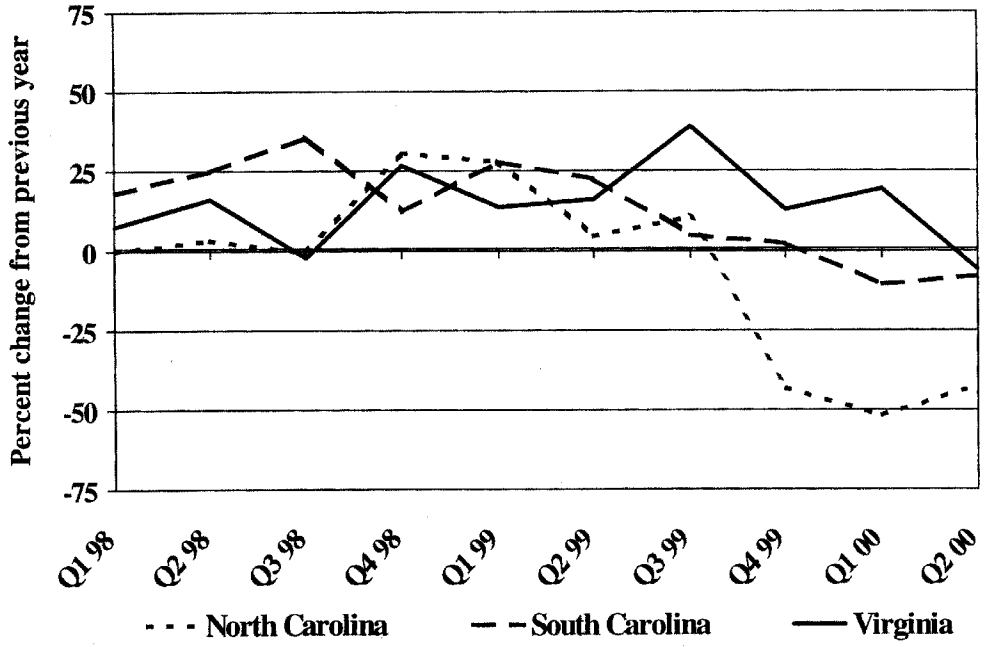
What To Do, and What Not To Do, About 'Predatory Lending'

Statement of Charles W. Calomiris

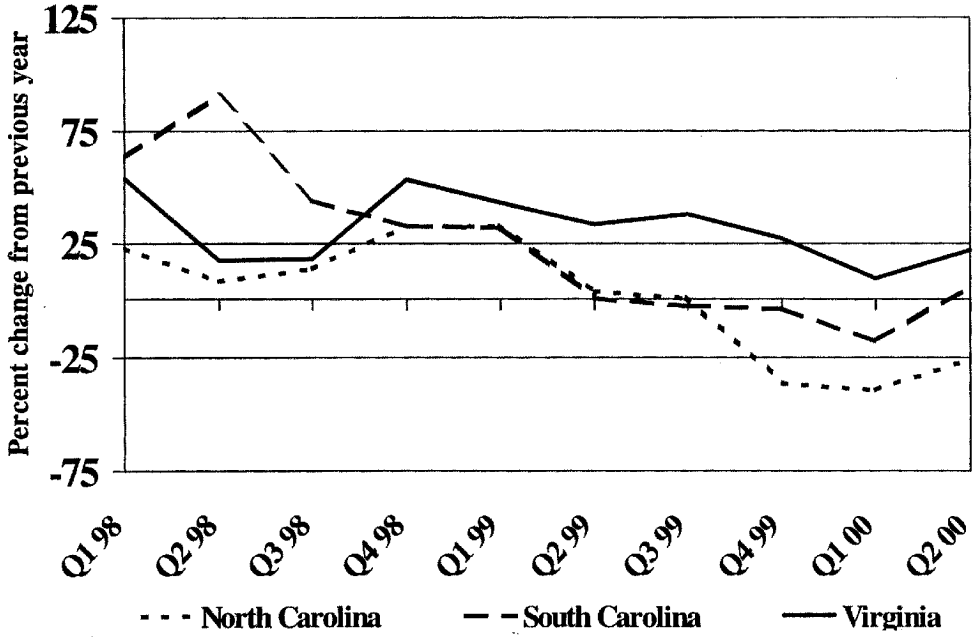
Before the Senate Banking Committee

July 26, 2001

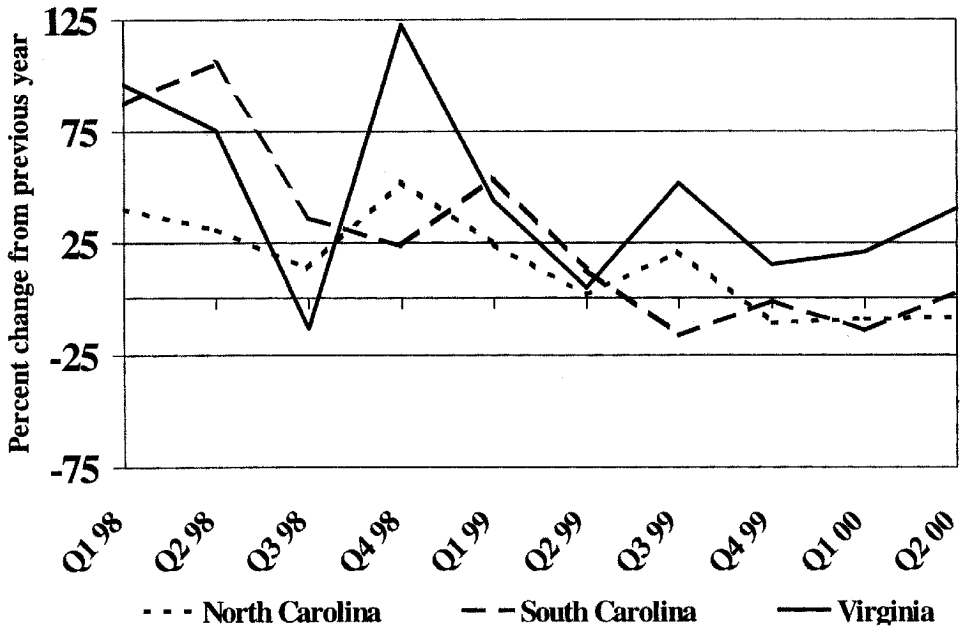
Year-over-Year Change in Originated Loans
First Liens: Borrower Income < $25,000



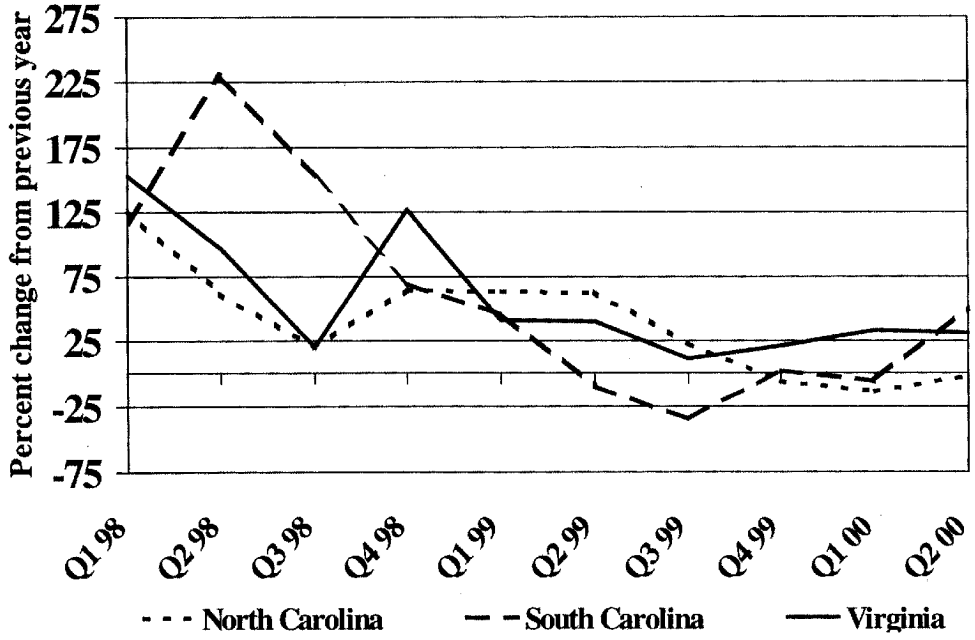
Year-over-Year Change in Originated Loans
First Liens: Borrower Income $25,000-$49,999



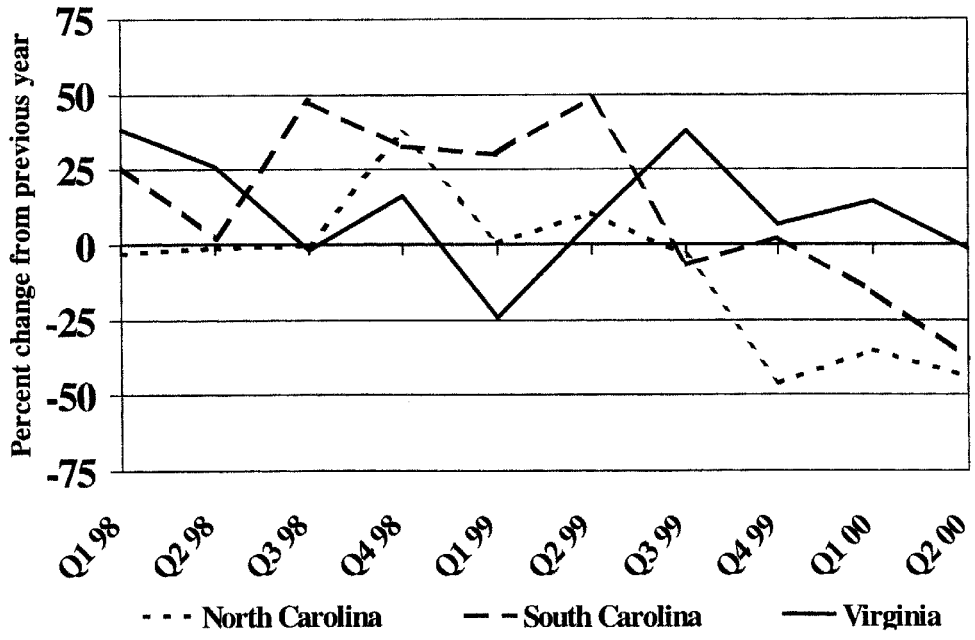
Year-over-Year Change in Originated Loans
First Liens: Borrower Income $50,000-$74,999



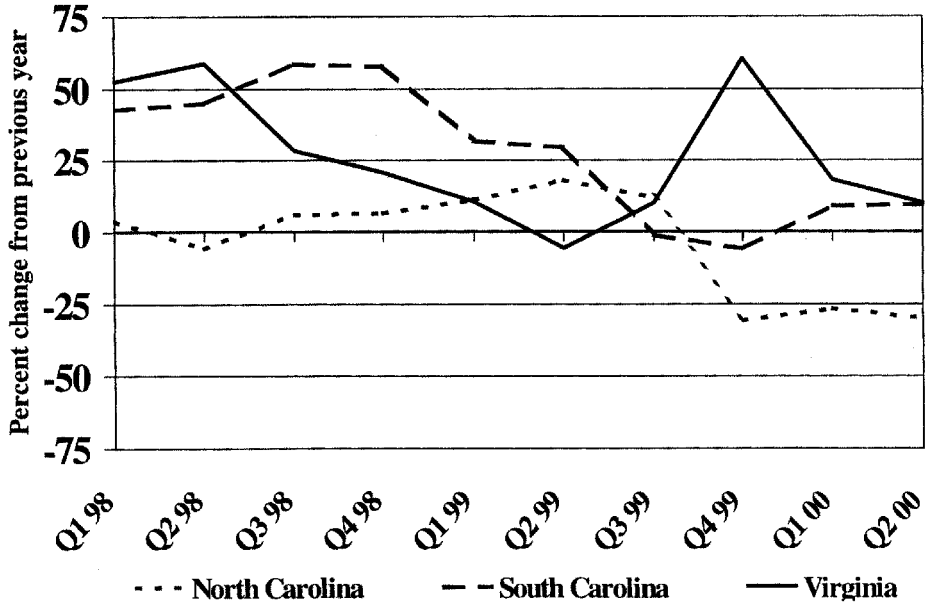
Year-over-Year Change in Originated Loans
First Liens: Borrower Income $75,000 or more



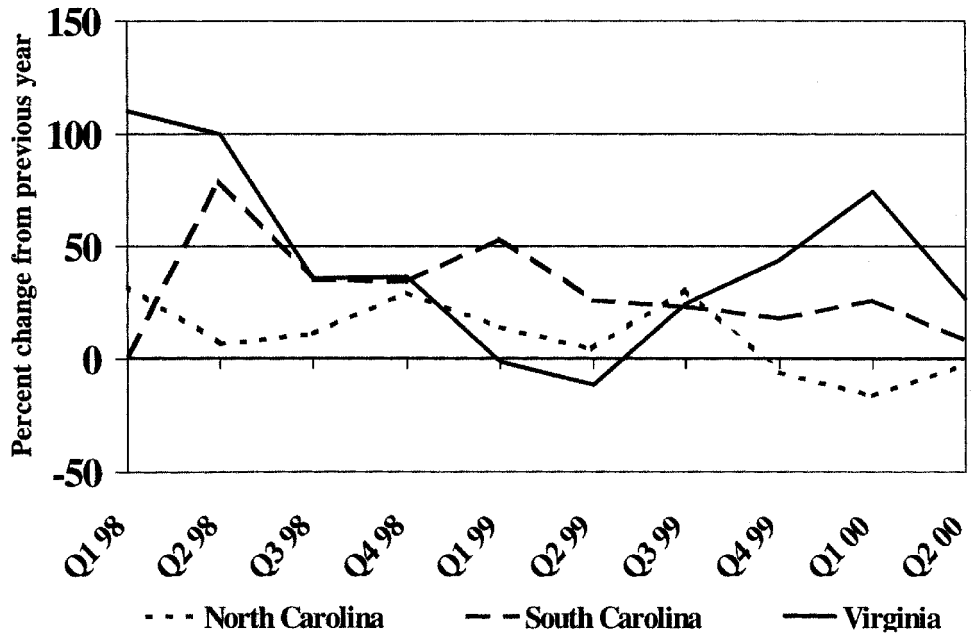
Year-over-Year Change in Originated Loans
Second Liens: Borrower Income < $25,000



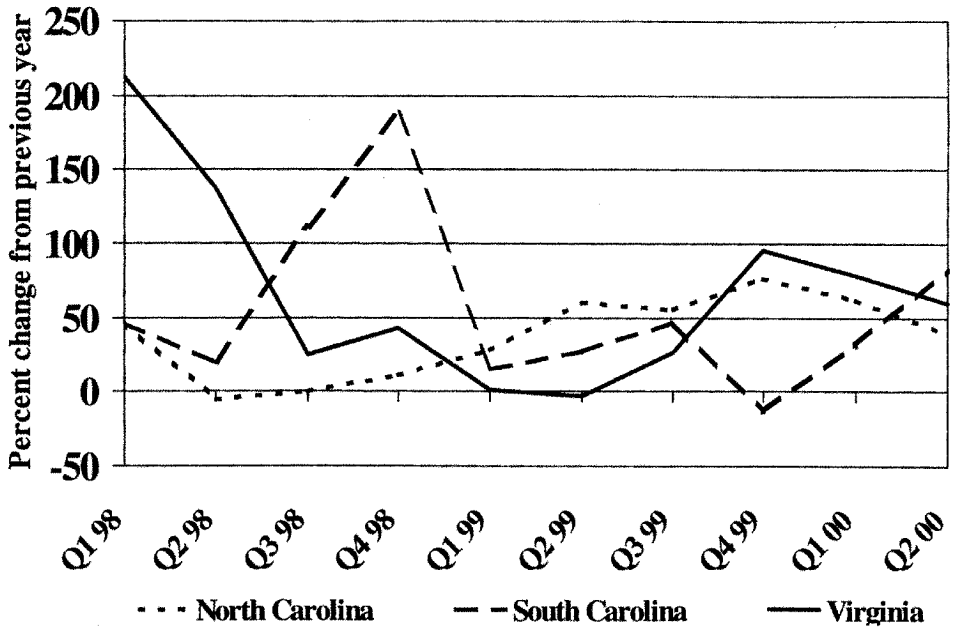
Year-over-Year Change in Originated Loans
Second Liens: Borrower Income $25,000-$49,999



Year-over-Year Change in Originated Loans
Second Liens: Borrower Income $50,000-$74,999



Year-over-Year Change in Originated Loans
Second Liens: Borrower Income $75,000 or more



PREPARED STATEMENT OF MARTIN EAKES

PRESIDENT AND CEO, SELF-HELP ORGANIZATION, DURHAM, NORTH CAROLINA

JULY 26, 2001

Mr. Chairman and Members of the Committee, thank you for holding this important hearing to examine the problem of predatory mortgage lending and thank you for providing Self-Help and the Coalition for Responsible Lending the opportunity to testify before you today.

Introduction

Fundamentally, I am a lender. Self-Help (*www.self-help.org*), the organization for which I serve as President, consists of a credit union and a nonprofit loan fund. Self-Help is a 20 year old community development financial institution that creates ownership opportunities for low-wealth families through home and small business lending. We have provided $1.6 billion dollars of financing to help 23,000 low-wealth borrowers buy homes, build businesses, and strengthen community resources. Self-Help believes that homeownership represents the best possible opportunity for families to build wealth and economic security and take their first steps into the middle class. Accumulating equity in their homes is the primary way most families earn the wealth to send children to college, pay for emergencies, and pass wealth on to future generations, as well as develop a real stake in society. Some would call us a subprime lender. We have had significant experience making home loans available to families who fall outside of conventional guidelines because of credit blemishes or other problems, and our loan loss rate is well under 0.5 percent each year. Self-Help's assets are $800 million.

I am also spokesperson for the Coalition for Responsible Lending (CRL). CRL (*www.responsiblelending.org*) is an organization representing over three million people through 80 organizations, as well as the CEO's of 120 financial institutions. CRL was formed in response to the large number of abusive home loans that a number of lenders and housing groups witnessed North Carolina. We found that the combination of the explosive growth in subprime lending, the paucity of regulation of the industry and the lack of financial sophistication for large numbers of subprime borrowers have created an environment ripe for abuse.

We discovered that too many families in our State—over 50,000—have been victimized by abusive lenders, losing their homes or a large portion of the wealth they spent a lifetime building. Some lenders, we found, target elderly and other vulnerable consumers (often poor or uneducated) and use an array of practices to strip the equity from their homes.[1] We even found that abusive lenders "flipped" over 10 percent of Habitat for Humanity borrowers from their zero percent first mortgages to high interest and high cost subprime loans.[2] The problem is not anecdotal; it is closer to an epidemic.[3]

The North Carolina Law

The standard industry response at the national level has been to fight against stronger rules and for tighter enforcement of existing laws. We found that those

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[1] See an example loan document at *www.responsiblelending.org/hud1.pdf*. Note that the borrower in this case needed $53,755.22 to pay off other debts. But total loan amount was $76,230.12, a difference of over $20,000. Five thousand dollars was dispersed to borrower. The bulk of the rest of the fees are a $4,063 origination fee and an $11,630 upfront credit insurance premium. The loan also includes a $63,777.71 balloon payment due at the end of the 15 year term. This is not an atypical case. Abusive lenders often obtain a list of homeowners in lower-middle class neighborhoods and target those with high equity, low-income and credit blemishes. The sales pitch focuses on lowering monthly payments by consolidating debts, getting cash for a vacation, or other needs. The unwitting borrower signs the loan, not realizing it is packed with credit insurance premiums, high origination fees, hidden balloons (that allow the lender to charge high fees AND show a lower monthly payment), and/or prepayment penalties that lock the borrower into the loan. And then, if there is more equity left, the same lender or broker or another lender will come and offer to refinance the loan again (or "flip it") and charge high fees once more.

[2] See *http://www.responsiblelending.org/PL%20Issue%20-%20Habitat%20FAQ.htm*

[3] See Joint HUD/Treasury Report, pp. 12–49; Panels I to III at May 24, 2000 House Banking Committee Hearings: *http://www.house.gov/banking/52400toc.htm*; Unequal Burden: Income and Racial Disparities in Subprime Lending in America, Department of Housing and Urban Development, April 12, 2000; National Training and Information Center, Preying on Neighborhoods: Subprime Mortgage Lenders and Chicagoland Foreclosure (September 21, 1999); Daniel Immergluck & Marti Wiles, Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development (The Woodstock Institute, 1999). See also *New York Times* Special Report by Diana Henriques with Lowell Bergman: MORTGAGED LIVES: A SPECIAL REPORT: Profiting From Fine Print With Wall Street's Help, March 15, 2000, Section 1, page 1 (companion piece ran on ABC's 20/20 the same night).

calls rang hollow: people's hard-earned equity was being stolen and their homes being lost through practices that complied with the law. These practices were entirely legal. Since Federal law was insufficient, as a second-best solution we decided to try to amend North Carolina's mortgage lending law to prohibit predatory lending practices.

Thus, in 1999, CRL spearheaded an effort that helped enact the North Carolina predatory lending law. The bill was the result of a collaborative effort supported by associations representing the State's large banks, community banks, mortgage bankers, credit unions, mortgage brokers, realtors, the NAACP, and consumer, community development, and housing groups. There were two principles we all agreed upon from the beginning. First, we would not rely on disclosures. In the blizzard of paper that constitutes a home loan closing, even lawyers can lose track of what they are signing. In addition, 22 percent of the adult American population is functionally illiterate, unable to fill out an application.[4] In our experience, disclosures often do more harm than good, because unscrupulous lenders use them as a shield for abuse. Second, we would not ration credit by attempting to cap interest rates. We believe in risk-based pricing; in fact, Self-Help has engaged in it for 17 years. Loans with higher risk should bear an appropriately higher interest rate in order to compensate lenders for this risk. We believe, however, that the risk should primarily be paid for through higher interest rates rather than fees, because a subsequent lender can always refinance a borrower out of a loan with an excessive rate (barring a prepayment penalty). Fees, on the other hand, must be paid in full once agreed to; there is nothing a responsible lender can do to help a borrower whose prior loan financed exorbitant fees.

The bill we supported utilized market principles and common sense rather than credit rationing or other extreme measures, it enjoyed widespread support within the North Carolina banking industry and the State's credit unions. Some would say that if the State's credit unions and banks could come to agreement over the bill, it had to be a good idea. Consumer groups did just that. They saw the bill as a credible response to the predatory lending that was harming our communities. As a result of the support of all major groups, the bill passed both chambers almost unanimously in July 1999.

Some say that it is impossible to define predatory lending. I disagree. The North Carolina bill did just that, in the same way that statutes attack any problem: by setting parameters for what is acceptable, that encourage certain actions while discouraging others. The practices that the North Carolina law discourages are exactly the abusive lending practices that we find most harmful to borrowers. Please see the Coalition for Responsible Lending Issue Paper entitled Quantifying the Economic Cost of Predatory Lending that is included in the appendix for a discussion of the cost that predatory lending practices imposes on hundreds of thousands of borrowers across the country.

Abusive Lending Practices

- Financing single-premium credit insurance on home loans.
- Charging fees, direct and indirect, over 3–5 percent of the loan amount.
- Levying back end prepayment penalties on subprime loans, which serve as anti-competitive tools to keep responsible lenders from remedying abusive situations.
- "Flipping" borrowers through repeated fee-loaded refinancings.
- "Steering" borrowers into loans with higher-rates than those for which they qualified.
- Permitting mortgage broker abuses, including broker kickbacks.
- Requiring mandatory arbitration clauses in any home loans.

I would like to briefly discuss these abusive practices and how the North Carolina law has defined and attempted to correct them.

Financing Single-Premium Credit Insurance On Home Loans

One type of credit insurance, credit life, is paid by the borrower to repay the lender should the borrower die. The product can be useful when paid for on a monthly basis. When it is paid for upfront, however, it does nothing more than strip equity from homeowners. This is why the mortgage industry is disavowing single-premium credit insurance (SPCI) in the face of heavy criticism.

Fannie Mae and Freddie Mac, U.S. Departments of Treasury and Housing and Urban Development, bills introduced in the Senate and House Banking Committees, and the Federal Home Loan Bank of Atlanta have all condemned the practice for

[4] "National Adult Literacy Survey," National Center for Education Statistics, 1992. These Level 1 individuals cannot read "well enough to fill out an application, read a food label, or read a simple story to a child." See *http://www.nifl.gov/nifl/faqs.html#literacy.*

all home loans.[5] In addition, Bank of America, Chase, First Union, Wachovia, Ameriquest, Option One, Citigroup, Household, and just this week, American General, have all decided not to offer SPCI on their subprime loans.[6] The Federal Reserve has proposed to count SPCI in determining what loans are "high cost," which will further disfavor the practice. Conseco Finance, formerly Greentree, seems to be the last large lender continuing to defend it. Conventional loans almost never include, much less finance, credit insurance. The North Carolina law prohibited the practice for all home loans.

Charging Fees Greater Than 3–5 Percent of the Loan Amount

Points and fees (as defined by HOEPA) that exceed this amount (not including third party fees like appraisals or attorney fees) take more equity from borrowers than the cost or risk of subprime lending can justify. By contrast, conventional borrowers generally pay at most a 1 percent origination fee. Again, subprime lenders can always increase the interest rate. The North Carolina law sets a fee threshold for "high cost" loans at 5 percent. If a loan reaches this threshold, a number of protections come into place: the lender cannot finance any upfront fees or make a loan without considering the consumer's ability to repay; the loan may not be structured as a balloon where the borrower owes a large lump sum at some point during the term or permit negative amortization; and the borrower must receive housing counseling to make sure the loan makes sense for his or her situation.

Charging Prepayment Penalties On Subprime Loans
(defined by interest rates above conventional)

- *Prepayment penalties trap borrowers in high-rate loans, which too often leads to foreclosure and bankruptcy.* The subprime sector serves an important role for borrowers who encounter temporary credit problems that keep them from receiving lower-rate conventional loans. This sector should provide borrowers a bridge to conventional financing as soon as the borrower is ready to make the transition. Prepayment penalties prevent this from happening. Why should any borrower be penalized for doing just what they are supposed to do—namely, pay off a debt?
- *Prepayment penalties are hidden, deferred fees that strip significant equity from over half of subprime borrowers.* Prepayment penalties of 5 percent are common. For a $150,000 loan, this fee is $7,500, more than the total net wealth built up over a lifetime for the median African-American family.[7] According to Lehman Brothers' prepayment assumptions, over half of subprime borrowers will be forced to prepay their loans—and pay the 4 percent to 5 percent in penalties—during the typical 5 year lock-out period. And borrowers in predominantly African-American neighborhoods are five times more likely to be subject to wealth-stripping prepayment penalties than borrowers in white neighborhoods. Prepayment penalties are therefore merely deferred fees that investors fully expect to receive and borrowers never expect to pay.
- *Borrower choice cannot explain the 80 percent penetration rate of prepayment penalties in subprime loans.* Only 2 percent of conventional borrowers accept prepayment penalties in the competitive conventional market, while, according to Standard & Poor's, 80 percent of subprime loans had prepayment penalties. The North Carolina law prohibited prepayment penalties on all loans of less than $150,000.

"Flipping" Borrowers Through Repeated Fee-Loaded Refinancings

One of the worst practices is for lenders to refinance subprime loans over and over, taking out home equity wealth in the form of high fees each time, without providing significant borrower benefit. Some lenders originate balloon or adjustable rate mortgages only to inform the borrowers of this fact soon after closing to convince them to get a new loan that will pay off the entire balance at a fixed rate. Others require borrowers to refinance in order to catch up if the loan goes delinquent. The North Carolina law prohibits refinancings that do not provide the bor-

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[5] See *http://www.freddiemac.com/news/archives2000/predatory.htm* and *http://www.fanniemae.com/news/speeches/speech—116.html;* Joint HUD/Treasury Report, page 91; H.R. 4250 (Rep. LaFalce/S. 2415 (Senator Sarbanes), Sec. 2(b)(3); Federal Home Loan Bank of Atlanta BankTalk, Nov. 27, 2000.

[6] See "Equicredit to Stop Selling Single-Premium Credit Life," Inside B&C Lending, April 2, 2001, p. 3 (Bank of America); Erick Bergquist, "Gloom Turns to Optimism in the Subprime Business," American Banker, May 15, 2001, p. 10 (Chase); "First Union and Wachovia Announce Community Commitment for the New Wachovia," May 24, 2001; statements by officers of Ameriquest and Option One; Jathon Sapsford, "Citigroup Will Halt Home-Loan Product Criticized by Some as Predatory Lending," *Wall Street Journal* (6/29/01); Anitha Reddy, "Household Alters Loan Policy," *The Washington Post* (7/12/2001).

[7] According to the 1990 census, median net worth for African-American families was $4,400 compared to $44,000 for white families. Home equity is the primary factor in this disparity.

rower with a net tangible benefit, considering all of the circumstances; this standard is similar to the "suitability" standard applicable to the securities industry.

Mortgage Broker Abuses, Including Broker Kickbacks

Brokers originate over half of all mortgage loans and a relatively small number of brokers are responsible for a large percentage of predatory loans. Lenders should identify—and avoid—these brokers through comprehensive due diligence. In addition, lenders should refuse to pay kickbacks (yield-spread premiums) to brokers. These are fees lenders rebate to brokers in exchange for placing a borrower in a higher interest rate than that for which the borrower qualifies. These lender kickbacks violate fair lending principles since they provide brokers with a direct economic incentive to steer borrowers into costly loans. While we decided to focus on lenders and not brokers in the bill, we are working in collaboration with the brokers' association in North Carolina on a mortgage broker licensing bill this session to crack down on abusive brokers.

"Steering" Borrowers Into Higher Cost Loans Than That for Which They Qualify

As Fannie Mae and Freddie Mac have shown, subprime lenders charge borrowers with prime credit who meet conventional underwriting standards higher rates than justified by the risk incurred. This is particularly troubling for lenders with prime affiliates—the very same "A" borrower who would receive the lender's lowest-rate loan from its prime affiliate pays substantially more from the subprime affiliate. HUD has shown that steering has a racial impact since borrowers in African-American neighborhoods are about five times more likely to get a loan from a subprime lender—and therefore pay extra—than borrowers in white neighborhoods. A minority borrower with the same credit profile as a white borrower simply should not pay more for the same loan. Therefore, lenders should either offer "A" borrowers loans with "A" rates, or refer such borrowers to an affiliated or outside lender that offers these rates. This is not a problem we were able to address in the North Carolina bill.

Imposing Mandatory Arbitration Clauses in Home Loans

Increasingly, lenders are placing predispute, mandatory binding arbitration clauses in their loan contracts. While many lenders' mantra has been the need to enforce current laws, many of these same lenders are making this goal impossible by denying borrowers the right to have their grievances heard. These clauses burden consumers because they increase the costs of disputing unfair and deceptive trade practices, limit available remedies, and prevent consumers from having their day in court. Mandatory arbitration imposes high costs on consumers in terms of filing fees and the costs of arbitration proceedings.[8] Arbitration also limits the availability of counsel, cuts off traditional procedural protections such as rules of discovery and evidence, slows dispute resolution, and restricts judicial review.[9] Lenders benefit unfairly from arbitration as repeat players, and in some cases, have used the mandatory arbitration clause to designate an arbiter within the industry, producing biased decisions. Further, lenders are able to use arbitration to handle disputes in secret, avoiding open and public trials which would expose unfair lending practices to the public at large.[10]

Lenders have used mandatory arbitration to close the courtroom door for millions of consumers and have forced borrowers to waive their constitutional right to a civil jury trial. This situation has only been made worse as many mandatory arbitration clauses have been expanded to also contain provisions that waive the consumers' right to participate in class action suits against the lender, making it more difficult for smaller claims to prevail. For these reasons, mandatory arbitration clauses are unfair to consumers who do not know what they are giving up or do not have a choice but to sign adhesion contracts. If an informed consumer thinks that arbitration is a helpful step in resolving a dispute with a lender, the consumer and lender should be permitted to agree to arbitration at that time. Because the Federal Arbitration Act preempts State regulation of mandatory arbitration clauses, we were unable to get any language prohibiting mandatory arbitration in the North Carolina bill.

And what are the results of North Carolina's law? The only significant data to date about the law's effects are comforting. The Residential Funding Corp., the Na-

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[8] See Victoria Nugent, *Arbitration Clauses that Require Individuals to Pay Excessive Fees are Unconscionable,* The Consumer Advocate 8, 9–10 (September/October 1999).

[9] Paul D. Carrington and Paul H. Haagen, *Contract and Jurisdiction,* 1996 Sup. Ct. Rev. 331, 346–9 (1996).

[10] See John Vail, *Defeating Mandatory Arbitration Clauses,* Trial 70 (January 2000).

tion's largest issuer of subprime mortgage securities, reported that North Carolina's share of subprime mortgages issued nationwide actually *increased* in 2000. And we have publicly and repeatedly challenged lenders to show us a single responsible loan made impossible under the law. No one has accepted our challenge to date.

Congress Should Address the Weaknesses in Federal Law That the North Carolina Law Identified

The fact that so many people went to so much trouble to help enact North Carolina's law is an indictment of current Federal law. While mortgage lending in our State conforms to reasonable rules, balancing consumer protections and lenders' need to make a profit, families in the rest of the country have no such protection. Ideally, therefore, Congress should pass a Federal statute that would address the seven predatory lending practices identified above in ways similar to what we accomplished in North Carolina.

The major Federal law designed to protect consumers against predatory home mortgage lending is the Home Ownership and Equity Protection Act of 1994. HOEPA has manifestly failed to stem the explosion of harmful lending abuses that has accompanied the recent subprime lending boom. Strengthening the law is important to protect homeowners from abuse. I recommend for the Committee's consideration two excellent HOEPA bills: legislation introduced last session by Chairman Sarbanes and Senator Schumer.

Looking at our definition of abusive lending practices, while I would go a bit further, the bill Chairman Sarbanes introduced is very strong. Specifically, it prohibits the financing of single-premium credit insurance, reduces the HOEPA points and fees trigger to 5 percent from the current 8 percent, imposes significant limits on prepayment penalties for high cost loans, disfavors broker kickbacks by including them in the definition of points and fees, and prohibits mandatory arbitration for HOEPA loans.

The Federal Reserve Board Should Promptly Issue Strong Predatory Lending Regulations

It is important that regulators take advantage of the authority that current laws have provided them to address predatory lending. The Federal Reserve Board (the "Board") is the regulatory agency with by far the most existing authority to address predatory lending practices. In December of last year, the Board proposed substantial regulations on HOEPA and the Home Mortgage Disclosure Act (HMDA). While modest, the Board's proposed HOEPA and HMDA changes are a very constructive step forward.

HOEPA Regulation Proposal

The proposed HOEPA regulations would broaden the scope of loans subject to its protections by, most significantly, including single-premium credit insurance and similar products in its fee-based trigger, as well as by reducing its rate-based trigger by 2 percentage points. In addition, the Board suggested a modest flipping prohibition that would restrict creditors from engaging in repeated refinancing of their own HOEPA loans over a short time period when the transactions are not in the borrower's interest and similarly restrict refinancing subsidized-rate nonprofit and Governmental loans.

The Board's HOEPA proposal to include SPCI would be an extraordinarily important move against predatory lending. In 1994, the Board stated that "The legislative history [of HOEPA] includes credit insurance premiums as an example of fees that could be included, if evidence showed that the premiums were being used to circumvent the statute."[11] It has become clear in the seven succeeding years that unscrupulous lenders have indeed used the exclusion of credit insurance from "points and fees" to circumvent the application of HOEPA to loans that really are "high cost". Financed credit insurance *alone* exceeds the HOEPA limits in many cases—up to 20 percent of the loan amount—yet the borrowers do not qualify for HOEPA protections.

The Board should address this evasion, as proposed, by including these fees in the definition of "points and fees". Since including SPCI in a loan in most cases will make it a HOEPA loan, and HOEPA imposes certain duties on lenders and has a stigma attached, lenders will have the incentive to provide credit insurance on a monthly basis, a form that does not strip borrower equity. This is exactly what has happened in North Carolina: lenders have uniformly switched from SPCI to monthly outstanding basis (except for CUNA Mutual, which has always done almost exclu-

[11] 59 Fed Reg. 61,832, 61,834 (December 2, 1994).

sively monthly outstanding balance credit insurance), and borrowers have benefited enormously.

The Board's proposal to reduce the APR trigger is welcome also, since at present only 2 percent of subprime loans are estimated to meet the very high HOEPA triggers. Finally, the restriction on refinancing subsidized loans would benefit thousands of borrowers and avoid what we experienced in North Carolina, where Habitat for Humanity borrowers were flipped from zero percent loans to 12 percent and 14 percent loans.

HMDA Regulation Proposal

The Board's proposed changes to HMDA would enhance the public's understanding of the home mortgage market generally, and the subprime market in particular, as well as to further fair lending analysis. At the same time, the Board has attempted to minimize the increase in data collection and reporting burden. Most significantly, the Board would require lenders to report the annual percentage rate of the loan. The lender also would have to report whether the loan is subject to HOEPA and whether the loan involves a manufactured home. In addition, it would require reporting by additional nondepository lenders by adding a dollar-volume threshold of $50 million to the current loan-percentage test.

The Board's proposal to require lenders to report the APR on loans is crucial. It is currently impossible to obtain any pricing data on loans and therefore to determine which loans are subprime and which are not, or to draw any conclusions about the cost of credit that borrowers undertake. The most important fair lending issues today are no longer the denial of credit, but the terms of credit. Providing the APR is a good start in providing information on terms. Requiring additional nondepository lenders to report is also important; Household Finance, the Nation's second largest subprime lender, does not currently report HMDA information because of a quirk in the rule that the Board rightly proposes to fix.

Because these proposed changes would significantly help in the battle to combat predatory lending, I would urge the Board not to backtrack on any of these suggestions and to finalize these regulations as soon as possible.

Notwithstanding our support for these proposals, I believe that each should be strengthened. For HOEPA, first, *the Board should count authorized prepayment penalties in the new loan in the points and fees threshold.* When a borrower pays a 5 percent prepayment penalty on the back end, that 5 percent is stripped directly out of the family's accumulated home equity wealth exactly the same as if it were a fee that was financed on the front end. This fee should therefore also be counted in determining which loans are high cost. Some mortgage industry representatives will argue that a prepayment penalty should not be counted because it is a contingent fee. When 50 percent of borrowers actually pay the fee, it is hardly a speculative contingency. If the contingent nature of an authorized prepayment penalty is persuasive to the Board, however, then the Board at minimum should include the authorized prepayment penalty discounted by the frequency with which it is paid.

Second, the Board should *hold the initial purchaser of a brokered loan responsible for the broker's actions, so the marketplace will self-police equity-stripping practices by mortgage brokers.* When these activities occur, borrowers are often left with no remedy because many brokers are thinly capitalized and transitory, leaving no assets for the borrower to recover against. The borrower generally cannot recover against the lender who benefited from the broker's actions because the broker is considered an independent contractor under the law. In addition, many times the holder-in-due-course doctrine prevents the borrower from raising these defenses against the note holder, even in a foreclosure action.

The Board should address the problem of brokers by making the original lender funding the loan responsible for the broker's acts and omissions, for all loans. To accomplish this goal, the Board should prohibit a lender from funding a loan where the broker violates State or Federal law in arranging the loan unless the lender exercised reasonable supervision over the broker transaction. In addition, the Board should prohibit lenders from funding a loan arranged by a broker who is not certified or licensed under State law.

For HMDA, the Board should *replace the HOEPA yes-no field with "points and fees."* Loan pricing is the most important issue in understanding the fairness of mortgage markets. Although in the popular mind, abusive lending is primarily associated with high interest rates, the primary issue is actually the high fee total charged to borrowers. Lenders should use the HOEPA definition of "points and fees," since lenders already count these fees to determine whether the loan is subject to HOEPA. HOEPA also provides the most comprehensive, and therefore descriptive, catalogue of charges available. It is a very simple calculation. Reporting APR does not lessen the need for reporting points and fees, because the APR under-

states the true cost of fees since the APR amortizes fees over the original term of the loan, and almost all loans are paid off well before the term expires.

At A Minimum, Weak Federal Law Should Not Preempt State Consumer Protections

Little is as frustrating or disheartening than to observe specific predatory lending abuses happening to real people; work successfully to get a State law or regulation passed to address the problem; and then find that Federal law has been interpreted to preempt this State consumer protection. Congress has not acted in a substantial manner against predatory lending practices since it enacted HOEPA in 1994. Since then, however, subprime lending has increased 1,000 percent, and abusive lending is up commensurately. Rather than acting as a sword in the fight against abusive practices, Federal law has functioned instead as a shield, enabling the continuation of abusive lending at the expense of entire neighborhoods.

I already discussed the problem of mandatory arbitration restrictions being preempted by the *Federal Arbitration Act.* The FAA was originally enacted in 1925 to overturn a common law rule that prevented enforcement of agreements to arbitrate between commercial entities. Ironically, it was intended to lower the costs of dispute resolution within the business community, but today is used to raise the costs of vindicating consumer rights. The States are unable to respond to this problem, because the Supreme Court has held that State laws that impose any restrictions specific to arbitration clauses are incompatible with the FAA. Preemption even applies to basic disclosure requirements such as a Montana law that required notice of an arbitration requirement to be "typed in underlined capital letters on the first page of the contract" in order to make the agreement enforceable.

The States are unable to protect their consumers from mandatory arbitration as long as the FAA preempts even requiring disclosure of arbitration clauses. We propose the prohibition of mandatory arbitration clauses in consumer loan contracts and amending the FAA to allow State regulation of consumer arbitration agreements. Of course, these changes would not affect the ability of consumers to voluntarily agree to submit a dispute with a lender to arbitration after the dispute had occurred. These changes would only protect consumers from signing away their rights before they knew the consequences.

A second important example is the Alternative Mortgage Transaction Parity Act (the *Parity Act*). Passed during the high interest rate crisis of the early 1980's, the Parity Act enabled State depository institutions and "other housing creditors" (unregulated finance companies) to make adjustable rate mortgages without complying with State laws prohibiting such mortgages. For 13 years, this Federal preemption did not pose a significant problem to consumers. However, in 1996, the OTS "reexamined" the purposes of the Parity Act and "reevaluated" its regulations. This "reinterpretation" occurred 10 years *after* States lost the ability to opt-out of the law. At that time, the OTS concluded the Parity Act required it to extend Federal preemption to restrictions on prepayment penalties and late fees.

Since this novel interpretation, predatory lending by unregulated finance companies has exploded, based in part on these companies' ability to avoid compliance with State laws, especially those State laws limiting prepayment penalties. In fact, the Illinois Association of Mortgage Brokers has filed suit asserting that the Parity Act preempts the State of Illinois' predatory lending regulations in their entirety for all alternative mortgages, including even the common sense requirement that lenders verify borrower ability to repay the loan. The OTS's definition of "alternative mortgage" is so loose, that nearly any loan could be made to fall under this category. CRL estimates that up to 460,000 families across the country have $1.2 billion stripped from their home equity *each year* directly as a result of the Parity Act.

Forty-six State Attorneys General, both Republican and Democrat, have urged the Office of Thrift Supervision (OTS) to reduce the scope of Parity Act preemption,[12] but without Congressional action, OTS feels constrained to act. The best solution to the legacy of problems caused by the Parity Act is simply to repeal the legislation. It serves no good purpose anymore, and many unregulated nondepository institutions are taking advantage of Federal preemption in ways that are abusive to borrowers without any corresponding regulatory obligations. If the Parity Act were repealed, finance companies would not be able to use the Federal law to avoid meaningful regulation by States. A less preferable, although still extremely helpful, solution would be to simply delete reference to finance companies in the Act. This would still allow State-chartered depository institutions to piggyback on the preemption authority that Federally chartered institutions have. At a minimum, given that

[12] See OTS comments of the National Association of Attorneys General at *http://www.ots.treas.gov/docs/48197.pdf.*

the Act's broad effect goes far beyond what was understood when it was enacted, Congress should reopen the opt-out period for States that did not initially opt-out (only six States did).

Finally, although it does not involve mortgage lending, we have been active in North Carolina attempting to reform payday lending. This relatively new industry has grown, rapidly to 10,000 outlets and provides desperate borrowers with a two-week loan, often at 500 percent annualized interest rates, secured by a deferred check. However, with such a short term, borrowers invariably lack the time to solve the problems that led them to take such a high fee loan in the first place. They therefore get stuck paying a $45 fee every 2 weeks just to keep same $255 loan outstanding; in fact, 90 percent of total payday loans come from customers caught on flipping treadmill (five or more payday loans per year). Reforming this industry is made much more difficult by the payday lenders engaging in a "rent a charter" partnership arrangement to enable them to take advantage of the Federal preemption of usury limits available to regulated depository institutions. For example, Eagle National Bank (1 percent of payday fee) claims preemption on behalf of its "agent" Dollar Financial (99 percent of payday fee).

Conclusion

Fundamentally, I am a lender. Attempting to make loans to borrowers stuck in predatory loans taught me what lender practices were abusive. Finding out that these practices were legal under Federal law made me angry. And so, on behalf of thousands of borrowers who face losing their homes and all the wealth they accumulated through a lifetime of hard work, I would ask the following: pass the bill that Chairman Sarbanes introduced last session, urge the Federal Reserve Board expeditiously to adopt the predatory lending rules it has proposed, and remove the obstacles placed on States in protecting their citizens by revising the Federal Arbitration Act, the Parity Act, and laws potentially allowing payday lending "rent a charters." If Congress could take these steps, then we will have come a long way to making sure that family home equity wealth is protected.

Thank you for the opportunity to testify before this Committee today. I am happy to answer any questions and to work with the Committee in the future.

Quantifying the Economic Cost of Predatory Lending

A Report from the
Coalition for Responsible Lending

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July 25, 2001

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I. Executive Summary

Federal Reserve Board Governor Gramlich has correctly noted that, just as with "safety and soundness" and "unfair and deceptive trade practices," there is not and should be no final definition of the term "predatory lending."[1] But just as capital ratios and delinquency rates tell a story about safety and soundness, certain overall indicators and loan level practices characterize predatory lending.

The Coalition for Responsible Lending, in this report, quantifies the cost of several predatory lending practices to American homeowners: **Using the best data available to us, we estimate that U.S. borrowers lose $9.1 billion annually to predatory lenders.**

This estimate is based on our analysis of the loan-level components of the following three predatory lending practices:

- **Equity Stripping**—Predatory lenders charge borrowers exorbitant fees, which are routinely financed into the loan. These costs result in substantially higher payments while the loan is outstanding and are stripped directly from the equity of the home when a borrower refinances or sells his or her house. At the loan level, equity stripping occurs when borrowers are provided loans that (1) finance credit insurance, (2) require exorbitant up-front fees, or (3) include prepayment penalties on subprime loans.

- **Rate-Risk Disparities**—Predatory lenders charge borrowers a higher rate of interest than their credit histories would indicate is justified—either by the lender's or its affiliate's own underwriting criteria. In fact, one recent study used sophisticated statistical modeling to show that 100 basis points of all subprime lending (and presumably much more for predatory lenders) could not be explained by credit risk.[2]

- **Excessive Foreclosures**—Predatory lenders make loans without regard to a borrower's ability to repay. Consequently, homeowners struggling to make payments under the combined weight of excessive fees and high interest rates often pay the ultimate price—the loss of their home. Perhaps of even greater concern is the pending wholesale loss of neighborhoods of homeowners, particularly in African-American communities. While this report discusses foreclosures, it does not attempt to quantify the costs.

Figure 1: Estimated Cost of Predatory Lending in the U.S.

Source	Predatory Practice	Annual Cost (billions)	Number of Families Affected Annually
Equity Stripping	Financed Credit Insurance	$2.1	500,000
	Exorbitant Up-Front Fees	$1.8	750,000
	Subprime Prepayment Penalties	$2.3	850,000
Rate-Risk Disparities	Excess Interest	$2.9	600,000
	Total	**$9.1**	

[1] Remarks before Consumer Federation of America conference, Washington, DC (Dec. 1, 2000).
[2] Peter Zorn, "Subprime Lending: An Investigation of Economic Efficiency", Freddie Mac (Dec. 21, 2000).

II. Introduction

Federal Reserve Board Governor Gramlich has correctly noted that, just as with "safety and soundness" and "unfair and deceptive trade practices," there is not and should be no final definition of the term "predatory lending."[3] But just as capital ratios and delinquency rates tell a story about safety and soundness, certain overall indicators and loan level practices characterize predatory lending.

This paper responds to Governor Gramlich's call for additional research to explore the significance of predatory lending by examining three common predatory lending practices: equity stripping, rate-risk disparities, and excessive foreclosures. It analyzes the loan-level traits that comprise each to estimate the economic toll imposed on American families. We conclude that the cost is, conservatively, **$9.1 billion each year of lost homeowner equity and back-end penalties and excess interest paid.**

While Self-Help[4] and other community development organizations around the country can be proud of the work we have done to create wealth in disadvantaged communities, the fact remains that all of us put together cannot come close to replacing $9.1 billion each year. Consequently, without action from federal and state lawmakers and regulators, there is no effective way to protect this home equity. The problem is particularly severe in minority communities.

III. Predatory Lending Practices

The threat posed by predatory subprime home lending is as severe as its growth is recent. Subprime lending, 80% of which consists of refinance loans for debt consolidation and consumer credit, has increased almost 1,000% in five years.[5] While increased access to credit for families with impaired credit histories is to be applauded, the prevalence of subprime loans with abusive characteristics has been devastating to families and neighborhoods.[6]

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[3] Remarks before Consumer Federation of America conference, Washington, DC (Dec. 1, 2000).

[4] I am vice president of Self-Help, which is a 20-year old community development financial institution that creates ownership opportunities for low-wealth families through home and small business lending. We have provided over $1.6 billion dollars in financing to help 23,000 low-wealth borrowers buy homes, build businesses and strengthen community resources. We believe that homeownership represents the best possible opportunity for families to build wealth and economic security and take their first steps into the middle class. Accumulating equity in their homes is the primary way most families earn the wealth to send children to college, pay for emergencies and pass wealth on to future generations, as well as develop a real stake in society. Self-Help has had significant experience making home loans available to families who fall outside of conventional guidelines because of credit blemishes or other problems, and our loan loss rate is well under 0.5% each year. Self-help has assets of $800 million.

[5] See Joint HUD/Treasury "Report on Recommendations to Curb Predatory Home Mortgage Lending" at pp 28-29 (citing 104,000 subprime home loans in 1993 and 997,000 such loans in 1998, June 20, 2000).

[6] See Joint HUD/Treasury Report, pp.12-49; Panels I to III at May 24, 2000 House Banking Committee Hearings: http://www.house.gov/banking/52400toc.htm; HUD, "Unequal Burden: Income and Racial Disparities in Subprime Lending in America" (April 12, 2000); National Training and Information Center, "Preying on Neighborhoods: Subprime Mortgage Lenders and Chicagoland Foreclosure" (Sep. 21, 1999); Daniel Immergluck & Marti Wiles, "Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development" (The Woodstock Institute 1999). See also Diana Henriques with Lowell Bergman, "MORTGAGED

A. Equity Stripping

Too many homeowners are losing the wealth they spent a lifetime building because of equity stripping. Equity stripping occurs when predatory lenders charge excessive fees. Fees include money collected in cash up-front (such as origination or broker fees), amounts financed into the loan at closing (including single premium credit insurance), and fees paid later on the back-end (prepayment penalties).

The problem of **excessive fees** for the subprime refinancing borrower is two-fold: the fees seem painless at closing and they are forever. They are *deceptively costless* to many borrowers because when the borrower "pays" them at closing, he or she does not feel the pain of counting out thousands of dollars in cash. The borrower parts with the money only later, when the loan is paid off and the equity value remaining in his or her home is reduced by the amount of fees owed. And *fees are forever* because, even if another lender refinances a family who financed exorbitant fees or who are subject to a prepayment penalty into a better loan just one week later, the borrowers' wealth is still permanently stripped away.

The fairer and more responsible approach for lenders to recoup costs on riskier loans is to be compensated through charging higher interest rates, not higher fees. If a lender charges too high of an interest rate, the market will respond and other lenders will compete to correct this situation by offering to refinance at a more reasonable rate. So long as there is no anti-competitive prepayment penalty or exorbitant financed fees, the borrower only loses excess interest for a period of time and closing costs, not a life-time of accumulated equity.

Despite the rationality of this pricing scenario, many predatory lenders continue to lock borrowers into equity stripping loans. The New York Times described the practices of First Alliance Mortgage, for example, which regularly charged borrowers 20% of the loan balance in points on loans.[7] This lender is an egregious, but not isolated, user of excessive fees.

Paying excessive fees once is bad enough. However, this abuse is often repeated, as many lenders "**flip**" borrowers through frequent fee-loaded refinancing transactions. This allows predatory lenders to strip equity through additional high fees each time without providing the borrower with a net tangible benefit. In their transactions with relatively unsophisticated borrowers, predatory lenders often disguise the fact that their mortgages have balloon payments or adjustable rates, only to inform the borrowers of this fact soon after closing to convince them to get a new and "better" loan. Other predatory lenders require borrowers to refinance in order to catch up if the loan becomes delinquent. In one case we are familiar with, a lender told a borrower she could use refinancing to "skip" her December payment to buy presents for her grandchildren – thousands of dollars in fees later, the presents turned out to be quite expensive.

LIVES: A SPECIAL REPORT: Profiting From Fine Print With Wall Street's Help", *New York Times* at Section 1, Page 1 (companion piece ran on ABC's 20/20 the same night, March 15, 2000).

[7] See MORTGAGED LIVES at note 6. According to Pamela Kogut, Assistant Attorney General of Massachusetts, 73% of first Alliance borrowers paid more than 10 points and 35% paid more than 20 points (comments made at Washington, D.C. meeting between Federal Reserve Board of Governors and Consumer Advocates on April 12, 2001).

In an especially egregious example of flipping, North Carolina research found that abusive lenders flip one in ten Habitat for Humanity borrowers from their 0% first mortgages into high interest subprime loans in order to strip the equity built up through borrower and volunteer sweat equity.[8] ABC News reported on a Charlottesville, Virginia man who went to an Associates First Capital office to get a small loan to buy groceries. He ended up being talked into 11 refinancing transactions in less than four years that resulted in a $50,000 mortgage at 19% interest that he could not afford. At this point, half the loan balance came from up-front fees.[9]

To analyze the cost of equity stripping, it is necessary to examine each of the following three loan level components that fuel the practice: (1) financed credit insurance, (2) exorbitant fees, and (3) prepayment penalties on subprime loans.

1. Financed Credit Insurance: $2.1 billion

Credit insurance is a loan product paid for by the borrower that repays the lender should the borrower die or become disabled. A case can be made for the usefulness of credit insurance when paid on a monthly basis (although conventional insurance policies can accomplish the same goal and are often a better deal for the consumer).

In the single-premium credit insurance (SPCI) case, however, the total premiums are added to the amount of the loan. Generally, this means that five years worth of premiums are added directly to the loan amount. The borrower then pays interest on this amount for the life of the loan and typically has not even begun reducing the loan's principal balance by the time the five-year credit life insurance coverage period expires. Consequently, **when a borrower moves or refinances out of a subprime loan after five years, all of the premiums for the terminated insurance are stripped directly out of the borrower's home equity.**

CRL believes that SPCI is one of the most significant predatory mortgage lending abuses. Financing credit insurance is equivalent to financing five years of utility or grocery bills over 15 or 30 years. Purchasing credit insurance in this way makes no sense since it is consumed and can be paid for every month, just like other insurance policies, thereby avoiding unnecessary interest payments and equity stripping. When insurance is purchased on a monthly basis, it is known as a monthly outstanding balance (MOB) form.

Thus, **when credit insurance is paid for up-front, it does little more than strip equity from homeowners**, which is why Fannie Mae and Freddie Mac, U.S. Departments of Treasury and HUD, bills introduced in the Senate and House banking committees (via the bills introduced by Sen. Sarbanes and Rep. LaFalce), the Federal Home Loan Bank of Atlanta and the North Carolina General Assembly have all condemned the practice for all home loans.[10]

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[8] See "Overview of Habitat for Humanities Refinances" (Coalition for Responsible Lending, Dec. 9, 1999) under "Studies" at http://www.responsiblelending.org.

[9] ABC News, "Prime Time Live" (April 23, 1997).

[10] See http://www.freddiemac.com/news/archives2000/predatory.htm and http://www.fanniemae.com/news/speeches/speech_116.html; Joint HUD/Treasury Report, page 91; H.R. 4250/S. 2415, Sec. 2(b)(3); Federal Home Loan Bank of Atlanta, *BankTalk* (Nov. 27, 2000);

In addition, **Bank of America, Chase, First Union, Wachovia, Ameriquest, Option One, Citigroup, Household and American General have all decided not to offer SPCI on their subprime loans.**[11] Conseco Finance, formerly Greentree, seems to be the last large lender continuing to defend it. The Federal Reserve has proposed to count SPCI in determining what loans are "high cost," which will further disfavor the practice. Conventional loans almost never include, much less finance, credit insurance. The North Carolina law prohibited the practice for all home loans.

Non-subprime ("conventional") loans almost never include, much less finance, credit insurance. One statewide study that found a 6% penetration rate for credit insurance on prime loans.[12] In contrast, subprime lenders such as CitiFinancial and Household have self-reported SPCI penetration rates of approximately 50% and the Associates' an even higher rate of 57%.[13]

Unscrupulous lenders use up-front financing as a tool for hiding the fact that borrowers are obtaining credit insurance at all, regardless of any disclosure requirements. According to an industry-funded study that considered consumer loans (which have much less paperwork to confuse borrowers than home loans), almost 40% of borrowers either did not know they had received credit insurance or thought that credit insurance was required or strongly recommended by their creditor.[14]

Lenders certainly have an incentive to push single premium credit insurance since they receive, on average, 30% commissions up-front on its sale.[15] The product is even more profitable for companies that own both lenders and insurance companies since credit life insurance only suffers a loss rate of 40% compared to a loss rate of 90% for group life insurance.[16]

We estimate that prohibiting financed credit insurance would save 500,000 families **$2.1 billion each year**. (Please see Appendix for an explanation of all cost estimates.)

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[11] See "Equicredit to Stop Selling Single-Premium Credit Life", *Inside B&C Lending* at p.3 (Bank of America, April 2, 2001); Erick Bergquist, "Gloom Turns to Optimism in the Subprime Business," *American Banker* at p.10 (Chase, May 15, 2001); "First Union and Wachovia Announce Community Commitment for the New Wachovia," (May 24, 2001); statements by officers of Ameriquest and Option One; Jathon Sapsford, "Citigroup Will Halt Home-Loan Product Criticized by Some as Predatory Lending," *Wall Street Journal* (June 29, 2001); Anitha Reddy, "Household Alters Loan Policy," *Washington Post* (July 12, 2001); Patrick McGeehan, "Third Insurer to Stop Selling Single-Premium Credit Life Policies", *New York Times* (American General, July 21, 2001).

[12] From Eric Stein's conversation with Robert Cook, Consumer and Community Affairs, Federal Reserve Board on Dec. 1, 2000.

[13] Richard A. Oppel Jr. and Patrick McGeehan, "Along With a Lender, Is Citigroup Buying Trouble?" *New York Times* at Section 3, p.1 (quoting internal Associates memo, Oct. 22, 2000).

[14] Credit Research Center, "Credit Insurance: Rhetoric and Reality", Credit Research Center, Krannert Graduate School of Management, Purdue University, pp 1-3 (1994).

[15] See Joint HUD/Treasury Report, page 88, note 84 (citing Consumers Union) and Consumers Union, "Credit Insurance: The $2 Billion A Year Rip-Off" (March 1999): http://www.consumersunion.org/finance/credit_info_page.htm

[16] Id.

2. Exorbitant Fees: $1.8 billion

Exorbitant fees include any fees greater than 5% of the loan amount plus any fees charged a borrower who receives no net tangible benefit in a refinancing transaction. Fannie Mae and the NC General Assembly have all found that points and fees greater than 5% are abusive.

Our view is that the limit on fees (as defined by HOEPA) should be 3% of the loan amount (4% for FHA/VA loans). By contrast, conventional borrowers pay, on average, a 1.1% origination fee.[17] However, for the purpose of estimating the economic cost of predatory lending, we will assume that 5%, rather than 3%, is the correct limit.

Because no borrower should be refinanced into a loan that fails to provide them with a net tangible benefit, all fees associated with such flips, by definition, should be considered excessive.

We estimate that exorbitant fees cost 750,000 families **$1.8 billion each year.**

3. Prepayment Penalties on Subprime Loans: $2.3 billion

The subprime sector serves an important role for borrowers who encounter temporary credit problems that keep them from receiving low-rate conventional loans. Ideally, this sector should provide borrowers a bridge to conventional financing as soon as the borrower is ready to make the transition. However, prepayment penalties are expressly designed to prevent this from happening.

Prepayment penalties for subprime borrowers are troubling because these consumers do not "choose" prepayment penalties in any meaningful sense; otherwise, 80% of subprime loans would not have such penalties, compared with only 2% of loans in the competitive, more transparent conventional market.[18] The competitive prime mortgage market provides a test for people's true preferences for a prepayment penalty in exchange for a lower rate. Rational subprime borrowers with market power should prefer them no more often, and probably less often, than conventional borrowers so that they can refinance into a conventional loan as soon as credit improves.

To permit prepayment penalties on subprime loans, then, is to protect the right of the very few sophisticated subprime borrowers who would affirmatively choose them at the expense of the 98% who would not. With such a penalty, these borrowers become trapped in higher rate loans, or refinance only to have their equity stripped away.

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[17] Peter Mahony, Associate General Counsel of Freddie Mac, reported that total points and fees for conventional loans has decreased from 1.6% in 1993 to 1.1% in 1999 at the Fannie Mae conference, "The Role of Automated Underwriting in Expanding Minority Home Ownership," Airlie Center, Warrenton, Virginia, (June 8, 2000).

[18] See *Mortgage Marketplace* (May 24, 1999); Joshua Brockman, "Fannie revamps prepayment-penalty bonds," *American Banker* (July 20, 1999). Standard & Poor's, "NIMS Analysis: Valuing Prepayment Penalty Fee Income" (Jan. 3, 2001).

Prepayment penalties are no more than hidden, deferred fees that strip significant equity from over half of subprime borrowers. Prepayment penalties of six months of interest if the borrower prepays at any time, for any reason, during the first five years of the loan are common.[19]

For a 10% interest rate loan, the penalty would be 5% of the loan balance. For a $150,000 loan, this fee is $7,500, more than the total net wealth built up over a lifetime for the median African American family.[20] This is especially troubling because we estimated that **borrowers in predominantly African-American neighborhoods are five times more likely to be subject to wealth-stripping prepayment penalties than borrowers in white neighborhoods.**[21] This money is stripped directly out of the equity, or cash value, of their home. Looked at another way, it takes almost nine years to pay down a typical loan by five percentage points.[22]

According to Lehman Brothers' prepayment assumptions, over half of subprime borrowers will be forced to prepay their loans – and pay the 4% to 5% in penalties – at some point during the five-year lock-out period.[23] Investors fully expect such prepayments, with their expectations taking tangible form as bids on a whole new class of securities (called class P securities) created by the prepayment penalty cash flows.[24] This stripping of subprime equity is lucrative business; as Lehman states, "the penalty cash flows themselves are substantial."[25]

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[19] Families prepay their loans to refinance because their credit improves enough to get a better loan or deteriorates so they cannot stay in their present one, or to move because their job is transferred, they want a better house or access to better schools, they get divorced or for other reasons. See Lehman Brothers' publication, "Asset-Backed Securities" p1 (July 17, 2000). Lehman Brothers' example is calculated on the amount prepaid over 20% of the loan balance; for simplicity we have assumed it is calculated on the entire balance, which many prepayment penalties are, and assumed a 10% interest rate rather than a higher rate. The Mortgage Bankers Association's Legislative Guidelines, page 3, also state that this is a common standard. It is worth noting that use of this complicated formula concerning a certain number of months of interest obscures the size of the penalty to lay people and, perversely, charges a family a higher penalty if it is trying to escape a loan with a higher interest rate.

[20] Net worth for the median African American family in the United States was $4,400, for the median white family, $44,000, according to the 1990 Census. 2000 Census figures will be higher once available.

[21] 51% of borrowers in predominantly African-American neighborhoods have subprime loans times 80% who have prepayment penalties (see "Unequal Burden" at note 6) equals 41% have prepayment penalties. 49% of borrowers in African American neighborhoods have prime loans times 1.5% have prepayment penalties equals 1%. 41% plus 1% equals 42% of borrowers in African American neighborhoods have prepayment penalties. 9% of borrowers in white neighborhoods have subprime loans times 80% equals 7% have prepayment penalties. 91% of borrowers in white neighborhoods have prime loans times 1.5% have prepayment penalties equals 1%. 7% plus 1% equals 8% of borrowers in white neighborhoods who have prepayment penalties. 42% is 5.25 times greater than 8%. This calculation assumes that, within the subprime universe, loans to African Americans have prepayment penalties at the same rate that white borrowers do. While this assumption bears further research, CRL estimates that the African-American percentage would actually be higher.

[22] 30-year, fixed rate loan at 12%.

[23] See Asset-Backed Securities, page 2. Assumptions based on Lehman's database of 130,000 subprime loans. Lehman assumes that the Constant Repayment Rate builds up to 17% per year for loans with prepayment penalties and builds up to 25% per year for loans without such penalties. As the attached spreadsheets show, 52.7% of borrowers subject to the 5% prepayment penalty will prepay during the five-year period (while 67.9% of borrowers not subject to penalty will prepay, a difference of 15%).

[24] Id. at p. 3, note 2.

[25] Id. at p. 2.

Prepayment penalties are not even very successful in preventing prepayments. Morgan Stanley reports that subprime loans that carry prepayment penalties are prepaid at about 90% of the rate that subprime loans without prepayment penalties are prepaid.[26] And according to Lehman data, only 15% of additional borrowers would have paid off their mortgages before the five-year period was up if these borrowers were not subject to prepayment penalties, or 3% more per year.[27]

The primary economic impact of prepayment penalties for subprime loans, therefore, is to benefit the holders of securities funded by prepayment penalties at the expense of over half of subprime borrowers, and not to stretch out the duration of loans. In other words, prepayment penalties are no more than deferred fees that investors fully expect to receive and borrowers never expect to pay.

We estimate that these subprime prepayment penalties cost 850,000 families **$2.3 billion each year.**

B. Rate-Risk Disparities: $2.9 billion

Rate-risk disparities occur when borrowers are charged more than risk can justify for a loan. Unfortunately, these disparities are commonplace in the subprime market. A recent Freddie Mac study used sophisticated statistical modeling to show that 100 basis points of pricing in all subprime lending (and presumably much more for predatory lenders) could not be explained by credit risk.[28]

Another way to consider the disparity between risk and rates has to do with the steering of borrowers to less than the most advantageous loan. Steering occurs when a borrower is placed in a loan with higher rates and or fees than another loan for which the borrower qualified.

According to Fannie Mae, up to half of all subprime borrowers could qualify for lower cost conventional financing.[29] Similarly, Freddie Mac estimates that 10% – 35% of subprime borrowers could have qualified, and cites a poll of 50 subprime lenders who estimate that half could have qualified for prime loans.[30] Pamela Kogut, Assistant Attorney General of Massachusetts, estimated that 20% of loans from First Alliance, which declared bankruptcy after a New York Times article exposed its predatory lending practices, went to "A" borrowers.[31] Finally, the CEO of one of the largest retail subprime lenders in the nation, Ameriquest

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[26] Morgan Stanley Dean Witter, Home Equity Loan Handbook 9 (1998 Ed.).

[27] See note 23.

[28] Peter Zorn, Subprime Lending: An Investigation of Economic Efficiency (Freddie Mac, Dec. 21, 2000).

[29] See Fannie Mae March 2, 2000 press release at page four: http://www.fanniemae.com/news/pressreleases/0667.html

[30] See Freddie Mac Special Report on Automated Underwriting (Sep. 1996) at http://www.freddiemac.com/corporate/reports/moseley/chap5.htm and "Half of Subprime Loans Categorized as 'A' Quality," *Inside B&C Lending* (June 10, 1996).

[31] Comments made at meeting between consumer advocates and the Federal Reserve Board of Governors (April 12, 2001).

Mortgage Company, estimates that 30% to 40% of their borrowers are in fact "A" quality borrowers.[32]

It is particularly troubling when subprime lenders with conventional affiliates charge borrowers who meet conventional underwriting standards higher rates than justified. The very same "A" borrower who would receive the lender's lowest-rate loan from its prime affiliate pays extra when he gets a loan from the subprime affiliate.

Borrowers are also charged too much when brokers convince them to accept a higher-than-justified rate ("broker originations"). Brokers originate over half of all mortgage loans, both prime and subprime.[33] Brokers receive as compensation up-front fees and back-end kickbacks ("yield-spread premiums" or "YSPs") -- fees lenders rebate to brokers in exchange for placing a borrower in a higher interest rate than for which the borrower qualifies.

Kickbacks (distinguished from bona fide servicing release premiums, which are unrelated to the terms of the loan) **are inherently abusive since they give the broker an incentive to make the interest rate to the borrower as high as possible without regard to the borrower's creditworthiness.** The higher the interest rate, the higher the premium and therefore the higher the broker's compensation becomes. In this way, kickbacks provide brokers an economic incentive to steer minority and other borrowers into costly loans.

Kickbacks are also inherently deceptive to the borrower. No one who understands their situation would knowingly accept a higher interest rate than they otherwise qualified for without receiving a benefit,[34] yet this is what borrowers pay when lenders split their above-par bounty with the broker after closing.

Rate-risk disparities appear to be especially common for minority borrowers. Recent studies have shown that black borrowers are commonly steered into high-rate and high-fee subprime loans when they in fact qualify for lower cost loans.[35] A 2000 HUD study found that **higher-cost subprime loans are five times more common in black neighborhoods than in white neighborhoods**, accounting for 51% of home loans in predominantly black neighborhoods in 1998 compared with 9% in white areas. According to the study, borrowers in *upper-income black* neighborhoods were twice as likely as homeowners in *low-income white* neighborhoods to receive subprime refinance loans.[36]

We estimate that total excess interest costs 600,000 families **$2.9 billion each year.**

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[32] Conversation with Martin Eakes, CEO, Self-Help.

[33] See Joint HUD/Treasury Report, page 39, notes 43 and 44.

[34] Brokers claim that YSP's are used to pay closing costs in no- or low-closing cost mortgages to the benefit of cash-poor borrowers. While this is true occasionally for conventional purchase-money mortgages, the Coalition for Responsible Lending has seen no evidence for it in the subprime arena. In fact, loans in which we have seen YSP's labeled on the HUD-1A have uniformly contained high fees as well.

[35] Immergluck & Wiles; see note 6; Fred Faust, "Acorn blasts Number of Sub-Par Loans Made in St. Louis Area", *St. Louis Post-Dispatch* at C8 (Oct. 22, 1999); National Training and Information Center, "Preying on Neighborhoods: Subprime Mortgage Lenders and Chicagoland Foreclosure" (September 21, 1999); Bruce Lambert, "Analysis Shows Racial Bias In Lending, Schumer Says", *New York Times* at Section 1, p.35 (April 9, 2000).

[36] HUD, Unequal Burden; see note 6.

C. Excessive Foreclosures

The ultimate and tragic consequence of this wealth-stripping and steering is the loss of families' homes, and the destruction of entire communities, through high rates of foreclosure. The Joint HUD/Treasury study mentions a number of reports demonstrating the disproportionate rise in foreclosures resulting from subprime loans. For example, HUD found that 45% of all foreclosure petitions in Baltimore City were from subprime loans, while the subprime share of originations was just 21%.[37] In another study of one subprime lender, one out of four loans were in foreclosure or well on their way *in the first two years* after origination, compared with just one-half of one percent of FHA loans during the same time period.[38]

One study by the National Training and Information Center suggested that subprime foreclosures were more likely than conventional foreclosures to be linked with the abandonment of buildings in an urban section of Chicago.[39] Another paper suggested that subprime foreclosures may have a more significant impact in low-income and African American neighborhoods where subprime loans account for a substantial portion of home lending in such cities as Baltimore, Chicago, and Atlanta .[40]

In addition to the obvious cost to the homeowners who are foreclosed on, communities with excessive foreclosure rates likely face a host of other costs, including lower property values and difficulty attracting investments. These additional costs along with those from resulting social externalities, such as increased rates of crime and drug abuse, may well dwarf other estimates made in this report. At least one study has found that high foreclosure rates are associated with increased rates of racial change in neighborhoods—from predominantly white toward predominantly African American.[41]

Theoretically, one could estimate the loss in homeowner equity that results from foreclosures due to unsound subprime lending practices by calculating direct losses to homeowners and then determining a multiplier that would capture consequential direct and indirect external economic losses. However, because these costs are exceedingly difficult to specify, this study makes no attempt to quantify them.

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[37] See Joint HUD/Treasury Report, page 50, notes 67-68.

[38] Testimony of Drake Law Professor Cathy Lesser Mansfield on a pool of mortgages by WMC, before the Committee on Banking and Financial Services, U.S. House of Representatives (May 24, 2000). This category included all loans that were more than 90 days or more delinquent, in foreclosure, in bankruptcy, or already foreclosed upon. By comparison, well under one-half of one percent of FHA loans had defaulted in their first two years throughout the 1990s. See Price Waterhouse Coopers' Actuarial Review of FY 1998 of FHA's Mutual Mortgage Insurance Fund (March 1, 1999). Well under two percent of all home mortgages in the country are currently 90+ days delinquent or in the foreclosure process, according to the most recent report of the Mortgage Bankers Association's National Delinquency Survey.

[39] National Training and Information Center, "Preying on Neighborhoods" (Sep. 21, 1999).

[40] Harold L. Bruce, *et al*, "Subprime Foreclosures: The Smoking Gun of Predatory Lending?" (U.S. Department of Housing and Urban Development); see http://www.huduser.org/publications/polleg/hpcproceedings.html)

[41] Vern Baxter and Mickey Lauria, Residential Mortgage Foreclosure and Neighborhood Change in v11, n3 *Housing Policy Debate* (Fannie Mae 2000).

Conclusion

Clearly, the calculations offered in this paper are rough, though conservative, estimates. We believe, however, that they provide an order of magnitude of the amount of equity stripped, each year, from those least able to afford it. They also attest to the notion that the most important lending issue today is no longer denial of credit but the terms of credit.

APPENDIX
Explanation of Estimated Costs

1. **Financed Credit Insurance.** Nationally, providers wrote $4.98 billion in credit life and credit accident and health insurance in 1999.[42] One provider, CUNA Mutual, writes virtually no single-premium credit insurance. Subtracting CUNA mutual's share of $0.51 billion from 1999 totals leaves $4.47 billion.[43] Based on conversations with regulators,[44] we conclude that half of this total amount written provides coverage on home loans, with 95% written on a single-premium basis. Accordingly, this calculation yields a total cost to consumers of $2.1 billion. Using the same methodology for North Carolina alone, a prohibition on financed credit insurance will, each year, save at least 10,000 to 20,000 homeowners almost $100 million of needlessly lost equity.[45] Extrapolating nationwide, that would be roughly $3.3 billion of equity for 500,000 families at a cost of $6,600 each per year saved by a general prohibition for all home loans.[46] However, we use the more conservative figure to arrive at a final estimate of $2.1 billion for 500,000 families nationwide.

2. **High Fees.** There are few data sources available on fees. Hence, we conservatively estimated fees based on loan documents reviewed by CRL. For instance, First Alliance Mortgage routinely charged over 20 points and we regularly see loans charging over 10 points. Based on these loans and other data,[47] we conservatively assume that 25% of

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[42] National Association of Insurance Commissioners, "Credit Life and Accident and Health Insurance Loss Rations for 1997-1999" (March 2001).

[43] Id.

[44] According to William F. Burfeind, Executive Vice President Consumer Credit Insurance Association, 95% of credit insurance is financed single-premium credit insurance. According to state insurance regulators, half of this amount is typically for mortgages, while the other half is written in connection with consumer debt.

[45] In North Carolina for calendar year 1997, according to the National Association of Insurance Commissioners, $204,814,627 in credit insurance policies for credit life and credit disability/accident and health insurance were written. Because of data limitations, this amount does not include credit property or credit unemployment insurance, which are both significant credit insurance products sold in the state. Using the assumptions in note 43 yields a total of $97 million in single-premium credit insurance policies written in connection with mortgages each year in the state. Since, 99% of the original balance of single premiums remains after its average life of five years on a standard amortizing loan, 99% of $97 million, or $96 million, is stripped out of the home equity of North Carolina families. The 10,000 to 20,000 figure comes from an average single premium ranging from $5,000 to $10,000 that we have observed, and is consistent with off the record comments about two major subprime lenders that half of retail subprime home loans originated by those lenders have financed single premium credit insurance (total subprime loans in NC in 1999 was 40,000).

[46] In 1999, North Carolina's population was 7.7 million, while the United State population was 274 million, according to U.S. Census Bureau. NC's population is therefore 3% of the total. If $100 million of lost equity due to financed credit insurance is also 3% of the country's total, then the national total is 33 times this amount, or $3.3 billion. There were 2.4 million subprime loans in 1999 ($160 billion in originations [Inside Mortgage Finance, Mortgage Market Statistical Annual 2000, Volume II, p. 1-2 and Joint HUD/Treasury Report, pp. 29-31] divided by $67,000 average loan size [see Joint HUD/Treasury Report, pp. 29-31] equals 2.4 million loans). Looked at another way, assume conservatively that 20% of subprime loans have financed credit insurance attached (500,000 borrowers each year); $3.3 billion divided by 500,000 is an average premium amount of $6,600. This figure is consistent with loan documents and other evidence we have reviewed. It is also consistent with loans examined by the Iowa Attorney General's office, see May 1, 2001 HOEPA comment letter from Kathleen Keest to the Federal Reserve System.

[47] See i.e. Charles W. Calomiris & Joseph R. Mason, "High Loan-to-Value Mortgage Lending: Problem or Cure?" at p12 (citing unpublished reports that HLTV loans average fees of 7 percent of the loan value, American Enterprise Institute 1999).

subprime mortgage loans charge an average of 7% in upfront fees. That amounts to an unnecessary 2% in fees on $40 billion of the $160 billion total for subprime mortgages. An extra 2% of a quarter of $160 billion in 1999 subprime originations, totaling $800 million in excess up-front fees paid by 600,000 borrowers each year. Again, the dearth of reported information on fees further points to the need for additional data reporting. The Federal Reserve's recent proposal requiring lenders to disclose the APR of all home loans would be a helpful step. However, without a corresponding disclosure of points and fees, as defined by HOEPA, the information would be incomplete.[48]

Through deed research at the county courthouses, we have seen loan after loan that has been flipped over and over. Based on our experience, we conservatively estimate that one-fifth of all subprime refinances do not benefit the borrower in economic terms. Thus, they should be deemed flipped. We assume that the average amount of fees charged in these flipping transactions is 4%.[49] 80% of all $160 billion in subprime loans are refinances, multiplied by an estimated 20% flipped, by 4% fees totals $1.0 billion in excess fees paid by 150,000 flipped borrowers each year.

Accordingly, fees charged over 5% and fees paid on flipped loans total approximately $1.8 billion in excess fees paid each year.

3. **Prepayment Penalties.** While Lehman states that a prepayment penalty of 5% that remains in effect for five years is standard, we conservatively assume that the average penalty is 4% for four years. Modeling Lehman's assumptions, 44% of borrowers actually pay this 4% fee. Multiply this times 80% of subprime borrowers who have penalties, by $160 billion in originations and it amounts to $2.3 billion in lost equity annually to 850,000 homeowners per year due to prepayment penalties.[50]

4. **Rate-Risk Disparities.** Fannie Mae and Freddie Mac estimate that somewhere between 10% to 50% of subprime borrowers would qualify for conventional financing. Assume conservatively the correct number is 20%. On December 1, 2000, conventional loan interest rates averaged 7.75%, while "A-" rates averaged 10%, "B" loans averaged 11.8% and "C" loans averaged 12.7%.[51] Based on the percentage distribution of A-, B and C credit loans in the subprime market, the weighted average interest rate of subprime loans over the interest rate on conventional loans is 3%.[52] Converting this amount to net present value, one should

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[48] See CRL comments on the Fed's HMDA proposal at: http://www.responsiblelending.org/hmda.htm.

[49] Based on our experience and unpublished industry reports, we believe this estimate to be very conservative for all the costs and fees associated with the loans.

[50] While some lenders argue that borrowers choose prepayment penalties in exchange for lower rates, we have found little evidence to support this claim in the subprime market. In addition, we have found repeated cases where prepayment penalties served to lock borrowers into *high rate* loans in loans where the lender paid a yield spread premium to a broker. This makes sense because lenders would have little incentive to pay brokers premiums for high interest rate originations unless those loans were protected from prepayment. In fact, we have evidence directly tying broker premium payments to the presence of a prepayment penalty.

[51] See Inside B&C Lending (showing A- averages 150 – 200 bp less than B credits, Dec. 4, 2000 at page 12); according to National Home Equity Mortgage Association, A- loans are 60% of total subprime market, B loans are 30%, and C loans are 9% (cited in Joint HUD/Treasury Report, page 34).

[52] An unpublished analysis of Mortgage Information Company data actually suggests this figure might be even higher at 4.2%.

use a multiple of roughly three,[53] for a total of 9% in fee-equivalent extra net present value that borrowers pay for loans due to rate-risk disparities. Multiplying this amount times the 20% of borrowers that would qualify for conventional mortgages, times $160 billion in originations, we find that there is $2.9 billion in needlessly lost equity by 600,000 families each year due to excess interest alone.

[53] Inside B&C gave the 12-month prepay speed of 23%, which translates into an average life, and thus yield-fee multiple, of just under three years, so I have used a multiple of three in calculating NPV.

August 9, 2001

The Hon. Paul Sarbanes
US Senate Banking Committee
309 Hart Senate Office Building
Washington, DC 20510

Dear Senator Sarbanes:

I would like to take the time to respond to Household Finance CEO Gary Gilmer's claims to the committee. Since he made some remarks that are totally untrue, I feel that I personally should respond and I will try to take them one point at a time. Please bear with me if this letter is long as I am trying to convey exactly what went on.

1. Mr. Gilmer tries to make it sound like they told us everything about our loan far in advance of the closing. But as I explained in my testimony, the loan we ended up getting was very different from what Beneficial had promised us and from the information in the papers they had given us.

2. **LIFE INSURANCE**-The only time we heard about life insurance was on the 21st of November – the day we closed on the loan. Michelle, the girl in the office, called me at work on the 21st and told me that they were going to add Life Ins. and Disability Ins. to our loan. When we got down to closing at the office Greg (Branch Mgr) said that we didn't need disability and we agreed with him on this point.

Greg then went into his speech so fast about the Life Ins. And also added and I quote "Life ins protects us and also Household." The exact words he used were "They had to protect themselves also," meaning Household. The way he said it made us feel that we probably wouldn't get the loan unless we took the life ins.

3. **DIRECT DEBIT**-We did the direct debit plan because they said it would help us pay off the loan faster. They said our monthly payments would just be cut in half and made every two weeks, which we thought was twice a month. But then it started and I got my first bank overdraft because there were three payments in one of the months.

I immediately called the branch mgr and explained to him that this situation isn't what I realized when I signed the papers. I told him that I got paid on the 6th and 21st of the month and that was when I would make my payments. He explained that wold make my payments longer and I said I can't understand why it would take longer, because they had said the payments would be lower if the loan lasted 30 years, but we were doing a higher amount each month, $1,222.00, to pay it off faster.

4. **LOAN PROCEEDS**-Mr. Gilmer states I thought my house was worth $110,000.00 and the appraisal came in at $106,000.00. When I called for a loan to pay off my credit cards which were around $7,000 and they talked us into refinancing; Michelle asked me

what my house was worth if I tried to sell it. I told her that I thought I could get $110,000.00 for it.

5. **CREDIT CARD DEBT**-As I stated earlier, I was responding to a flyer they sent (see attachment) about getting $35,000.00 to pay off bills. They did pay off $1191.00, it fell short by around $5,800.00. At the closing when we didn't get all the credit cards paid off Greg (Branch Mgr) said and I quote "I can get you a side loan on your car for the extra to pay off credit cards."

Greg said we were good customers and were never late on our side loan. We want to help our valued customers and if we didn't then we wouldn't be in business long. That sure meant to me that we would get more on the side loan. When we got home there was a letter waiting for us that we were turned down for the extra money and the side loan. Greg knew this before we left and he still lied to us about our side loan.

Mr. Gilmer states why didn't I after 3 days cancel the loan. Greg the manager said that there's no problem I will appeal this and being a good customer who was never late on a payment, I figured seeing as he is the manager he would get it for me. I had no worries about the appeal. We signed the papers for 2nd loan and figured we would be back when everything got approved.

The next week we got another letter of rejection. No call from Greg the manager as to how sorry he was or if there is anything else he could do to help us. It was as if we didn't exist.

6. **ALLEGATION THAT LOAN HELPED**-Mr. Gilmer states that they paid my first mortgage off which had a balloon payment. This is true, but we had plenty of chances ahead of us to refinance during those 13 years, or even to sell the house, since we will both be retired by then.

Now we are paying more than $250.00 more on our house payment, our biggest credit cards did not get paid and because of 3 deaths in the family since Jan. 1, (My wife's sister just passed away on August 4th) which is not Household's fault, but if they would have made our loan proceeds like we wanted and if they didn't charge such an outrageous interest rate we wouldn't have felt these situations so much. Do you know how hard it is to be in a position at our age where we can't help loved ones out because of our situation.

7. **CREDIT INSURANCE**-I don't want to elaborate on this subject, except to state again we felt that we would not have gotten the loan if we refused it. In response to Mr. Gilmer saying that the branch mgr quoted to us what our payment would be is another lie. If this is true why weren't there papers waiting for us stating what the payment would be in case we decided not to take the credit insurance. They weren't there because they had no intention of us leaving there without signing for the credit insurance.

Another fact that is misrepresented is that Mr. Gilmer says that both the branch mgr and associate told us about the credit ins. They were not in the office together with us. If

Greg came in then Michelle went out to get something and when Michelle came in Greg would leave.

I never called the branch mgr about the credit insurance. He called me at work after receiving my letter requesting that the insurance be cancelled. I told Greg that they had never told me I could cancel my insurance. It was only after I talked with people from ACORN that I realized I could cancel it.

8. **CREDIT RATING**-My wife and I were proud of the credit rating we had built up. At the time we consolidated with Beneficial, we had never been late on any of our mortgage payments and were right on-time with our other payments. Of the five dings on our credit report for the several previous years, two were flat-out mistakes that have now been taken off. All of the others had been paid off at least two and a half years before the Beneficial loan.

In summarizing my letter I want to say that my wife and I learned a very valuable lesson. Do not sign anything anymore without reading every line and understanding each section. We feel we were victims of a predatory lender. My wife and I come from an era of the 50's and early 60's where the churches were open all night and you didn't have to lock your doors all the time. A handshake was your contract in a lot of cases, and you could trust that others wouldn't take advantage of you.

This is the third mortgage we financed since 1998 and the other two were just fine. We didn't get into a fix with them. If a person could go back and redo something believe me this would be one of them. No one wants their dirty laundry and their stupidity exposed to the whole world.

The one thing my wife and I agree on is that if we help other people to see what predatory lenders can do to you, then we feel it was worth it. Thank you for your time.

Sincerely,

Paul and Mary Lee Satriano
ACORN of Minnesota

Attachment

395 N Robert St Ste 102
St Paul, MN 55101-1804
(651) 222-6806

Paul Satriano
881 E Magnolia
St Paul MN 55106-3227

Keep **More** *of your* PAYCHECK.

**You can receive up to $35,000,
with payments to fit your budget.**

Dear Paul Satriano:

I was thinking about the best way to thank you for being a valued customer. Then I thought, if you're like me, you could probably use extra money. Who couldn't, right?

So, I'd like to offer you a larger loan -- as much as $35,000.* If you can use the money, please take advantage of this Preferred Customer Certificate today.

**Pay off your credit cards, car loans, and other bills --
and have money left over.**

The best thing about this money is that you decide how to spend it. For example, if you feel your monthly bills are out of control, just use this loan to pay them all off immediately.

Your Beneficial payment could be much less than those you're making now. That means you'll have more money on hand after you've paid off your other bills. I can't think of a better way to say thanks to my best customers.

We'll make it fast and easy to apply.

Just call us at (651) 222-6806 and we'll make it as easy as possible for you to apply for -- and get -- this loan. We'll talk one-on-one to understand how much money you'll need, and answer any questions you may have.

(*continued on back*)

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STATEMENT OF ELIZABETH C. GOODELL, COUNSEL

COMMUNITY LEGAL SERVICES OF PHILADELPHIA, INC., PHILADELPHIA, PENNSYLVANIA

ON BEHALF OF LEROY WILLIAMS

JULY 26, 2001

The interest (note) rates on Mr. Williams' loans were as follows: EquiCredit, 9.65 percent. New Jersey Mortgage, 14.5 percent. Option One, 11.25 percent. We do not know the APR's for the loans from EquiCredit and New Jersey Mortgage, but the APR for the Option One loan is 13.136 percent.

We do not know, if the loans from EquiCredit or New Jersey Mortgage were HOEPA loans. Based on the TILA disclosures for the Option One loan, the fees, and other prepaid finance charges totaled 7.469 percent of the amount financed, just barely under the HOEPA fee trigger of 8.0 percent.

The transaction costs in the third loan (including prepaid finance charges and fees that are not included in the finance charge) total approximately $2,700, or 8.3 percent of the principal balance of the loan. Although we do not have all the loan documents from the first two loans, if the transaction costs of the first and second loans were similar to the costs of the third loan, Mr. Williams paid approximately $8,700 to lenders, brokers and title companies (including the prepayment penalty and interest paid on the second loan when the third tender refinanced it barely 3 months after origination) in connection with the three loans, representing nearly 27 percent of the $32,435 principal balance of the most recent loan.

Mr. Williams' story is typical of low income homeowners with subprime loans in several respects. First, once Mr. Williams had executed one high-cost loan, he became the victim of targeted marketing by other brokers and lenders of high-cost subprime loans. We find that brokers and lenders research public records to identify homeowners with mortgages originated by other subprime lenders and target such homeowners, attempting to sell new loans within a relatively short period of time. Like many low income homeowners with a succession of subprime, high-cost loans, Mr. Williams was sought out by the lenders rather than seeking them.

Second, Mr. Williams was caught up in loans with complex terms he did not understand. Based on the loan documents, the second (New Jersey Mortgage) loan included a prepayment penalty and a balloon. Mr. Williams did not know about and did not understand either of these terms. The third (Option One) loan includes a prepayment penalty, a variable rate, and an arbitration provision. Again, Mr. Williams did not know about and did not understand these terms, although there is some indication that the broker tried to explain the prepayment penalty.

It is a fiction that the market—or present statutes and regulations—adequately protect homeowners when they are unsophisticated about consumer lending. Additional protections are needed to prevent what happened to Mr. Williams. A lower HOEPA fee trigger which included the prepayment penalty might have discouraged the third senseless and in fact harmful refinancing. Substantive prohibitions against such blatantly inappropriate/no benefit refinancings would accomplish the same goal directly, as would imposing a duty on mortgage brokers and lenders to avoid making loans that are unsuitable, a duty already required of stockbrokers.

STATEMENT OF DANIEL F. HEDGES, COUNSEL

MOUNTAIN STATE JUSTICE, INC., CHARELSTON, WEST VIRGINIA

ON BEHALF OF MARY PODELCO

JULY 26, 2001

In thirty years of representing low income consumers, I have always observed some level of home improvement fraud (particularly in the decade of the 1970's, to a lesser extent in the 1980's). In the last 5 to 7 years, however, there has been an explosion of predatory home equity lending and flipping. Predatory practices on low income consumers, and in particular, vulnerable consumers such as the elderly, illiterate working families and minorities, have become routine.

Current law provides no meaningful restriction on the kind of flipping that occurred in Ms. Podelco's case and occurs in hundreds of other cases per year in my State, which results in the skimming of equity from borrowers in their homes. Meaningful prohibition of flipping calls for a simplified remedy (for example, the prohibition of charging new fees and points). West Virginia had such a time limitation on refinancing by the same lender and charging new points and fees. The 2000

enactment was repealed in 2001, after the new Banking Commissioner pushed for the elimination of that restriction at the industry's behest.

The opportunity for recurring closing points and fees financed in the loan and the lender to be rewarded immediately for refinancing leads to disregard of whether or not a borrower can repay. Ms. Podelco is typical of a frequent pattern of consistent loan flipping with the last loan pushed off onto another lender who takes the loss. Ms. Podelco provides one example of hundreds of West Virginians. On these loans no laws are being broken but the flipping is so exploitive that it results in loss of the individual's equity in their home, and ultimately in many cases the loss of the home, forcing the elderly or otherwise vulnerable citizens out of their residence.

A meaningful cap on fees and on financing points and fees would have a substantial impact upon these exploitive loans. I would urge the Committee to consider an easy definition that limits high points and fees up front and provides other protections against exploitive equity based lending, a system that rewards the lender immediately on closing, no matter what the fees, regardless of whether the borrower pays, and provides economic incentive for this type of conduct to continue unchecked.

A single definition of high points and fees is easily enforceable. Lowering the HOEPA points and fee trigger to the greater of 4 percent of the loan amount or $1,000 is a first step but it is still not low enough to prevent the abuses. The proposed legislation will be helpful in (1) prohibiting balloon mortgages, (2) creating additional protections in home improvement loans, (3) expanding the TILA rescission as a remedy for violations of all HOEPA prohibitions, (4) prohibiting the sale of lump sum credit insurance and other life and health insurance in conjunction with these loans, and (5) limiting mandatory arbitration.

Virtually all of the subprime balloon mortgages observed in my State are very exploitive to the consumer. The fact of such balloon payment predestines foreclosure for the consumer in many cases.

Mandatory arbitration clauses are now used by the majority of home equity lenders and they are increasing daily as the technique to deny consumers any meaningful opportunity to contest the loss of their home. Arbitrators selected by the creditors now decide whether a consumer gets to keep his home. Notwithstanding the fact that there are many exploitive abuses, the arbitrator designated by the lender in the loan agreement now decides the merits of all claims. Practically speaking, this means that the consumer loses, and arbitration rules provide that the practices of the lender are kept confidential.

In the subprime mortgage context, that is, outside of conventional loans, there is an urgency to address the following exploitive lending practices:

(1) Prohibition of mandatory arbitration clauses in all subprime loans.

(2) Prohibition of subprime balloon payment loans. Low income borrowers generally cannot meet these loans and the lender cannot expect them to make a balloon payment. Such loans assure (a) the loss of a home or (b) require refinancing on usually very exploitive terms if the borrower can even get the loan.

(3) Excessive interest rates, not justified by any additional risk, are frequent for the vulnerable consumer groups. The risk is covered by the real property security.

(4) Broker kickbacks should be prohibited. They are a very anticompetitive practice and in the subprime market result primarily in increasing the cost.

(5) Home solicitation scams have been with us for many years but as a means for skimming the equity from unsophisticated consumers, home equity lenders are now more frequently using them as a solicitation tool.

(6) Altered and falsified loan applications are now becoming commonplace in the subprime market. These are altered after signature by fudging the income of the prospective borrower or by alteration of the proposed loan amount. The impact is a level of payments that the consumer cannot make.

(7) Credit insurance packing (by consumer finance companies) into regular, nonhome secured consumer loans and flipping them into home equity secured loans is commonplace. Consumer finance loans with five insurance policies are common to a greater extent than home equity loans with credit life insurance.

(8) Excessive loan points and broker fees are primary incentives to abuses. Conventional mortgages with 1–1½ percent broker fees are standard, while the lack of sophistication of vulnerable groups leads to broker compensation of 3 to 7 percent. These are very discriminatory to unsophisticated consumers given the similarity in the work performed.

(9) Excessive loan to value loans. One hundred twenty five percent to 200 percent of actual market value loans are not uncommon for brokered loans given the financial incentives to flip, and the lack of any concern for ability of the borrower to pay. The broker's only concern is closing the loan for the fee.

Ameriquest Mortgage Company Retail Best Practices

Ameriquest Mortgage Company has worked closely with the Leadership Conference on Civil Rights, the National Fair Housing Alliance, the Association of Community Organizations for Reform Now (ACORN), and the National Association of Neighborhoods to develop a set of industry-leading fair lending practices. Many of them are perhaps obvious and, in fact, reflect practices Ameriquest implemented long before "predatory lending" became the catch phrase it is today.

Through our discussions with these parties, we found common ground on a number of matters. All parties are in agreement that utilizing practices that are clearly abusive, or the use by lenders of lawful practices in an abusive, unfair or deceptive manner, are both abhorrent. Such conduct has no place in either the prime or the subprime mortgage industry or, for that matter, in any credit transaction. The question, therefore, is not whether such lending practices should be prevented -- they must be. The only question is "how best to do so."

There seems to be universal agreement that it is necessary to balance two principal objectives in devising appropriate safeguards against abusive lending practices. On the one hand, lenders should be subject to rules that effectively prevent them from engaging in misleading and deceptive practices and from imposing unfair terms or prices; on the other hand, it must be recognized that these rules should not impede the subprime industry's continuing contribution to the highest homeownership rates in the nation's history. Rules should not be adopted that have an unduly adverse effect on the positive role that subprime lending plays in providing affordable credit to those who most need it.

The practices set forth below meet the foregoing standards. However, we also believe a number of the practices set forth below are unprecedented, and that the entire list is an appropriate template, not only for a set of industry "best practices," but also for legislation that would require these practices as the appropriate measured response to very legitimate concerns.

1. Full And Timely Disclosure Of Loan Terms And Conditions

We do not condone misrepresentation of the terms and conditions of a loan. Ameriquest uses an automated system, which ensures that good faith estimates are sent to all potential borrowers within three (3) business days from when their loan application is received, and which contain reasonable estimates of the costs of the loan based on the information provided by the borrower at that time.

The price and the terms of a loan may change between the time a good faith estimate is sent to the borrower and the time of the loan closing, based on information received from credit reporting agencies, other lenders, bankruptcy records and the like. It is Ameriquest's policy to notify its customers immediately by telephone whenever it receives such information, to explain to the customer any changes that may be necessary to the loan terms and to determine whether the customer still wishes to obtain the loan in light of those changes. At the closing, the borrower receives a written document disclosing the differences, if any, between the loan terms that were reflected in the good faith estimate and the final loan terms.

2. **PLAIN ENGLISH; RECOMMENDING CREDIT COUNSELING**

In order to provide borrowers with as much guidance and disclosure in the simplest terms possible, Ameriquest has enhanced its already comprehensive disclosure policy by adding two short disclosure forms that assist borrowers in understanding their loan transaction. The two forms are written in plain English with a simple-to-read format.

One form is sent out with the initial good faith estimate so the borrower understands the loan transaction as early in the loan process as possible. This disclosure form: a) explains the benefits, obligations and risks of borrowing against one's home; b) contains cautionary tips (borrow within your income and budget, don't be pressured into signing documents you don't understand, shop around, be advised that the price of the loan or other loan terms might change by the time of closing, maintain a good payment record prior to the loan closing); c) explains the right to cancel, if applicable; and, d) provides the toll free "800" telephone number for access to names, addresses and phone number(s) of independent, third-party, HUD-certified credit counselors, accessible to the borrower, and makes a recommendation that the borrower consult with such a counselor about the loan both prior to the closing and during the rescission period. At the loan closing, another copy of this short-form disclosure is the first document given to the borrower and its provisions are orally reviewed with him/her. The borrower signs the form with an acknowledgment that it was provided to, and reviewed with, the borrower.

A second disclosure form is presented to the borrower at the closing. This document explains: a) whether or not the loan contains a prepayment penalty and, if so, how it will be calculated; b) the amount of the borrower's monthly payments; c) whether the loan has a variable rate feature and, if so, how the variable rate might affect future monthly payments; and d) the loan fees being paid by the borrower and information regarding the amount paid to third parties for services or fees charged in connection with their loan.

Ameriquest believes these enhanced, plain English disclosure forms ensure that all our borrowers have adequate opportunity to be fully and fairly informed of their loan terms and conditions and to receive independent expert advice regarding whether to accept our loan.

3. **PROVIDING THE BORROWER WITH ADEQUATE TIME TO EVALUATE THE FINAL, WRITTEN LOAN TERMS – A ONE-WEEK CANCELLATION PERIOD**

The plain English disclosure form that is sent to each borrower at the time a loan application is taken and provided to each borrower at the loan closing notifies the borrower of the right to cancel, if applicable. Current law requires that certain borrowers be given three (3) business days after a loan is consummated within which the borrower may cancel the loan for any reason. We believe fairness dictates additional opportunity for consideration of a financial transaction as significant as a mortgage secured loan. In order to provide these borrowers with additional time within which to evaluate their final, written loan terms, to seek the assistance of credit counselors and to shop for another loan, Ameriquest a one week cancellation period extends to borrowers refinancing their owner-

occupied mortgage loans. Borrowers are permitted to waive this period in appropriate circumstances; however, any such waiver requires approval of an Ameriquest supervisor.

4. **Determining Whether The Borrower Has The Ability To Repay Our Loan**

We have a vested interest in ensuring that we make loans only to borrowers who can afford to repay them. Money is lost virtually every time we are compelled to foreclose on real property serving as security for a loan. Moreover, if we make too many loans upon which borrowers default, we will destroy our relationships with the investors upon whom we depend to buy our loans. Accordingly, Ameriquest has developed an automated underwriting system that is designed to evaluate an applicant's ability to repay his or her loan. Debt to income ratios alone are insufficient criteria. We recognize the need to assure minimum disposable income after all monthly payments have been made. We are also firmly committed to confirming income sources prior to reaching agreement on loan terms.

5. **Reasonable Rates, Points and Fees**

Ameriquest does not originate high cost loans as currently defined in the Home Ownership and Equity Protection Act of 1994. We have developed and use a price monitoring system to ensure that we do not charge higher rates, points and/or fees to one group of borrowers versus another.

6. **Prepayment Penalties That Are Fair, and Fully Disclosed**

We do not require that our borrowers accept prepayment penalties. Our borrowers can and do negotiate for a higher interest rate or higher points in lieu of a prepayment penalty. When a loan does contain a prepayment penalty, that fact is fully disclosed. Nevertheless, we provide additional notice of any prepayment penalty on the short-form disclosure document given to each borrower at the loan closing.

7. **Prohibited Practices - Flipping, Balloon Payments, Negative Amortization and Mandatory Arbitration Clauses; Single Premium Credit Life Insurance Policies**

Ameriquest tracks all refinancings of existing customers and, unless the loan is being paid, off by another lender, does not allow refinancing of a loan originated by our company within 24 months of its origination. We do not offer loans with mandatory arbitration clauses. Although there are circumstances when loans with balloon payments or negative amortization may be appropriate, and although they are both legal, Ameriquest does not offer loans with these features. Ameriquest does not finance single premium credit life insurance to borrowers.

8. **Marketing Based Solely On Financial Characteristics**

Our loans are made to individuals with impaired credit. We use information regarding the credit profiles and debt levels of homeowners to identify potential customers. Our marketing efforts are made without regard to age, gender, ethnic origin or income level. We are committed to compliance with HMDA reporting requirements.

9. FAIR LENDING

We have developed and implemented a thorough fair lending training program for all employees, from our origination personnel through our servicing staff. The fair lending policy of the company is distributed to and acknowledged by each associate of Ameriquest. We also assure that each training manual, operation manual, marketing piece and document, intended for dissemination either internally or to the public, complies with all fair lending laws.

10. REPORTING OF BORROWER PAYMENT HISTORIES TO CREDIT BUREAUS

We report our borrowers' mortgage payment performance to the three major credit reporting agencies on a monthly basis. Borrowers who make their payments on time are able to develop a better credit history and eventually obtain access to the prime credit market.

11. ARMS-LENGTH RELATIONSHIPS WITH THIRD PARTIES

Ameriquest maintains arms length relationships with all third parties involved in loan originations, including title companies, appraisers, etc. We pass through the fees charged by such third parties at cost only, with no added mark-up coverage. If the proceeds of a loan are used in whole or part for home improvements, we issue checks made payable only to the borrower, the borrower and the contractor jointly or a third party escrow account.

12. FAIR COLLECTION PRACTICES

Our overall philosophy is one of workout, not intimidation. We provide a minimum of 80 hours of training for all of our loan collection personnel regarding fair debt collection practices, win-win negotiation skills and workout remedies. If a borrower becomes delinquent, we include on every billing statement the identity of a reasonably accessible credit counseling service and a statement encouraging the borrower to seek assistance. We permit extensive workout and repayment plans in an effort to permit our customers to bring their delinquent accounts current. We generate daily reports on the number of calls made to each delinquent borrower and the number of messages left, and we monitor these calls for quality control purposes.

13. WEBSITE REFERRALS

We have linked our company's Website to those of credit counselors and community groups that can provide information to all potential applicants regarding both prime and nonprime mortgage loans.

14. Donate Foreclosed Properties

We are developing a pilot program whereby we will donate to community groups properties acquired though foreclosure and wherein we have the right to retain the proceeds of any sale of the property.

15. Maintenance Of Escrow Deposit Accounts

Ameriquest provides all its borrowers with the option to have the company maintain escrow accounts for the monthly deposit of funds to pay taxes and hazard insurance. We recognize the concern that if an escrow account is not required, a borrower may be misled into believing that a proposed new loan which excludes the required monthly payments for taxes, etc. will result in lower monthly payments than the borrower's original loan which included an escrow account. We believe, however, that this concern is better addressed through adequate disclosure rather than restricting a borrower's freedom of choice.

16. Educational Initiatives; Consumer Mortgage Education

In 1996, Ameriquest supported the formation of the Consumer Mortgage Education Consortium (CMEC) in conjunction with three leading Washington D.C.- based civil rights organizations. They are the Leadership Conference on Civil Rights, the nation's oldest and largest civil rights coalition; the National Fair Housing Alliance; and the National Association of Neighborhoods. CMEC was founded to stimulate the availability of home loans for all Americans and to promote a better understanding of loan products and lending processes through various initiatives:

17. Appraisal Reviews

We do not benefit from any inflated appraisals. In fact, there is a great likelihood that we will sustain significant losses in the event of default by the borrower if the collateral is insufficient to secure the debt. In order to prevent problems associated with incompetent or corrupt appraisers, we perform an automated review of all appraisals we receive and, in addition, we audit a random sample of appraisals on a monthly basis.

18. Prompt And Responsive Customer Service

Our Servicing Department welcomes all new borrowers immediately after their loans are finalized by phoning them to verify basic loan information and to ensure that they understand the loan terms, payment amount and payment date. These welcome calls help us to promptly identify any origination-related problems. Customer service representatives are available to respond to customer inquiries at any time regarding loan terms and conditions. We also have a separate, trained staff that responds promptly to customer complaints.

STATEMENT OF AMERICA'S COMMUNITY BANKERS

JULY 26, 2001

America's Community Bankers (ACB) is pleased to take this opportunity to submit a statement on predatory lending practices. ACB represents the Nation's community banks of all charter types and sizes. ACB members pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities.

General

ACB members participate in many important programs and partnerships that help average Americans become and remain homeowners. This commitment of ACB's members to homeownership is good for communities and is good for business. In contrast, predatory lending practices undermine homeownership and damage communities. ACB pledges to work with this Committee and other policymakers to eliminate predatory lending practices in the most effective way and to enhance all creditworthy borrowers' access to sound loans. ACB also would appreciate the opportunity to provide the Committee with the views of our recently formed task force on predatory lending when they are available.

Legislative and regulatory attempts to deal with predatory lending face serious challenges. New laws and regulations could discourage certain types of lending by inaccurately labeling loans as "predatory" or stigmatizing legitimate loan terms and at the same time failing to stop predators from engaging in egregious practices. It is essential to recognize the important difference between legitimate loan product terms and predatory lending practices. Any loan term is subject to abuse if it is not properly disclosed or if the loan officer falsifies documents.

An overly broad law or regulation could impose restrictions that would limit the availability of credit while allowing predators to continue their deceptive practices. Rather than imposing more regulations on heavily supervised institutions, ACB continues to recommend stronger supervision of unsupervised lenders. A combination of vigorous enforcement of existing laws and regulations and enhanced opportunities for homeownership education and counseling would be the best approach to the problem.

The Board of Governors of Federal Reserve System (Federal Reserve) is considering amendments to its regulations implementing the Home Ownership and Equity Protection Act of 1994 (HOEPA).[1] The Office of Thrift Supervision and the FDIC continue their review of regulations and policies. In addition, the new Administration—particularly the Department of the Treasury and the Department of Housing and Urban Development (HUD)—have indicated that they will become engaged on the topic. While this Committee's hearings are timely and appropriate, Congress will likely wish to review the Federal Reserve's and the agencies' final regulations and receive the Administration's views before moving on legislation.

One troubling development is the actions by various State and local governments regarding predatory lending. They have considered—and in some cases passed—overly broad legislation. The effect has already been to discourage lenders from making subprime loans in some of these jurisdictions, cutting off credit to those who need it most.

While regulation and improved supervision have important roles to play, the consumer is the first line of defense against abusive practices. Homeownership education and counseling cannot be overemphasized as a way to help borrowers avoid becoming victims of predatory lenders. This is particularly true for borrowers with little or no experience in homeownership and finance. ACB members currently provide counseling on their own or in combination with other institutions or community groups. ACB will continue to work with the American Homeowner Education and Counseling Institute as a founding member to provide more education and counseling. Lenders, community groups, and public agencies should work to expand these programs.

Equal Enforcement Is Essential

Most proposed legislation and regulations would, in theory, apply to almost all mortgage lenders. Indeed, many nondepository institution lenders assert they must adhere to the same regulations that insured depository institutions must follow. However, many of the firms most commonly associated with predatory practices are not Federally insured and are not subject to regular examination and rigorous su-

[1] Pub. L. 103–325, Title 1, Subtitle B (September 23, 1994). Our comments on the Federal Reserve's proposed amendments are an appendix to this testimony.

pervision. Such firms are examined on a complaint-only basis. The joint report by the Federal Reserve and the HUD issued in 1998 acknowledged these facts, stating:

> Abusive mortgage loans are not generally a problem among financial institutions that are subject to regular examination by Federal and State banking agencies. Abuses occur mainly with mortgage creditors and brokers that are not subject to direct supervision.[2]

Abusive practices—for example, falsifying documents; hiding or obscuring disclosures; orally contradicting disclosures—are the essence of predatory lending. The proper remedy for these abuses is to ensure that loan originators do not violate laws against fraud and deceptive practices and properly disclose loan terms. If existing and new regulations are effectively applied only to Federally supervised depository institutions, they will fail to deal with the problem. ACB is concerned that the current focus on abusive lending practices could lead to overly broad regulations. By unduly tightening restrictions on subprime lending, there is a risk of discouraging insured depository institutions from making responsible subprime loans, which would effectively open the door even wider to unregulated predators.

To avoid this, the focus of regulatory efforts should be on enhancing systems to detect and deter deception and fraud without restricting the availability of credit. Borrowers should enjoy the same consumer protections, regardless of the institutions they patronize, and the institutions that offer similar products should operate under the same rules. Therefore, ACB strongly encourages increased supervision of non-Federally insured lenders.

ACB recommends that Congress provide the Federal Trade Commission (FTC) with adequate resources to enforce the laws under its jurisdiction, particularly with respect to unsupervised lenders. The Federal banking agencies should work with the States and the FTC to ensure that Federal regulations apply in practice, as well as in theory, to all lenders, including State-licensed, nondepository lenders.[3] The application of the standards and enforcement of these regulations is particularly important because State-licensed lenders can choose to follow regulations issued by the Office of Thrift Supervision under the Alternative Mortgage Transactions Parity Act.[4] Without adequate enforcement, there may be situations where State law is preempted but Federal regulations are not enforced.

Subprime Lending vs. Predatory Practices

It is important that policymakers distinguish between subprime lending and predatory lending practices. These terms are often mistakenly used interchangeably. Subprime lending provides financing to individuals with impaired credit or other risk factors, though at somewhat higher rates or under stricter terms than are available to more creditworthy borrowers. The rise of subprime lending has given many previously underserved borrowers access to credit; before the expansion of subprime lending, a consumer either qualified for a prime loan or was denied credit. Subprime loans now offer a middle ground and have helped consumers achieve and maintain home ownership at record levels.

A properly underwritten subprime mortgage benefits both the borrower and the lender. To be considered properly underwritten, a subprime loan—indeed any loan—must be priced appropriately. The best credit risk enjoys the lowest rate; those with weaker credit histories are risk priced at higher rates for access to credit. By expanding the pool of eligible borrowers, lenders are able to add earning assets to their books. However, subprime borrowers also add risk to the balance sheet. By taking borrowers' circumstances into account in pricing, lenders are properly compensated for the risks they take. Done right, subprime lending is good for an institution's customers, community, stakeholders, and deposit insurance fund.

In contrast, true predatory lending benefits only the lender. All lending should balance the interests of lenders and borrowers. In the case of loans made on an abusive or predatory basis, the mortgage broker, home improvement contractor, or lender receive excessive fees, while borrowers who cannot meet the terms of their loans may diminish their equity, damage their credit ratings, and even risk the loss of their home. To avoid foreclosure, borrowers must often carry ultra-high debt service until they can secure new financing. These predatory lenders charge far more than what is required to fairly compensate for risk or lend to borrowers that are unqualified. They do so to extract as much profit from the transaction as possible.

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[2] Joint Report to the Congress Concerning Reform to the Truth in Lending Act and the Real Estate Settlement Procedures Act, July 1998, p. 66.

[3] Letter of July 5, 2000 in response to OTS advanced notice of proposed rulemaking on responsible alternative mortgage lending.

[4] 12 U.S.C. 3801–3806.

Adjusting the HOEPA Triggers

The Federal Reserve has authority under HOEPA to adjust the annual percentage rate (APR) trigger from 10 to 8 percentage points over the comparable treasury rates. The Federal Reserve may also include additional fees in to the points and fees trigger.

Adjusting the APR Trigger

There are many descriptions of predatory lending practices, but they cannot easily be translated into a clear statutory or regulatory definition of predatory lending. Rather than attempting to define the term, HOEPA draws a line between high-cost loans—which require special disclosures and restrictions—and all other loans. This bright line has the advantage of clarity, but HOEPA does not encompass all loans that might be predatory. That is probably an impossible goal, but ACB members believe that the current APR threshold of 10 percent over comparable Treasuries could be lowered to 8 percent without restricting the subprime market.

According to last year's report on predatory lending practices by HUD and the Treasury, only 0.7 percent of subprime loans originated from July through September of 1999 met the current HOEPA APR threshold.[5] By lowering the threshold from 10 to 8 percent, HUD and Treasury estimated that 5 percent of subprime loans would be covered.[6] ACB recommended that the Federal Reserve take this step under its current HOEPA authority.

Lowering the threshold to 8 percent would cover a larger universe of transactions and provide additional protection to consumers. Doing so will not, however, solve the problem. Some lenders may try to avoid the HOEPA trigger by shifting the coupon rate and the upfront fees by small amounts. In any event, predatory lenders may not bring the HOEPA disclosures to the borrowers' attention or may tell the borrower the disclosures are irrelevant. As pointed out above, rules without enforcement are no solution.

In addition, we caution against lowering the thresholds too far, as proposed in some legislation. That could unfairly label legitimate subprime loans as predatory and impose additional burdens on legitimate subprime lenders.[7] Imposing additional disclosures; restrictions on terms; and reduced access to the secondary market would be harmful, but still not effectively deal with the predatory lending problem.

Regulators have suggested that they will not consider HOEPA loans for purposes of Community Reinvestment Act compliance, a step ACB supports. The secondary mortgage market, at least as far as the Government-sponsored enterprises are concerned, will not now accept HOEPA loans. These are helpful steps under the current HOEPA limits, but could be perversely damaging if the current trigger values are decreased too far. Such a chain of events could force more borrowers away from regulated lenders to the unregulated.

Points and Fees Trigger

In general, ACB opposes adding additional items to the points and fees trigger. We recommend applying the HOEPA definition to a substantial number of additional loans by reducing the APR trigger. That change, when coupled by the increased reluctance of lenders to make any HOEPA loans and investors to buy such loans, would have a substantial effect. Policymakers risk overreaching if they also bring more loans under HOEPA through the points and fees mechanism. If Congress or the Federal Reserve believe it is necessary to add items to the points and fees trigger, ACB believes it should apply only to cases where the refinancing takes place within a relatively short period, such as 12 months or less.

Prepayment Penalties

ACB opposes including prepayment fees in the points and fees trigger for HOEPA loans as proposed by the Federal Reserve. Prepayment penalties are a common option the borrower can accept in exchange for other consideration, such as a lower interest rate. This earlier transaction has no direct relationship to the new loan. ACB understands the concern with the abusive practice known as "loan flipping" that is used to increase opportunities for predatory loan arrangers to impose inap-

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[5] "Curbing Predatory Home Mortgage Lending: A Joint Report" (June 20, 2000) p. 85.

[6] *Id* at p. 87.

[7] Federal Reserve Governor Edward Gramlich described the problem this way in his May 1, 2000 letter to Senate Banking Committee Chairman Phil Gramm. The Governor wrote: "HOEPA's triggers may bring subprime loans not associated with unfair or abusive lending within the acts's coverage. Similarly, abusive practices may occur in transactions that fall below the HOEPA triggers." In a similar letter sent on May 5 to Chairman Gramm, Comptroller of the Currency John D. Hawke, Jr. summed up the problem this way: "I am concerned that attempting to define this term [predatory lending] risks either over- or under-inclusiveness."

propriate costs and fees at closing. However, the suggestion that a new rule be imposed runs the risk of bringing legitimate loans and lenders into the HOEPA ambit. ACB recommends that policymakers attack these abuses directly, through better enforcement and consumer education and counseling. This is a better approach than unfairly stigmatizing legitimate transactions.

Points

As with prepayment penalties on the original loan, ACB believes that points paid on that loan have no relationship to the points and fees—and hence the HOEPA trigger—on a new loan. The proposed addition to the points and fees trigger is another way to discourage loan flipping by predatory lenders. Again, ACB urges policymakers to attack this problem directly.

Scope of Restriction on Certain Acts or Practices

In its request for comment last year, the Federal Reserve sought comment on several approaches to deal with predatory lending practices and asks whether they should apply to:

- All mortgage transactions;
- To refinancings only; or
- To HOEPA loans only.

The current anecdotal information does not implicate the vast majority of mortgage transactions or refinancings. Therefore, ACB recommended that any new restrictions apply only to HOEPA-covered refinancings to avoid limiting the availability of legitimate subprime loans.

Specific Terms and Conditions

During the debate on this issue, a number of specific proposals have been advanced to attempt to prevent predatory lending practices. ACB is concerned that certain rates and terms might be defined as "predatory," even though in most circumstances they would be appropriate. Whether a particular term is predatory generally depends on the facts and circumstances of the particular transaction. Blanket restrictions on loan terms that have a legitimate role in the marketplace is not the right solution.[8]

These are ACB's comments on some of these specific issues:

Unaffordable Loans

One practice used by predatory lenders is to make a loan to an individual that he or she is clearly in no position to repay, based on the stated amortization schedule. ACB opposes such a practice where the borrower does not understand the terms of the loan and has no other means to repay. However, there may be some situations where both the lender and the borrower understand at the outset that the borrower lacks the capacity to amortize the loan from ordinary sources but structures the loan to accommodate repayment from an extraordinary source. One common example is a "bridge loan" where repayment will come from the sale of the borrower's current residence. ACB urges that policymakers avoid imposing legislation or regulation that might interfere with these kinds of accommodating transactions.

Federally insured banks and savings associations must already demonstrate that their loans are made according to sound underwriting guidelines. They have a good record of making loans that borrowers can repay. If other lenders adhered to similar good business practice, this aspect of the predatory lending issue would be substantially mitigated.

There are some indications that the capital markets are already pulling away from predatory lenders because of losses due to foreclosures and increased public and regulatory scrutiny. While many predatory loans may remain on the books and reports suggest that borrowers are continuing to suffer from predatory practices, capital market discipline is likely to become increasingly effective. Therefore, it is important that policymakers not overreact and impose rules that discourage mainstream lenders from providing credit to underserved areas and populations.

Limits on Refinancing

Another predatory technique involves frequent refinancings, sometimes within a brief period. One of the most egregious examples involves refinancing low-cost loans

[8] Governor Gramlich described the problem with new rules this way before the House Banking Committee on May 24, 2000: "Frankly, the value of rules prohibiting such practices is uncertain, given the nature of predatory practices. Some occur even though they are already illegal, and others are harmful only in certain circumstances. The best solution in many cases may simply be stricter enforcement of current laws."

on community development housing and simply replacing them with much higher-rate loans. Such practices are completely inappropriate.

Yet additional regulation to protect consumers is not the answer. First, refinancing a loan at a higher rate is not, by itself, a predatory practice. For example, a borrower may wish to convert a substantial amount of equity into cash, resulting in a higher loan-to-value ratio and risk profile for the new transaction. Alternatively, that borrower may find that market rates may have simply risen since the original loan was made. While repeated refinancings at higher rates may well be a common predatory practice, a borrower and a lender may find it mutually agreeable to restructure their business relationship. A well-informed consumer who chooses and can afford the obligation should not have that option foreclosed.

Second, repeated refinancing is generally just one aspect of a broader predatory lending scheme that involves deceiving the borrower, falsifying loan papers, and "packing" the loan with hidden fees. Without these illegal practices, there would be little point in repeated refinancing. Thus, a special rule on refinancing is not necessary.

Some have suggested language that would permit refinancing at higher rates if there is a tangible net benefit to the borrower. This is an intensely fact-based standard that—if imposed by law—could create an unprecedented burden on institutions, for example to analyze and document the "tangible net benefit" for every loan. ACB opposes this standard as both unnecessary and overly burdensome.

Balloon Payments

Balloon payment provisions can be used by predatory lenders to force a refinancing or even foreclosure. However, it is important to recognize that balloon payments can serve legitimate purposes. A balloon provision would make sense for a borrower who wishes to pay the loan on a long-term schedule, but fully expects to refinance or repay the loan before the date the balloon payment is due. For example, a borrower may have a fixed-rate, fully amortizing loan (no balloon) coupled with a line of credit with interest-only payments until a date certain when the loan must be paid in full. Properly used balloon transactions give borrowers the benefits of short-term interest rates and long-term amortization of the loan debt. A borrower who is fully informed by the lender and who understands his or her obligations can avoid foreclosure by a planned sale of the property, refinancing the balloon transaction, seeking an extension before the final due date, or taking some other action.

These positive features depend on an informed borrower who understands the implications of a balloon payment. Based on the anecdotal information provided during last year's HUD-Treasury forums, it appears that some victims of predatory lending practices have not understood this particular loan term. As indicated below in the discussion of improved disclosures, ACB believes that it should be determined why this is the case and steps taken to correct the problem, rather than imposing unnecessary and disruptive restrictions.

Prepayment Penalties

Unreasonable prepayment penalties can make it extremely difficult for a borrower to replace a loan made on an abusive or predatory basis. In other instances, prepayment penalties which are typically in effect only a few years—are appropriate and beneficial to borrower and lender alike. They decrease the likelihood that a borrower will pay off a loan quickly (decreasing anticipated income to investors) or compensate the investor for lost income if the borrower does decide to prepay the loan.

What is the benefit to the borrower? Investors are willing to accept a loan with a lower interest rate, with the protection of a prepayment penalty. This is an especially good option for borrowers who expect to remain in their homes for a longer period. It is also important to emphasize that these clauses may discourage the refinance option for only a limited time and may not be binding at all if the borrower seeks to sell the home. In some cases, borrowers prefer loans without prepayment penalties and lenders do not include them. This is an appropriate market response.

Some have proposed limiting prepayment penalties to cases where the borrower receives a benefit, such as lower upfront costs or lower interest rates. This is similar to the "tangible net benefit" test discussed above in connection with limits on refinancing. However expressed, ACB believes that it would be extremely difficult for an institution to reliably measure and demonstrate compliance with such a requirement across an entire loan portfolio, especially in periods of high mortgage interest rates. Each case would depend on particular facts and circumstances, requiring an economic analysis of each situation.

Regulatory evaluation could even turn on the subjective intent of the borrower. For example, a borrower who had no intention, at the time of closing, of selling the home soon might later decide for any number of reasons to sell his or her house

and prepay the mortgage. He or she would have received a lower interest rate or fewer points in exchange for a prepayment penalty that he or she never expected to incur. However, what might have looked like a good bargain at closing could turn out to be relatively costly just a short time later simply because the borrower chose a different course.

ACB believes that this is another case where informed consumer consent, rather than a difficult to enforce standard makes the most sense.

Negative Amortization

Some loans have payment schedules that are so low that interest is added to the principal, rather than being paid as it accrues. This can be harmful if too much interest is added to the loan's principal and the loan terms do not provide a way to reverse the process. However, like a prepayment penalty, the possibility of negative amortization can help borrowers. For example, some lenders offer fixed-payment, adjustable rate loans that—depending on prevailing interest rates—could result in some negative amortization. These loans are sometimes made to ease the debt service requirement for a defined and often limited period. The interest rate on these loans is capped, the possibility of negative amortization is fully disclosed, and the negative amortization potential is itself capped. Sometimes the negative amortization is provided to assist the borrower in a time of financial stress or in times of unusually high short-term interest rates.

Misrepresentations Regarding Borrower's Qualifications

Some have suggested a rule that would prohibit lenders from misleading consumers into thinking that they do not qualify for a lower cost loan. In a request for comment last year, the Federal Reserve indicates that, "Such a practice generally would be illegal under State laws. . . ."[9] ACB believes that State authorities should enforce these laws with respect to lenders they regulate. It is unlikely that Federally insured depository institutions are engaged in these practices and, if they are, the existing examination process would correct them.

Reporting Borrowers' Payment History

One important potential benefit of responsible subprime lending is that it can give those borrowers with credit blemishes a chance to qualify for prime loans. ACB strongly supports the reporting of all loan performance data and is opposed to the reported practice by some lenders of choosing not to report positive performance for fear their customers will be targeted by competitors for refinancing. If a lender does not report positive credit experience, the credit report is no longer accurate and the benefit of an improved credit report is lost. Lenders that report data must report all data and not subjectively choose what to report. This is an instance where consumers benefit from appropriate disclosure of their financial information.

Referral to Credit Counseling Services

ACB strongly supports homeownership education and counseling and our members have no objection to telling borrowers that counseling is available. In fact, many of our members offer counseling or participate in joint programs. And, as indicated above, ACB is a founding member of the American Homeowner Education and Counseling Institute. However, we are reluctant to endorse mandatory counseling for all high-cost loans, as some have suggested—particularly if a substantially higher number of loans are covered by a new definition. Mandatory counseling could create perverse incentives and give rise to meaningless counseling programs. Consumer representatives told the HUD-Treasury joint task force that they were concerned that counseling certifications could become yet another document that predatory lenders would routinely falsify. And, they indicated that if the mandatory counseling actually took place, it could be used as a shield against later claims that the loan was predatory or otherwise improper.

Nevertheless, ACB believes that counseling can be a real benefit to borrowers, especially those with little or no experience in homeownership and finance. Counseling gives potential victims of predatory lenders tools to avoid an inappropriate transaction.

Mandatory Arbitration

Arbitration agreements have been criticized when included in some HOEPA loans or loans deemed "predatory." However, arbitration can be a simple, fast, more affordable alternative to foreclosure litigation. Attorneys who represent homeowners victimized by predatory lenders often complain that they lack the time and resources to pursue claims in court. Fair and properly structured arbitration arrange-

[9] 65 *Fed. Reg.* 42892 (July 12, 2000).

ments could help them. Of course, they must be fully and properly disclosed. In legitimate agreements, consumers retain all of their substantive legal rights. And, the record shows that there is no inherent bias against consumers in arbitration proceedings.

HOEPA Disclosures

In addition to increasing the number of loans considered high-cost, some have suggested increasing the disclosures that must be made for these loans. ACB believes that requiring substantial additional disclosures would provide little benefit. The HUD-Treasury forums presented convincing evidence that the existing disclosures are sometimes ineffective, and more elaborate disclosures might even give predators more opportunities to confuse consumers. Rather, ACB recommends that the Federal Reserve and other policymakers thoroughly study why the existing disclosure regime is ineffective and what alternatives might work. Those efforts should concentrate on simpler, "plain English" disclosures that focus consumer attention on relevant information. Regulators also should work to ensure that disclosures are provided in a timely way, particularly by institutions that are not regularly supervised.

One approach might be adapted from the Truth in Lending Act (TILA) tables required for mortgage loans and the requirement that credit card solicitations include a special table (sometimes known as the "Schumer box") that highlights key terms.[10] For a loan (as opposed to credit sale) the highlighted terms are:

- Annual percentage rate
- Finance charge
- Amount financed
- Total of payments
- Payment number, amount, due dates

The form also includes information on credit insurance, security interest, filing fees late charges, and prepayment penalties.

For credit cards, these terms are:

- Annual percentage rate
- Variable rate (if any)
- Method of computing the balance for purchases
- Annual fees
- Minimum finance charge
- Transaction fee for purchases
- Transaction fee for cash advances and fees for paying late or exceeding the credit limit

These special disclosure boxes provide consumers with conspicuous disclosures of the key terms, though do not substitute for the full TILA disclosures.

In contrast, the special HOEPA disclosures—provided 3 days before closing—are limited to APR, monthly payment, and statutorily prescribed language that states, "You are not required to complete this agreement . . ." and ". . . you could lose your home . . .".[11] These disclosures do not address the predatory practices used to strip equity from borrowers' homes.

ACB suggests that policymakers carefully study why the current HOEPA disclosure system may be inadequate and determine how it could be improved. As things now stand, in some situations borrowers do not understand the disclosures or lenders do not provide the disclosures or discourage their use.

If the problem is lack of borrower understanding, the disclosures should be improved and lenders should make greater efforts to educate and counsel consumers. If the problem is with the lenders, ACB urges greater enforcement.

Certainly, disclosures should be written using plain language. But in addition, ACB recommends that Congress direct the agencies to work with lenders to field test the entire disclosure system. Such a review may reveal that even disclosures drafted in plain language are not fully understood by consumers. ACB cautions against overloading consumers with too much detail. ACB members' "field tests"—conducted at loan closings every day—demonstrate that many consumers do not understand the current disclosures.

Open End Home Equity Lines

Some have raised concern that lenders could use open-end credit lines to evade HOEPA and, if so, whether such structuring should be prohibited. ACB does not have any evidence that HOEPA is being evaded in this fashion. In addition, ACB

[10] Regulation Z, Appendix G–10(A) & (B) & H–2.
[11] 15 U.S.C. 1639(a).

members generally do not offer open-end mortgage loans; secured lines of credit are generally offered for a specified term, for example, 5 or 10 years, to give the lender an opportunity to review and restructure the agreement. In any case, ACB believes it would be very difficult to distinguish between legitimate lines of credit and "evasions," because whether a particular loan was an evasion would depend on the lenders state of mind.

Community Outreach and Consumer Education

The Committee should be aware of a wide variety of community outreach activities and consumer education efforts already underway. As indicated above, ACB is a founding member of the American Homeowner Education and Counseling Institute (AHECI), a nonprofit organization, which supports national standards for organizations and individuals that provide education and counseling services. This organization is the creation of a diverse group of mortgage industry stakeholders who realized that existing educational programs or counseling services had neither uniform content or value. The effort also recognized the need to determine and measure the qualifications and standards of conduct of those who deliver these services. AHECI has established minimum standards for educational program content and duration; these standards have been widely circulated and well received by the industry. AHECI certification of instructors and program approval will provide borrowers and lenders of a degree of assurance as to the quality and utility of locally offered programs never before available, once the certification/approval process is in place.

ACB also participated with other associations in the creation of a brochure designed to help consumers understand the terms of their loans *before* they commit in writing. This brochure defines key loan terms and includes a worksheet to help consumers compare their monthly spending plans before and after taking out a new mortgage loan. It also helps consumers compare all the terms of various mortgages. Finally, the brochure lists key rights available to protect against predatory lenders, such as the right to cancel a refinancing within three business days of a closing. A copy of this brochure is included with this statement. (Brochure held in Senate Banking Committee files.)

Whether through formal counseling programs or in the normal loan underwriting process, ACB member institutions work to ensure that borrowers understand their responsibilities and will be able to fulfill them.

Despite these efforts, supervised mortgage lenders have a difficult time competing with the aggressive marketing tactics of some lenders and brokers. The economics faced by the different types of lenders may go a long way toward explaining the problem. Simply put, a predatory lender that charges rates and fees substantially above prime can afford to devote substantial resources to marketing. This may include print, broadcast, and even "house calls" by loan sales people. Prime or near-prime lenders may have a better product, but their profit on a given loan is too small to support a similarly aggressive sales campaign.

Because of this imbalance in the market and because of the important public policy goal of blunting predatory lending practices, ACB believes that the Government agencies have a role in consumer information and education. The FDIC recently launched a financial literacy program with the Department of Labor. The OTS and the Comptroller of the Currency also have financial literacy programs. Federal Reserve Banks provide training sites for education and counseling services. Government agencies could—through public service announcements and the like—urge consumers to seek out education and counseling and encourage lenders to offer or recommend those services. In addition, ACB strongly supports funding for HUD's home ownership education and counseling programs.

Mortgage Lending Reform

Some assert that simplifying the application and settlement rules could go a long way toward solving the predatory lending problem. ACB supports simplification efforts, but we also recognize they are not a panacea for predatory lending. Industry and policymakers have tried repeatedly to streamline this process, but no matter how successful they are, making the biggest purchase and taking on the biggest financial obligation in your life is inherently complicated. But as indicated above, solid education and counseling can help borrowers learn enough about the process to understand whether or not they are being fairly treated.

Conclusion

In conclusion, we would like to emphasize the following points:

- Policy makers should avoid imposing over-inclusive legislation or regulations that unfairly label legitimate loans as predatory or stigmatize legitimate loan terms;

- Many firms associated with predatory practices are not subject to regular examination and rigorous supervision, and the Federal financial supervisory agencies should work with the FTC and the States to help ensure that new and existing rules are effectively and equally applied to all mortgage lenders;
- Unless all lenders are subject to the same rigorous enforcement, new rules only will increase the burden on institutions that are now heavily supervised while failing to solve the predatory lending problem;
- Existing disclosures should be made clearer—and validate these improvements through field testing—rather than adding lengthy new disclosures.
- Education and counseling can be an effective way to prevent predatory lending. ACB and its members pledge to increase access to high-quality homeownership education and counseling.

NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS
P.O. BOX 3769 • WASHINGTON, DC • 20007-0269
(703) 522-4770 • (800) 336-4644 • FAX (703) 524-1082

July 24, 2001

The Honorable Paul Sarbanes
Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, DC 20510

Dear Chairman Sarbanes:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only national trade association that exclusively represents the interests of our nation's federal credit unions, we support your hearings on predatory lending. While NAFCU believes there is little, if any, evidence of predatory lending practices by credit unions, we acknowledge the anecdotal evidence of consumers paying more than they otherwise might when obtaining or refinancing home-related loans.

Predatory lending in any form is unacceptable to the credit union community and NAFCU disapproves of any practices that take advantage of uninformed and unwary consumers by subjecting them to deception, misleading and incomplete information, falsifications, or outright fraud. In this regard, NAFCU strongly supports meaningful efforts to eliminate predatory lending practices in all sectors of the economy.

NAFCU believes there is little, if any, evidence of predatory lending practices by credit unions and that credit union specific regulation on predatory lending would be misdirected and, is therefore, not needed. Information from the Federal Reserve suggests that most predatory lending involves non-depository institutions and other lenders that are not subject to routine regulatory compliance audits and examination.

Before issuing new sets of regulations, the appropriate government regulatory agencies should determine whether effective enforcement of the Truth in Lending Act, the Home Ownership Equity Protection Act, relevant Fair Lending laws, and the Real Estate Settlement Procedures Act, would adequately protect consumers against predatory lending practices. Existing laws and regulations need to be effectively enforced and applied to all individuals and businesses that regularly extend credit for personal, family or household purposes.

As you are aware, credit unions are not-for-profit cooperative financial institutions. Credit unions return any earnings to their members typically as reduced fees or reduced interest rates on loans or as dividends on shares, or reinvest those earnings in the credit union as retained earnings for purposes of safety and soundness. Also, credit unions rely on unpaid, volunteer boards of directors elected by, and drawn from, each institution's membership. This structure ensures the maximum responsiveness to members, thus resulting in outstanding service.

e-mail: nafcu@nafcunet.org • **website:** www.nafcunet.org

In a resolution condemning predatory lending, the NCUA Board noted, "credit unions are generally recognized to be a part of the solution and not a part of the problem[.]" Other studies have also cited the superior service that credit unions provide their members. In a recent report published by Consumer Reports, which surveyed more than 14,000 individuals, it was found that:

> ... [E]ighty-eight percent of credit union customers were either completely satisfied or very satisfied with the service they received versus just 63 percent of respondents who had accounts at a commercial or savings bank.

Similar findings have also been published in the American Banker's annual consumer satisfaction survey. It is, therefore, readily apparent that credit unions have consistently outdistanced all other financial service providers in offering affordable financial services.

NAFCU believes that many of the problems that Congress will be investigating during their hearings are not problems within the credit union community. Furthermore, federal credit unions are prohibited by law from engaging in some practices that have been associated with predatory lending. For example, federal credit unions cannot charge more than 15 percent per year on any loan (12 USC 1757(5)(A)(vi)), unless an alternative rate is established by federal regulation. (Today that rate is 18%). In addition, federal credit unions are prohibited from charging pre-payment penalties to their members (12 USC 1757(5)(A)(viii)).

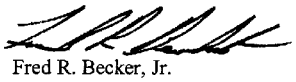
Many credit unions have taken on the responsibility of serving individuals of small means. According to the Federal Credit Union Act, Congress intended credit unions "to make more available to people of small means credit for provident purposes." (12 USC 1751) Credit unions have always taken this responsibility very seriously and have a proven track record in serving those individuals. It is vital that credit unions can continue to serve not only individuals of small means but also all individuals who wish to have credit union service. In fact, low-income expansions are growing at twice the rate they did in 2000. In the first six months of this year, there have been 97 low-income additions, which translates into 4.97 million potential members.

According to the Credit Union Membership Access Act (CUMAA, Public Law 105-219), credit unions must follow a very complicated formula laid out in the Community Development Banking and Financial Institutions Act of 1994 to determine which neighborhoods would be considered underserved. (12 USC 1759(c)(2)(A)(1)). NAFCU recommends that this definition be simplified and spelled out in the Federal Credit Union Act itself. In addition, NAFCU also believes that there are other areas in which the Federal credit union charter can and should be enhanced in order to better enable credit unions to serve America's financial services consumers. NAFCU has already had preliminary discussions as to how the Federal charter might be enhanced with individual Members of the Committee on Banking, Housing and Urban Affairs. We would be pleased to further discuss these critically important issues with you, Mr. Chairman, and the Members of your Committee and their staffs, at the earliest feasible opportunity.

In conclusion, NAFCU would like to urge Congress to examine all aspects of predatory lending, before moving forward with legislation. As a result, Congress may conclude that through enforcement of existing laws and the tightening of regulations, legislation to address the problem may not be necessary. It is vitally important that, when action is taken to protect consumers in the lending market, no one, especially those of lesser means, is left empty-handed.

If you or your staff has any questions regarding this matter, please don't hesitate to call NAFCU's Senior Vice President, Bill Donovan, or me at 703-522-4770. We look forward to working with you and the other members of the Committee on matters of mutual concern.

Sincerely,



Fred R. Becker, Jr.
CEO/President

STATEMENT OF GALE CINCOTTA

EXECUTIVE DIRECTOR, NATIONAL TRAINING & INFORMATION CENTER
NATIONAL CHAIRPERSON, NATIONAL PEOPLE'S ACTION

JULY 25, 2001

I want to thank Chairman Sarbanes and other Members of the Senate Banking Committee for holding hearings on predatory lending. My name is Gale Cincotta and I serve as Executive Director of the National Training & Information Center (NTIC) as well as the Chairperson of National People's Action (NPA). In these positions, I remain committed to stomping out this scourge. We hope that these hearings will lead to Federal legislation which would protect homeowners from the deceptive and equity-stripping practices used by predatory lenders.

NTIC is a 30 year old training and resource center for grassroots community organizations across the country. NPA is a coalition of 302 community groups from 38 States who organize locally and coalesce nationally around issues of mutual concern that require national action.

We are proud that Chicago was the first city to pass an antipredatory lending ordinance that required financial institutions with city deposits or contracts to swear-off predatory lending practices. We are also proud that Illinois passed strong antipredatory lending regulations in April (see *http://www.obre.state.il.us/predatory/predrules.htm* for details and attached articles).

Documenting the Problem

Both of these victories came after NTIC spent 2 years organizing at the local and State levels to address predatory lending. We argued for reform by getting homeowners and advocates directly involved in the fight.

We also documented that subprime lenders are the source of an explosion of foreclosures in the Chicago area—subprime lenders went from initiating 163 foreclosures in 1993 to filing 4,796 in 1999 (see attached maps). Similarly, the share of foreclosures by subprime lenders grew from 2.6 percent in 1993 to 36.5 percent in 1999 for the same seven county metropolitan area.

The countless stories associated with the foreclosure dots on the maps reveal a dozen or so predatory practices that pushed the borrower into bankruptcy and foreclosure. While this foreclosure data does not exist in most cities, the stories do. A dozen local organizations across the midwest, southwest, and northeast have been organizing homeowners ripped-off by predatory lenders. The stories are similar and the effects are devastating: elderly and other borrowers are left homeless, the equity wealth and credit records of entire families is ruined, and communities are left with abandoned buildings. (See attached articles).

The roots of these problems—predatory lending—must be pulled up. We have begun the process in one State, Illinois, and are willing to work in 30 more. However, we are pleased that you are using your leadership powers to move Federal legislation.

The organizations affiliated with NTIC and NPA who are working on this issue have all achieved intermediate success. (See attached "NPA's National and Local Accomplishments on Predatory Lending"). All agree, however, that ultimately the solution is strong Federal legislation that is strictly enforced. The money to be made through predatory lending will last as long as Americans have equity in their homes.

Predatory Lending Policy Recommendations

NTIC and affiliated organizations have found that effective legislation should contain the following elements:

1. *Sets the annual percentage rate (APR) triggers at T-bill plus 4 percent points and fee triggers at 3 percent of the total loan amount to capture the full range of loans likely to contain predatory loan terms.* Predatory lending is most often found in refinance and equity loans that carry higher-than-normal interest rates and fees. Currently, the Home Ownership Equity Protection Act (HOEPA) captures only a tiny percentage of the subprime loans. Predatory lenders have learned to originate loans that fly under the radar of HOEPA's annual percentage rate and fee triggers; in fact, only loans with close to a 16 percent interest rate are subject to restrictions on predatory terms under HOEPA. However, borrowers with interest rates of even 10 percent are being successfully targeted with predatory loans that steal equity out from under the homeowner. Similarly, HOEPA applies too high of a fee trigger to loans. While Freddie Mac has determined that banks charge a prime rate customer 1–2 percent points of the loan amount in fees, predatory lenders often charge borrowers 5–20 percent in

financed fees. These come in the form of inflated origination & broker fees, as well any number of "junk fees."

2. *Prohibits Steering:* Charging high, subprime interest rates (9–25 percent) on borrower's who have good enough credit to qualify for prime-rate loans (7–9 percent).

3. *Prohibits lending without ability to repay:* Making a loan based on the equity that the borrower has in the home, without regard to the borrower's ability to repay the loan.

4. *Prohibits single-premium credit insurance packing:* Including overpriced insurance such as credit life, disability, and unemployment insurance. The lender finances the insurance as part of the loan, instead of charging periodic premiums outside of the loan.

5. *Prohibits Loan Flipping:* Frequent, unnecessary refinancings of a loan with no benefit to the borrower.

6. *Prohibits fees in excess of 3 percent of the total loan amount:* While Freddie Mac has determined that banks charge a prime-rate customer 1–2 percent points of the loan amount in fees, predatory lenders often charge borrowers 5–20 percent in financed fees. These come in the form of inflated origination and broker fees, as well any number of "junk fees."

7. *Prohibit Prepayment Penalties:* Huge fees charged when a borrower pays off the loan early or refinances into another loan. Prepayment penalties are designed to lock borrowers into high-interest loans, thereby undermining our free market economy by taking away a borrower's right to choose the best product available to them at a given time.

8. *Prohibit Balloon Loan:* A loan that includes an unreasonably high payment due at the end of or during the loan's term. The balloon payment is often hidden and almost the size of the original loan. These loans are structured to force foreclosure or refinancing.

9. *Prohibit Adjustable Rate Mortgages (ARM's):* ARM's by predatory lenders are usually indexed so that they only adjust up, increasing a borrower's interest rate a full point every 6 months. As a result, a borrower's monthly payment increases twice a year even though they likely were told that the adjustable rate mortgage would fluctuate with the economy.

10. *Requires lenders to escrow for property insurance and tax premiums:* Many predatory lenders artificially reduce a borrower's monthly payments by not charging them the full amount necessary to pay for property taxes and insurance premiums out of an escrow account. As a result, homeowners who have never had to worry about saving for separate property tax and insurance payments are hit with bills potentially as big as their mortgage payments twice a year.

11. *Prohibits Home Improvement Scams:* A home improvement contractor arranges the mortgage loan for repairs, often charging the borrower for incomplete or shoddy work.

12. *Prohibits Bait & Switch:* A lender offers one set of loan terms when the borrower applies, but pressures the borrower to accept worse terms at the closing.

Other Efforts To Combat Predatory Lending

While the Congress begins to debate the legislative remedy to this issue, we will continue to pursue four distinct strategies to combat predatory lending:

Compelling and Supporting Increased Enforcement Through the Federal Trade Commission (FTC), State Banking Departments, and Attorneys General

In March 2001, Assistant to the Director of Consumer Protection, Ron Isaac, represented the FTC at the NPA Conference. At the conference, Mr. Isaac committed the FTC to participating in predatory lending hearings in seven cities over within 12 months. Mr. Isaac committed to attending himself (or sending a representative of equal authority from the national FTC office), asking a regional representative to also attend, and to attending the NPA Conference in 2002. At the hearings, local organizations will expose predatory lenders through personal testimony and statistical supporting evidence. NTIC and NPA also recognize that the FTC has sweeping powers under Section 5 of the FTC Act to write regulations that would guard against "unfair practices." We will be asking the FTC to use these powers to regulate against predatory lending practices.

Targeting Citigroup's CitiFinancial/Associates, Nationally, and Other Problem Lenders, Locally, for Lending Reform

Pressure from NPA and other groups has forced Citigroup to discontinue one of its most profitable and abusive lending practices—the sale of single-premium credit insurance. But while celebrating the conglomerate's decision, NPA demands that Citigroup take additional steps toward lending reform.

NPA leaders in Chicago, Cincinnati, Cleveland, Des Moines, central Illinois, Indianapolis, Pittsburgh, Syracuse, Wichita, and other cities say that Citigroup must cap fees at 3 percent, eliminate terms that lock borrowers into predatory loans, and allow borrowers their American right to sue predatory lenders in court.

Furthermore, Citigroup must review and restructure the predatory loans made by The Associates and CitiFinancial which tens of thousands of homeowners are currently struggling to repay. Many of these homeowners will ultimately end up in bankruptcy and foreclosure unless Citigroup repairs the loans so that borrowers are able to repay their loans and remain in their homes.

Finally, NPA calls on Citigroup to offer affordable, prime-rate loans throughout the 48 States where they operate. Currently, most borrowers can only get high-interest loans through CitiFinancial branches, even if they have good credit and qualify for a prime-rate loan. This Citigroup policy creates a discriminatory loan system where most borrowers pay too much for mortgage credit.

Pursuing Increased Protection in States Where Local Groups Are Positioned—Through Either State-Level Legislation or Regulation

Several States are at or nearing the point where they are poised to push for legislative or regulatory protection from predatory lending as was accomplished in Illinois in 2001.

Working With Responsible Lenders To Develop Lending Products That Provide an Alternative to the Quick-cash Predatory Loans

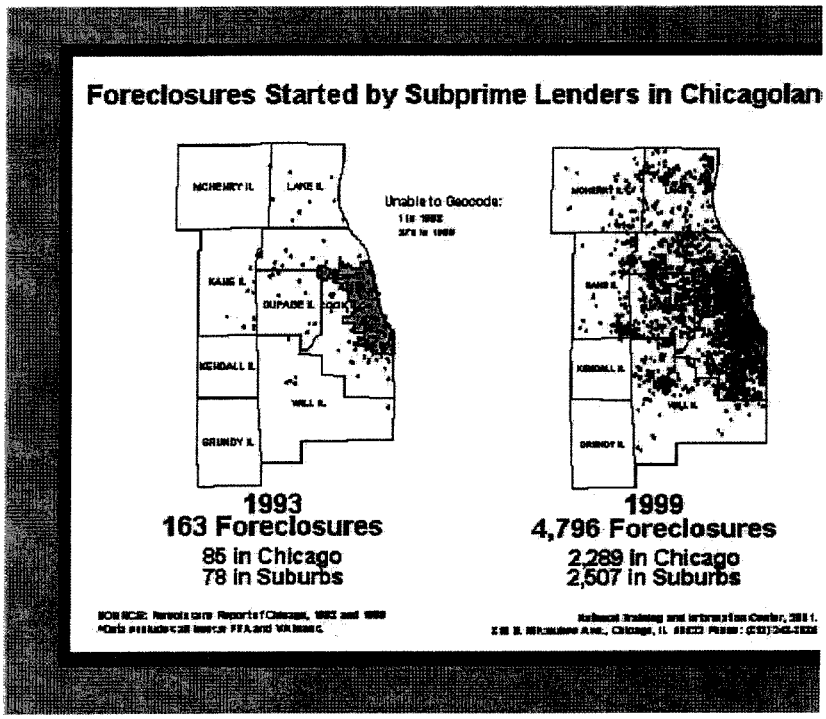
Under the Predatory Lending Intervention and Prevention Project, NTIC, and affiliated NPA organizations joined Fannie Mae and several lenders in Chicago last November to kick-off a pilot product that refinances borrowers out of predatory loans and into loans that they can afford to repay. Similarly, some groups such as the Northwest Neighborhood Federation in Chicago are pursuing banks to develop their own loan products to provide borrowers alternatives to the quick-cash promises of predatory loans. We are currently expanding this pilot to central Illinois, Cincinnati, Cleveland, and Des Moines.

While these are all important ways to stop predatory lending, everyone would agree that thorough, strong Federal regulation is the most effective way to protect borrowers.

Please let me know how I, NTIC, and NPA can help the Banking Committee on this issue in the future.

Please See the Attachments That Follow

1. Maps of "Foreclosures Started by Subprime Lenders in Chicago, 1993 and 1999"
2. Maps of "Foreclosures Started by Subprime Lenders in Chicagoland, 1993 and 1999"
3. Selected articles
4. "NPA's National and Local Accomplishments on Predatory Lending"


Foreclosures Started by Subprime Lenders in Chicagolan
MCHENRY IL
LAKE IL
KANE IL
DUPAGE IL
COOK
KENDALL IL
WILL IL
GRUNDY IL
Unable to Geocode:
1993
163 Foreclosures
85 in Chicago
78 in Suburbs
1999
4,796 Foreclosures
2,289 in Chicago
2,507 in Suburbs

NTIC Attachment #4, 7-25-01

NPA's National & Local Accomplishments on Predatory Lending

As of 7-25-01

National accomplishments of National People's Action (NTIC and affiliated local organizations)

1. NPA formed partnership with the Federal Trade Commission's Bureau of Consumer Protection to hold hearings in seven cities on predatory lending over the coming year.

2. NPA targeted Citigroup for a reinvestment agreement to address predatory and two-tiered lending once they purchased The Associates.

3. NPA advanced proposals with federal bank regulators to protect against predatory lending through hearings in five cities.

4. NTIC helped design and implement Fannie Mae's "Anti-Predatory Refinance Initiative" in Chicago as a way to help borrowers escape from predatory loans. We are currently expanding this pilot to several other cities including Cincinnati, Cleveland, Des Moines, and Central Illinois.

5. NTIC provided training, research, & technical assistance on predatory lending and community reinvestment to affiliated groups in a dozen cities.

Local Victories

1. East Side Organizing Project (Cleveland, OH) – Through a series of actions, public and smaller meetings, negotiated receipt of foreclosure & mortgage lien data from Cuyahoga County, allowing ESOP to analyze subprime foreclosure patterns and providing a pool of folks affected by predatory lending in the Cleveland area. Similarily, advocated for the successful passage of a resolution against predatory lending by the Cuyahoga County Commissioners. ESOP is currently in negotiations with Major League Mortgage, a local mortgage broker accused of pushing hundreds of Cleveland families into predatory loans. ESOP held hearing with federal bank regulators. ESOP will hold a hearing on predatory lending with the FTC.

2. Central Illinois Organizing Project – Won a commitment from two national banks that they would not count subprime loans toward the commitments made in their reinvestment agreements. CIOP provided research and testimony at the state level, successfully advocating for the passage of regulations to protect borrowers from predatory lending practices. CIOP participated in the Chicago hearing with federal bank regulators. CIOP held the first hearing on predatory lending with the FTC on July 14; the hearing was attended by 103 CIOP members, as well as representatives from the state's Office of Banks and Real Estate, Department of Financial Institutions (enforcement agencies for the newly-created anti-predatory lending regulations), Attorney General, and Senator Fitzgerald's office.

3. Northwest Neighborhood Federation (Chicago, IL) – Co-developed a pilot product with a regional bank to refinance borrowers with predatory loans out of foreclosure. Won support from four banks to fund a northwest-side housing counselor to assist predatory lending victims. Successfully spearheaded a coalition that worked with the Cook County Board of Commissioners to pass an anti-predatory lending ordinance.

NTIC Attachment #4, 7-25-01

4. Syracuse United Neighbors (Syracuse, NY) – Stimulated extensive press coverage exposing the two-tiered lending & redlining by a regional bank in Syracuse as part of their 100-person hearing with representatives of the four federal banking regulators on reinvestment & predatory lending. SUN will hold a hearing on predatory lending with the FTC.

5. Sunflower Community Action (Wichita, KS) – Publicly negotiated a commitment from the state Banking Commissioner to air PSA's warning folks about predatory lending, investigate one national predatory subprime lender active in Wichita, help leverage a meeting between SCA and the lender, and follow-up with SCA in the coming months. SCA will hold a hearing on predatory lending with the FTC.

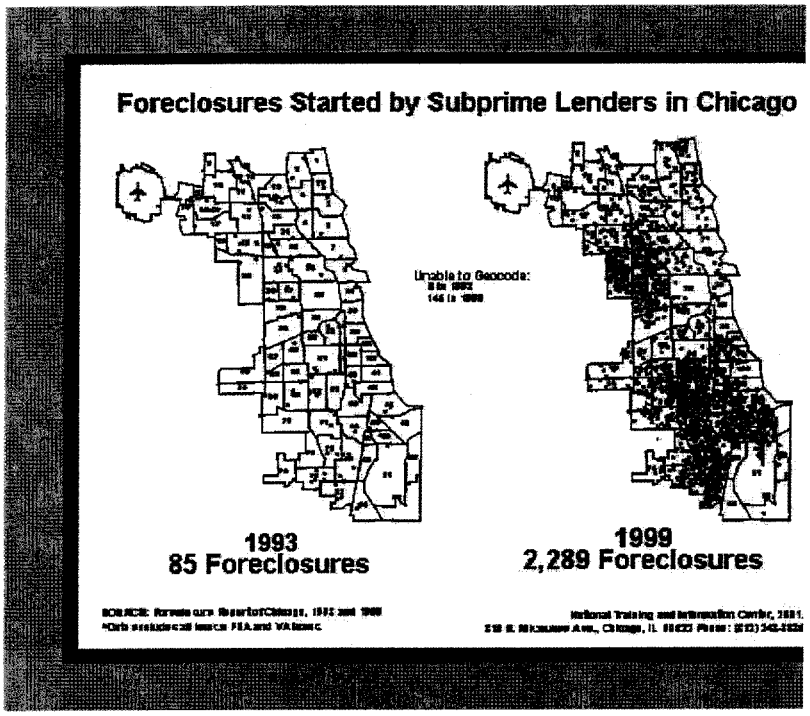
6. Michigan Organizing Project (Grand Rapids, MI) – Won a public commitment from Old Kent (a Grand Rapids-based regional bank being acquired by an outside bank, Fifth Third) to develop a non-predatory subprime loan product which rewards a borrower with a lower interest rate as they repay on time.

7. Communities United for Action (Cincinnati, OH) -- After a series of negotiations, announced a commitment from a Cincinnati-based regional bank to not use several of a list of predatory practices at a reinvestment and predatory lending hearing before 100 community leaders and representatives of the four federal banking regulators. CUFA will hold a hearing on predatory lending with the FTC.

8. South Austin Coalition Community Council (Chicago, IL) – Through a dozen actions, public testimony, and official hearings, pushed through the nation's first anti-predatory lending ordinance in Chicago. SACCC participated in the Chicago hearing with federal bank regulators. SACCC will hold a hearing on predatory lending with the FTC.

9. Organization for a New Eastside (Indianapolis, OH) – Through a series of actions appealing directly the to lender and to the attorney general, won a ground-breaking release of a mortgage found to be predatory by a Citigroup as it acquired The Associates.

10. Iowa Citizens for Community Improvement (Des Moines, IA) – In an 80-person hearing with representatives of the four federal banking regulators on reinvestment & predatory lending, won a commitment from a bank to not refer unqualified borrowers out of the bank to any subprime lenders. Advocated for and received a commitment from a state legislator to hold a series of four hearings across the state on predatory lending over the summer. CCI met with Iowa's Attorney General Tom Miller on July 24, 2001, urging him to investigate the predatory lending practices of Conseco Finance. CCI will hold a hearing on predatory lending with AG Miller and the FTC.


Foreclosures Started by Subprime Lenders in Chicago
Unable to Geocode:
1993
85 Foreclosures
1999
2,289 Foreclosures

STATEMENT OF ALLEN J. FISHBEIN

GENERAL COUNSEL, CENTER FOR COMMUNITY CHANGE, WASHINGTON, DC

JULY 26, 2001

My name is Allen J. Fishbein, and I am General Counsel of the Center for Community Change and I also Codirect the Center's Neighborhood Revitalization Project. Mr. Chairman and Members of the Committee, I want to commend you for holding this hearing on the problems associated with predatory mortgage lending and thank you for the opportunity to provide testimony on behalf of my organization on this important topic.

Prior to rejoining the Center in December of last year, I served for almost 2 years as the Senior Advisor to the Assistant Secretary for Housing at the U.S. Department of Housing & Urban Development. My duties at HUD included helping to direct the activities of National Task Force on Predatory Lending, which the Department established in conjunction with the Treasury Department.

The Center for Community Change (*www.communitychange.org*) is a national, nonprofit organization that provides training and technical assistance of many kinds to locally based community organizations serving low income and predominately minority communities across the country. For the last 25 years, the Center's Neighborhood Revitalization Project has advised hundreds of local organizations on strategies and ways of developing innovative public/private partnerships aimed at increasing the flow of mortgage credit and other financial services to the residents of these underserved areas.

The rapid rise in predatory lending has been a disturbing part of the growth in the subprime mortgage market. It threatens to quickly reverse much of the progress made in recent years to expand homeownership to underserved households and communities. At a time when a record number of Americans own their own home for too many families the proliferation of abusive lending practices has turned the dream of homeownership into a nightmare. Abusive practices in the subprime segment of the mortgage lending market have been stripping borrowers of home equity they spend a lifetime building and threatens thousands of families with foreclosure, destabilizing urban and rural neighborhoods and communities that are just beginning to reap success from the recent economic expansion. Further, predatory lending disproportionately victimizes vulnerable populations, such as the elderly, women-headed households and minority homeowners. The predators selectively market their high-cost loans to unsuspecting borrowers, saddling these families with expensive debt, when in many cases, they qualify for less costly loans.

Given the nature and prevalence of this problem, a comprehensive approach is required, involving all levels of government, the mortgage and real estate industries, together with community and consumer organizations. This was the approach recommended last year by the Treasury Department and HUD and we think this approach makes the most sense.

To be sure, increased consumer awareness about predatory lending practices must be part of the mix and there is much that industry and nonprofit organizations are doing and can do to improve the financial literacy, especially for at-risk homeowners. Expanded enforcement is needed as well.

However, efforts to increase financial literacy among consumers and incremental increases in enforcement, in and of themselves, will not be sufficient to curb the growing problem of predatory lending. Existing consumer protections must also be strengthened, since existing laws are simply inadequate to prevent much of the abuse that is occurring. Further, better mortgage loan data collection by the Federal Government is necessary to provide regulators and the public with more comprehensive and consistent information about those areas most susceptible to predatory lending activity. And there is much more to be done by those who purchase or securitize high-cost subprime loans to ensure that, knowingly or unknowingly, they do not support the activities of predatory loan originators.

Later in my testimony I discuss our recommendations for the additional Federal action that is needed to combat the problem.

What Is Predatory Mortgage Lending?

The term "predatory lending" is a short hand term that is commonly used to encompass a wide range of lending abuses. The local community organizations, housing counseling agencies, and legal aid attorneys we work with report a steep rise over the past few years in the incidence of these abusive practices. Disturbingly, while home mortgage lending is regulated by the States and at the Federal level, local groups working on this issue find that many of the most abusive practices by predators are technically permissible under current law.

Predatory lending generally occurs in the subprime market, where most borrowers use the collateral in their homes for debt consolidation or other consumer credit purposes. Most borrowers in this market have limited access to the mainstream financial sector, yet some would likely qualify for prime loans. While predatory lending can occur in the prime market, it is ordinarily deterred in that market by competition among lenders, greater homogeneity in loan terms and greater financial information among borrowers. In addition, most prime lenders are banks, thrifts, or credit unions, which are subject to more extensive Federal and State oversight and supervision, unlike most subprime lenders.

The predatory lending market works quite differently than the mainstream mortgage market. It usually starts with a telephone call, a mailing, or a door-to-door solicitation during which time unscrupulous lenders or brokers attempt to persuade a borrower to use home equity for a loan. High-pressure sales techniques, deception, and outright fraud are often used to help "close the deal." According to a recent AARP survey over three quarters of seniors who own homes receive these types of solicitations, while many takeout loans relying solely on these overtures, without taking the necessary time to shop around to find the best possible loan deal for themselves.

Some would have this Committee believe that the term predatory lending is not well defined and therefore, cannot be used as a basis for enacting stronger regulation. A broad consensus emerged last year among a diverse range of institutions, including Federal and State regulators and the Government Sponsored Housing Enterprises (GSE's) about the common elements associated with predatory lending. Testimony from victims and others at the public forums sponsored by Treasury and HUD, and by the Federal Reserve Board, also illustrated the all too-frequent abuses in the subprime lending market.

The joint report issued last year by the Treasury Department and HUD, Curbing Predatory Home Mortgage Lending (June, 2000), catalogued the key features commonly associated with predatory loans. These include the following:

- Lending without regard to a borrower's ability to repay. Instead of establishing the borrower's ability to pay, predators underwrite the property and charge very high origination and other fees that are not related to the risk posed by the borrower.
- Packing. Single-premium credit life insurance policies and other fees are "packed" into loans but not disclosed to borrowers in advance. The financing of these products and fees increases the loan balance, stripping equity from the home.
- Loan flipping. The predators pressure borrowers into repeated refinancings over short time periods. With each successive refinancing the borrower is asked to pay more high fees, thus stripping further equity.
- Prepayment penalties. Excessive prepayment penalties ensure that the loan cannot be paid off early without paying significant fees, trapping borrowers into to high-cost mortgages.
- Balloon payments. Predatory loans may have low monthly payments at first, but the loan is structured so that a large lump sum payment is due within a few years.
- Mandatory arbitration. Mandatory arbitration clauses to resolve disputes are usually required as a condition for receiving a loan. Such clauses reduce the legal rights and remedies available to victims of predatory lending.

The report concluded that practices such as these, alone or in combination, are abusive or make the borrower more vulnerable to abusive practices in connection with high-cost loans.

What Are the Reasons for the Growth in Predatory Lending?

The Nation's economic success has caused home values to rise. Consequently, Americans have found greater equity in their homes, which has fostered an enormous expansion in consumer credit, as many homeowners have refinanced their mortgages to consolidate their debts or pay-off other loans. The growth in the subprime lending over the last several years may have benefited many credit-impaired borrowers. Subprime lenders have allowed these borrowers to access credit that they perhaps could not otherwise obtain in the prime credit market. Nationally, subprime mortgage refinancings rose from 100,000 in 1993 to almost one million in 1998, a ten-fold increase in just 6 years.

However, studies by HUD, the Chicago-based Woodstock Institute, and others have demonstrated that subprime lending is disproportionately concentrated in low income and minority communities. Mainstream lenders active in white and upper-income neighborhoods were much less active in low income and minority neighborhoods effectively leaving these neighborhoods to unregulated subprime lenders. Certainly, not all predatory practices are confined to the subprime market. However,

as the Treasury-HUD report concluded, subprime lending has proven to be fertile ground for predatory practices.

According to HUD statistics, subprime lenders are three times more likely in low income neighborhoods than in upper-income neighborhoods and five times more likely in predominately African American neighborhoods than in white neighborhoods. Moreover, subprime lending is twice as prevalent in high-income African American neighborhoods as it is in the low income white communities (See, HUD's report *Unequal Burden: Income and Racial Disparities in Subprime Lending in America,* April 2000).

The Effects of Predatory Lending

The dramatic growth in foreclosure actions in some neighborhoods that has accompanied the growth in subprime lending over the last several years suggest the damaging effects of lending abuses. In fact, foreclosure rates for subprime loans provide the most concrete evidence that many subprime borrowers are entering into mortgage loans that they simply cannot afford. And the most compelling evidence that subprime lending has become a fertile ground for predatory practices is the current, disproportionate percentage of subprime loan foreclosures in low income and minority neighborhoods.

HUD and others have documented the wave of foreclosures now coming out of the subprime market in recent research studies. Studies of subprime foreclosures in Chicago (by the National Training and Information Center), Atlanta and Boston (by Abt Associates) and Baltimore (by HUD), as well as other research, reinforce raises serious concerns about the impact of subprime loans on low income and minority neighborhoods in urban areas. These findings provide recent evidence that predatory lending can potentially have devastating effects for individual families and their neighborhoods.

Additional Federal Action Is Needed To Combat Predatory Lending

Predatory lending has received considerable attention in the news media, largely because of the efforts of national and local community and consumer organization, some of who have provided testimony to this Committee on this subject. In addition, growing concerns about abuses in the subprime market have led States and increasingly, localities to mount their own legislative and regulatory efforts to curb predatory lending.

Some industry groups have complained about and lobbied against the adoption of State and local antipredatory laws. They say they fear being subjected to growing set of local, and possibly, conflicting standards. However, in our opinion, these local legislative efforts will continue and expand in the absence of decisive action being taken at the Federal level.

We believe that the Federal Government can make a significant dent in the problem of predatory lending by taking action in five key areas (similar recommendations were endorsed by the Treasury-HUD report):

Strengthening the Home Ownership and Equity Protection Act (HOEPA) and the Fair Lending Laws

A key recommendation in the Treasury-HUD report was that HOEPA needs to be strengthened (HOEPA is the key Federal protection for borrowers of certain high-cost loans by requiring lenders to provide additional disclosures and by restricting certain terms and conditions that may be offered for such loans). We agree that Congress needs to take this action.

As witnesses before this Committee in connection with these hearings have testified, the "dirty, rotten secret" of predatory lending is that many of the worst abuses are not necessarily illegal under existing consumer protections. This means that beefed-up enforcement of the existing laws alone will not curb the problem.

Currently, HOEPA is a useful, but limited tool. For one thing, it covers very few high-cost loans (about 1 percent). It does not cover home purchase or home equity and home improvement loans that are structured as open-end credit lines. Moreover, the statute currently does not cover some critical abusive practices associated with high-cost lending and the civil remedies that are provided need to be enhanced.

We are pleased that the Federal Reserve Board is contemplating using the administrative discretion it has under HOEPA to revise and expand some limited aspects of the regulations governing the implementation of this statute. For example, the Board is proposing to adjust the existing interest rate trigger to bring additional loans under HOEPA. The proposal also would expand the Act's coverage to include most loans in which credit life or similar products are paid by the borrower at or before closing.

But the Board has yet to act on its proposal and even if these changes were eventually adopted, the vast majority of high-cost loan borrowers (95 percent or more, according to most estimates) still would not be covered by HOEPA's protections.

Consequently, we support the type of legislation that was introduced last year in the Senate by Chairman Sarbanes and in the House of Representatives by Representative LaFalce (and reintroduced in the House again this year, as H.R. 1051, by Mr. LaFalce). We also commend Senator Schumer for legislation he offered last year. Passage of this type of legislation would help to curb what appear to be the key elements of abusive mortgage lending. We are pleased, Mr. Chairman, that you have indicated your intention to reintroduce your bill and your strong desire to have a bill reported out of Committee.

The proposed legislation extends HOEPA protections to a greater number of high-cost mortgage transactions, restricts additional abusive practices in connection with high-cost lending, and strengthens consumer rights and legal remedies. Moreover, the proposed legislation balances curbs that are need to deter the abusive lending without cutting off the legitimate access to credit that helps families of modest means to move up the economic ladder.

Also, since predatory mortgage lending appears, in many respects, to be a fair lending problem, legislation is needed to make the Equal Credit Opportunity Act (ECOA) a more effective tool in this area. In particular, ECOA should be amended to explicitly prohibit "reverse redlining" (that is, the discriminatory steering of inferior loan products to neighborhoods disinvested by prime lenders). Tougher penalties for those lenders who persist in engaging in these practices are also needed. Representative LaFalce has introduced legislation in the House of Representatives that addresses both of these points (H.R. 1053). Mr. Chairman, we urge you to introduce similar legislation in the Senate.

Providing Additional Federal Funding of Home Mortgage Counseling

Virtually everyone associated with mortgage lending, both industry and consumer and community organizations alike, agree that understanding the terms of a home loan and taking the time to shop around for the best available loans are critical steps that borrowers must take to avoid being victimized by predatory lenders. This is especially true for borrowers in the subprime mortgage market since a substantial number of these may qualify for less expensive, prime mortgages.

The borrowers who have access to qualified premortgage loan counseling are less likely to enter into loans they cannot afford. Current law requires certain categories of these borrowers, such as recipients of HUD's Home Equity Conversion Mortgage program (HECM) to receive preloan counseling. However, a substantial gap in qualified counseling exists, especially for those homeowners most vulnerable to being victimized by predatory lenders.

Congress should require lenders to recommend certified housing counseling to all high-cost loan applicants. Additional Federal funding should be provided to increase the availability premortgage loan counselors. These funds should be targeted to borrowers and communities most susceptible to predatory lending.

Encouraging the Expansion of Prime Lending In Underserved Communities

The lack of competition from prime lenders in low income and minority neighborhoods increases the chances that borrowers in these communities are paying more for credit than they should. According to HUD research, higher income African-American borrowers rely more heavily on the subprime market than low income, white borrowers which suggests that a portion of subprime lending occurs with borrowers whose credit would qualify them for lower cost prime loans. There is also evidence that the higher interest rates charges by subprime lenders cannot be fully explained solely as the function of the additional risk they bear (for example, Fannie Mae has estimated that one-half and Freddie Mac has estimated that 10 to 35 percent of subprime borrowers could qualify for lower cost loans). Thus, a greater presence by mainstream lenders could possibly reduce the high interest and fees currently being paid by the residents of underserved areas.

One of the problems that may contribute to the misclassification of borrowers is that by and large financial institutions do not have adequate processes in place to refer-up borrowers who qualify for prime credit from their subprime affiliates to mainstream banks and thrifts. Expanding the universe of prime borrowers would help to curb predatory lending.

Accordingly, Congress should urge the Federal banking regulators to use authority under the Community Reinvestment Act and other laws to "promote" borrowers from the subprime to the prime market, while penalizing lenders who make predatory loans. Moreover, the Federal Reserve Board should utilize the authority it has under the Gramm–Leach–Bliley Financial Modernization Act to conduct examina-

tions of subprime lenders that are subsidiaries of bank holding companies where it believes that such entities are violating HOEPA or otherwise engaging in predatory lending.

Improving Loan Data on Subprime Lending

Despite the explosive growth in subprime mortgage lending over the past several years, there is no consistent, comprehensive source of data on where those loans are being made geographically, by which lenders, and to what types of borrowers. In truth, the data collection requirements of the Federal Government have failed to keep up with these trends.

Virtually all of the research to date is based on a list of subprime lenders compiled, on his own initiative, by an enterprising researcher at HUD. The Federal Reserve Board, HUD, and other Governmental agencies, as well as lenders, academics use this list, and anyone else interested in the field. Lenders on the list are classified as subprime if they identify themselves as such. All loans reported by those lenders are counted as subprime, and no loans reported by lenders that do not identify themselves as subprime are counted. Further, HUD is under no mandate to compile this list, and should it cease to do this, there would be virtually no future information available about where and to whom they are going. This is the best information available on subprime lender, and nobody thinks that it serves the need adequately.

The Federal Reserve Board has proposed to amend the Home Mortgage Disclosure Act regulations (with which this information about subprime lenders is combined). The Fed's proposal would, among other things, collect and disclose information on the annual percentage rates of loans reported, and indicate whether a particular loan was classified as a HOEPA loan. The proposal would also revise the rules to ensure that some large, nondepository subprime lenders, not currently covered under HDMA, would be required to submit annual reports on their loan activities. Unfortunately, the Fed has yet to finalize these rules.

Accordingly, Congress should adopt legislation requiring more systematic reporting by lenders under HMDA on their subprime lending activities. In addition to revising ECOA, the LaFalce bill (H.R. 1053) I referenced previously amends HMDA to require reporting on subprime lending. It also provides HUD with the necessary authority to impose civil money penalties to enforce compliance with HMDA by nondepository lenders, similar to the authority banking regulators have for banks and thrifts. The lack of reporting by many nonbank financial institutions has hindered the ability of regulators to track lenders that may engage in abusive lending. Providing HUD with the necessary statutory authority in this area also would establish a more level playing field between depository and nondepository mortgage lenders.

We believe that similar legislation should be introduced in the Senate as well.

The Federal Government Should Take Steps to Prevent the Secondary Market From Supporting Predatory Lending

Ultimately predatory lending could not occur but for the funding that is provided by the secondary market to finance these loans. The rapid rise in subprime lending that has occurred in recent years was possible because many of these loans were purchased in the secondary market either whole or through mortgage-backed securities (about 35 percent of subprime loans by dollar volume in 1999 was securitized).

While the secondary market to some extent has been part of the problem connected with predatory lending, it can become an important part of the solution. The refusal by the secondary market to purchase or securitize loans with abusive features, or to conduct business with lenders that originate such loans could curtail their liquidity and thus, reduce their profitability.

Last year, Fannie Mae and Freddie Mac, the two Government sponsored housing enterprises, pledged not to buy loans with predatory features. HUD acted further to discourage the GSE's from purchasing predatory loans, when it also elected to disallow the GSE's from receiving credit toward fulfillment of their affordable housing goals for the purchase of loans with predatory features. The GSE's pledges and the provisions in the Affordable Housing Goals rule must be monitored to ensure that the two enterprises are living up to their commitments.

However, the GSE's constitute a relatively small share of the subprime market and unfortunately, other secondary market players have been less willing to adopt similar corporate policies against predatory lending. HOEPA provides that purchasers or assignees of mortgages covered by that statute are liable for violations unless ordinary due diligence would not reveal them as such. Similarly, Section 805 of the Fair Housing Act makes the secondary market potentially liable for financing discriminatory loans.

Consequently, the secondary market institutions appear to have taken at least some notice of their potential legal liability for the purchase of high-cost loans involving HOEPA violations. However, because HOEPA loans represents such a small share of the highcost loan market and discrimination claims are difficult to prove, these developments have not yet resulted in across the board vigilance and screening by the secondary market that makes an impact by constricting the funding pipeline for predatory lenders.

Expanding HOEPA coverage to a greater share of the market and clarifying that parent companies are liable for the sins of their subprime affiliates (a provision contained in the Sarbanes and LaFalce bills) could encourage loan purchasers to develop the necessary due diligence to filter out abusive loans from their business activities. Expanding liability in this area is critical given the recent influx of many of the Nation's largest financial institutions into the subprime market. Unfortunately, some of the subprime lenders acquired by these giant entities are being sued or otherwise have been exposed for their connection to predatory lending practices. Establishing that parent companies and officers of lenders, or subsequent holders of loans by contractors, or liable for the predatory practices of originators would encourage these mega-financial institutions to develop the necessary internal controls to deter abusive loan practices.

We urge this Committee and the Congress to move decisively in the areas we have identified. It will take such comprehensive action by the Federal Government to curb the predatory lending problem.

Thank you Mr. Chairman for the opportunity to provide our views on this subject.

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July 26, 2001

The Honorable Paul S. Sarbanes
Chairman
Committee on Banking, Housing and Urban Affairs
U.S. Senate
Washington, DC. 20510

Dear Mr. Chairman:

Household International would like to take the opportunity to respond to the testimony provided today by two witnesses, Mr. Paul Satriano and Mrs. Mary Ann Podelco, before the Senate Banking Committee. Several Senators on the Committee have asked for our response. Because these customers have chosen to put their personal financial information on the public record before the Committee, we feel it important for all interested parties to know these additional facts relating to both transactions.

Mrs. Mary Ann Podelco

Unfortunately, our records on Mrs. Podelco are sparse as her last loan with Beneficial was paid in full in February, 1996. This was over two years before Household purchased Beneficial. As such, it is difficult for me to comment on the additional facts of that loan or the income she disclosed to the Beneficial loan officer at that time.

I can tell you, however, that the Beneficial system was converted to Household's policies in June 1998 upon completion of the acquisition, and I can assure you that under these policies, ability to repay the loan (without consideration of equity value) is a primary factor. If Podelco's income were as limited as she has testified, the loan would not have been made. I can further assure you that foreclosure is a relatively rare event at Household, and that we review every customer's circumstances prior to initiating such action. Should we ever find a customer with circumstances described by Mrs. Podelco in her testimony, she would not face foreclosure at either Beneficial or Household Finance Corporation (HFC).

Mr. Paul Satriano

Mr. Satriano testified that he was rushed through the transaction and did not understand the specifics of his loan.

- The facts of the transaction are quite different from what Mr. Satriano represented. The process itself, from the date the application was taken until it was closed, took 28 days and throughout that time, our branch personnel were in constant contact, both in person and by phone with Mr. Satriano answering questions. In particular, our account executive recalls several phone calls to Mr. Satriano to discuss the loan's rate, buy-down points, and payments both with and without insurance. Further, on November 21, 2000, our branch manager discussed insurance and loan terms with Mr. and Mrs. Satriano. Our account executive spent more than 45 minutes in the loan closing covering every part of the transaction in detail, to include rates, terms, conditions, and disbursements. In addition, following the account executive's overview, our branch manager held a specific discussion with the Satriano's. He asked them if they understood the terms and conditions of their loan (they said they did), and he gave another overview of how their direct debit product would work, as well as their prepayment penalty. Our branch manager specifically recalls this conversation, and even recalls telling the Satriano's that in the event of a refinance with Household, there would be no prepayment penalty.

- Beyond these conversations and document reviews, Mr. Satriano was provided with a complete set of the documents which explained in writing each and every term and condition. On top of all of this, Mr. Satriano was given three business days to go home and review these materials in the privacy of his home, in an unhurried way, and to seek legal advice should he choose do so.

Mr. Satriano further testified that the loan he took did not help him. He stated his disappointment that the loan did not pay off his credit cards. At the same time, Mr. Satriano also complains that the loan was made for 100% of the value of his home, thus limiting his ability to refinance his house again.

- First, the loan did indeed payoff $1,191 in higher interest rate credit card debt. Mr. Satriano's credit application shows (and our account executive also clearly recalls) that Mr. Satriano thought his home was worth $110,000. An independent appraiser, however, appraised the value of the Satriano's home at $106,000. This lower home value did have the effect of lowering Mr. Satriano's loan amount, a fact of which Mr. Satriano was very well aware.

  Contrary to his testimony, at no time during the loan closing or during the three day cooling off period, did Mr. Satriano complain or express concern about his loan paying off enough credit card debt.

  In terms of the overall allegation that Mr. Satriano's loan did not help him, the fact is that his loan accomplished the following:

1. Consolidated Mr. Satriano's first mortgage, which was a balloon loan, and his second mortgage, which carried a 13.99% interest rate, along with $1,191 in high rate credit card loans.

2. Provided Mr. Satriano with a product that will enable him to completely pay off his mortgage in 17.8 years. This was made possible because the Beneficial product that Mr. Satriano took includes a "pay rewards" feature that will enable him to enjoy the benefits of reduced rates after the first 36 months of his loan, assuming he makes his payments on time and doesn't file for bankruptcy. As a side note, he is well on his way to qualifying for this reduction. Our branch manager specifically recalls that Mr. Satriano was very pleased about the prospect of having his mortgage paid in full in less than 18 years. Further, Mr. Satriano elected to utilize the bi-weekly direct debit product, another money saving feature. The net result of this was that the Beneficial loan significantly improved Mr. Satriano's situation, and provided him the opportunity to save thousands of dollars when compared to his previous circumstance.

3. The Beneficial loan paid off a balloon note in the amount of $91,098.85. Without the Beneficial loan, Mr. Satriano would have been faced with coming up with a lump sum payment of $74,469.38 in 13 years, a potentially devastating challenge.

Mr. Satriano testified that he was made to "feel like" he would not get the loan if he did not take credit insurance.

- The fact is that no one ever suggested or insinuated that insurance was in any way associated with the loan approval. In fact, our branch employee specifically explained to Mr. Satriano that his purchase of insurance was completely optional. Further, to assure a clear understanding, the branch employee quoted exactly what the monthly payment would be if Mr. Satriano took the insurance and what it would be without it. In fact, both our branch manager and account executive specifically recall Mr. Satriano stating both before the loan close and during the loan close that he had concerns about his health and wanted life insurance. Further, Mr. Satriano signed two documents-- nine pages of insurance disclosure and insurance application -- which clearly and in bold print describe the optionality of the insurance.

  Further, our branch manager states that when Mr. Satriano called him to request the insurance cancellation, Mr. Satriano told him the reason he was canceling was because he was running into financial problems and needed the cash refund.

Mr. Satriano testified that that he was not aware of "so-called discount points".

- The fact of the matter is that our account executive recalls a specific conversation with Mr. Satriano whereby she explained the loan points. Mr. Satriano chose to pay the points. Beyond that, as mentioned earlier in this note, Mr. Satriano was provided with detailed disclosure and given several days to review them. Again, these disclosures clearly reflect the exact terms of his loan, including his contract rate and discount points.

Finally, Mr. Satriano suggests that his credit history qualified him for consideration as a prime rate borrower.

- Mr. Satriano's credit profile is below average. In fact, his FICO score, the standard industry measure of credit risk, places Mr. Satriano in the bottom 5% of all U.S. borrowers. Borrowers scoring in Mr. Satriano's range are 23 times more likely to default on their loans than the average U.S. borrower.

Mr. Chairman, we appreciate the opportunity that you afforded us on Monday to meet with you and the members of your staff to discuss the many initiatives that Household has underway to address the problem of predatory lending and to continue our important role of providing credit to subprime borrowers across the country. Vice-Chairman Larry Bangs and I indicated that we wanted to work with you to provide responsible reforms in the secured mortgage lending field, and I hope that you will call on us at the Committee's next hearings to report on our efforts.

I would appreciate your making sure that this letter is included in the Committee's hearing record, and I am sending an individual copy of this letter to other members of the Committee. Please do not hesitate to call on us for any additional information that might be of assistance to the Committee in oversight activities. I assure you of our cooperation.

Sincerely yours,

Gary D. Gilmer

cc: Senator Phil Gramm

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August 2, 2001

The Honorable Paul Sarbanes
Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Chairman Sarbanes:

On behalf of the Real Estate Services Providers Council, Inc. (RESPRO®), I would like to commend you and members of the Committee for your efforts to curb predatory practices in the mortgage lending industry by bringing public attention to these practices in your July 26, 2001 and July 27, 2001 hearings.

RESPRO® also would like to submit written testimony for the hearing record on two specific issues addressed in the hearings and in pending legislative proposals: (1) the definition of "points and fees" under the 1994 Home Owners Equity Act (HOEPA); and (2) a proposal presented in other witnesses' testimony to reform the Real Estate Settlement Procedures Act (RESPA) and the Truth in Lending Act (TILA).

Background of RESPRO®

RESPRO® is a national non-profit trade association of business alliance partners from all segments of the home buying and financing industry. Our membership includes mortgage lenders, mortgage brokers, real estate companies, home builders, title underwriters and agents, vendor management companies, and technology companies (see attached membership list). The majority of our members (1) offer mortgage loans either directly, through wholly-owned subsidiaries, or through joint ventures; and/or (2) offer closing services to accompany the mortgage loan.

The common bond of RESPRO® members is that they all offer multiple services ("one-stop shopping") to consumers through affiliations and strategic alliances with other settlement service providers. As an association of providers across industry lines, RESPRO®'s goal is to promote competition and consumer choice a regulatory environment that enables all providers to compete in a level playing field, regardless of their industry or affiliation.

1. HOEPA's "Points and Fees" Definition

Currently, a mortgage loan is considered to be "high cost" under HOEPA – and therefore subject to its restrictions -- if the points and fees paid by the consumer exceed the greater of 8 percent of the loan amount or $400, whichever is greater.

The Act defines "points and fees" to include all charges listed under 12 C.F.R. § 226.4(c)(7) (including title, appraisal, credit report, and other closing costs) "unless the charge is reasonable, the lender receives no direct or indirect compensation with the charge, *and the charge is not paid to an affiliate of the lender* (emphasis added)".

Consequently, HOEPA currently *excludes* reasonable closing costs that are paid to *unaffiliated* third parties, but *includes* reasonable closing costs that are paid to *affiliated* parties in determining which loans are subject to its restrictions.

RESPRO® believes that the current definition of "points and fees" inadvertently discriminates against mortgage originators and closing service providers who are part of affiliated business arrangements, without fulfilling HOEPA's purpose. This is because HOEPA includes points and fees based on the mortgage originator's business structure, as opposed to the reasonableness of the closing costs.

For example, a $1,000 charge for title insurance and $300 charge for an appraisal in a particular loan transaction by an *unaffiliated* settlement service provider would *not* be counted as "points and fees", while similar or even lower charges by an *affiliated* settlement service provider (e.g., $750 for title insurance and $250 for an appraisal) *would* count as "points and fees".

a. Consumer Benefits of Affiliated Businesses

The only conceivable basis for treating the charges of affiliated businesses differently than unaffiliated businesses would be an unfounded concern that affiliated businesses charge higher fees for settlement services. But in fact, affiliated businesses in the mortgage marketplace over the last 20 years have consistently been proven to potentially increase competition and lower costs for home buyers and owners.

The Department of Housing and Urban Development (HUD), which regulates affiliated businesses under the Real Estate Settlement Procedures Act (RESPA), has repeatedly recognized the potential consumer benefits of affiliated businesses. In a 1994 proposed RESPA rule, HUD said, "controlled business arrangements [today called affiliated business arrangements] and so-called 'one-stop shopping' may offer consumers significant benefits, including reducing time, complexity, and costs associated with settlements."[2] In a Regulatory Analysis accompanying a 1996 final RESPA regulation, HUD stated, "[T]here is some reason to expect that referrals

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[2] 59 Fed. Reg. 37360, 37361-61 (July 21, 1994).

among affiliated firms may reduce costs to businesses and consumers. Business may benefit from lower marketing costs and the ability to share information on the home purchase or refinancing among settlement service providers. In the long run, any cost savings should be passed on to consumers in most cases. Consumers may benefit additionally from reduced shopping time and related hassles."[3]

In its last statement on the consumer benefits of affiliated business arrangements, the Department of Justice expressed a similar opinion: "...[A]rrangements among providers of different goods or services who do not compete with one another -- including diversification by a single firm into the provision additional complementary services -- may benefit consumers in a variety of ways. Regulatory efforts to interfere with such arrangements should not be undertaken in the absence of a strong showing that they are economically harmful to consumers." [4]

The only empirical studies on the impact of affiliated businesses in the home financing marketplace have reinforced the opinions of HUD and the Department of Justice. In 1992, Anton Financial Economics, Inc. compared the prices for a basket of title/closing services offered by affiliated and unaffiliated providers in the Minneapolis-St. Paul marketplace by sampling 16 firms that operated in 77 offices in the Twin Cities area (70% of the offices in the marketplace). It concluded that unaffiliated title companies in the Minneapolis-St. Paul marketplace *charge approximately $13 more for a basket of title/closing services* than affiliated title companies, and that the growth of affiliated businesses in the Minneapolis-St. Paul area has increased competition in the marketplace over an 11-year period.

In 1994, RESPRO® commissioned a study by Lexecon, Inc., a national economic consulting firm specializing in the application of economic data to legal and regulatory debates, which analyzed the title and closing costs of over 1000 home purchase transactions -- affiliated and unaffiliated -- during a one-week period in September 1994. The study concluded that title services for transactions involving affiliated title/closing businesses not only are competitive with those provided by unaffiliated title/closing companies, but actually result in a two percent (2%) savings.

In its 1996 Economic Analysis [5], HUD recognized the Lexecon, Inc. study and concluded that the results may *underestimate* the costs benefits of affiliated companies:

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3 1996 Department of Housing and Urban Development Regulatory Analysis, accompanying June 7, 1999 Real Estate Settlement Procedures Act (RESPA) final regulation at 61 Fed Reg 29237 (June 7, 1996).

4 Letter from Robert A. McConnell, Assistant Attorney General, Department of Justice, to Chairman Henry B. Gonzalez, Chairman, Subcommittee on Housing and Urban Development, Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, April 26, 1983 (opposing legislation to restrict affiliated businesses, which was subsequently rejected by a House of Representatives Subcommittee by voice vote)

5 Id at 3.

"HUD is aware of only one study that compares prices of settlement services provided by affiliated and non-affiliated firms. RESPRO®, an association of controlled businesses, commissioned a study by an independent contractor, Lexecon, Inc.*[T]he study may be] biased in favor of the unaffiliated firms. Therefore, the [study] results might suggest that affiliated firms on average have lower prices than their competitors* (emphasis added)."

b. *The Issue Should Be Reasonableness of Charge, Not Who Provided The Service*

Even if Congress was concerned that affiliated businesses may charge higher fees than unaffiliated mortgage originators when it enacted HOEPA, HOEPA's definition of "points and fees" already mandates that the charges of ancillary service providers are to be counted if they are not reasonable. Therefore, there is no need to retain a superfluous and discriminatory requirement that they be paid to a provider that is not an affiliate of the mortgage lender. In fact, as our initial example illustrates, HOEPA counts the ancillary fees of an affiliated service provider toward the "points and fees" threshold even if they were lower than the fees charged by an unaffiliated provider. This serves no purpose.

Some legislative proposals, such as S. 2415, which you introduced in 2000, would attempt to create more uniformity in the definition of "points and fees" by including *all* closing costs – whether paid to affiliated parties *or* unaffiliated third parties -- in the "points and fees" test.

While this amendment would eliminate the unjustified discriminatory treatment of affiliated businesses under HOEPA, we recommend that it be accompanied by an increase in the minimum dollar amount for coverage to reflect the reasonable value of the closing services to be included in the "points and fees" definition. Otherwise, it has the effect of further reducing the "points and fees" trigger beyond what is intended by the HOEPA amendment.

But RESPRO® believes that the preferable solution is to exclude fees paid to *both* affiliated and unaffiliated closing service providers from the points and fees definition, and to instead focus on whether the charge is "reasonable".

Under such an approach, HOEPA would be amended as follows:

(g) Points and fees mean . . .

(2) all charges listed under Section 226.4(c)(7) of Title 12 of the Code of Federal Regulations . . . unless the charge is reasonable <u>and</u> the lender receives no direct or indirect compensation in connection with the charge. <u>For purposes of this section the fact that the lender may be affiliated with the provider of any of the services listed under Section 226.4(c)(7) shall not in and of itself constitute direct or indirect compensation to the lender</u>.

The underscored language represents new language. The last underscored sentence that we propose is simply intended to ensure that the "direct or indirect compensation" standard will not be misread so as to maintain the status quo and to clarify that the charges of affiliated businesses will be treated the same as unaffiliated businesses.

2. Real Estate Settlement Procedures Act (RESPA) Reform

Several witnesses representing the mortgage industry have suggested that predatory lending can be addressed by "comprehensive mortgage reform", which would involve legislative or regulatory changes to the Real Estate Settlement Procedures Act (RESPA) and the Truth in Lending Act (TILA).

Specifically, these witnesses propose that mortgage originators disclose to consumers the firm, not estimated, costs of the settlement services needed to make the loan for which the consumer has applied. In return for offering this guaranteed settlement service "package", mortgage originators would be exempted from Section 8 of RESPA (which prohibits referral fees and fee-splitting) for arrangements they negotiate with the providers of the settlement services that are included in the firm disclosure.

RESPRO® has actively participated on behalf of affiliated settlement service businesses in the Mortgage Reform Working Group, the industry-consumer group that attempted to reach a consensus on "comprehensive mortgage reform" in 1997 and 1998. As you know, the group was unable to reach a consensus, although the Department of Housing and Urban Development (HUD) and the Federal Reserve Board (Fed) used some of its findings in its 1998 Joint Report to Congress on RESPA/Truth in Lending Act Reform.

RESPRO®'s cross-industry membership engaged in the same dialogue over that time period, however, and reached an internal consensus on some of the fundamental issues associated with RESPA/Truth in Lending reform that we would like to share with the Committee.

This cross-industry consensus was based on a fundamental premise: that any new RESPA legislative or regulatory framework should be carefully structured to ensure competition and consumer choice in the marketplace by allowing *all* providers, regardless of industry or affiliation, to participate under the same regulatory standards.

In order for this to occur, we believe that any RESPA statutory amendment or regulation that provides incentives for providers to guarantee a comprehensive loan "package" should contain three elements:

a. Packaged Services Should Be Optional, Not Mandatory.

First, "packaged" services should be optional, not mandatory. The federal government should not mandate any one delivery system for home buying and financing services, but instead should continue to allow providers to offer consumers the choice of either a guaranteed loan

"package", affiliated loan services under current "affiliated business" rules, or unaffiliated loan services.

b. Any Provider Should Be Able to Offer a Guaranteed Settlement Service "Package" Directly To The Consumer.

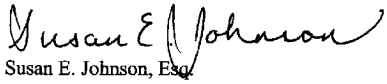
Second, *any* provider should be able to offer a guaranteed "package" directly to the consumer. Today, both lenders and non-lenders offer a variety of one-stop shopping alternatives through affiliated businesses or contractual relationships, depending on the needs of their customers. A real estate broker-owner or home builder, for example, may choose to offer its customers a complete menu of mortgages and closing services, while others may decide to offer just a package of closing services that would accompany a loan provided by an unaffiliated lender, subject to that lender's approval. We believe that consumers should continue to have this choice.

c. Services Included In the Package Should Be Disclosed To the Consumer.

Finally, individual closing services that accompany the loan should be disclosed whether or not the provider offers a loan "package". Consumers who want to compare any two "packages", or packaged loan services with non-packaged loan services, would not have the information they need to do so if they do not know what services are in each "package" offered to them.

We appreciate the opportunity to testify on these two issues. If you have any questions, or would like to obtain background information referenced in our testimony, please feel free to call me at 202-408-7038 or to e-mail me at respro@erols.com.

Sincerely,



Susan E. Johnson, Esq.
Executive Director

Habitat for Humanity® International

THE WASHINGTON OFFICE
Thomas L. Jones, Managing Director

Building houses in partnership with God's people in need

August 13, 2001

The Honorable Paul Sarbanes
Chairman/Senate Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Sarbanes,

On behalf of Habitat for Humanity International (HFHI) and our homeowner partner families, thank you for this opportunity to include comments for the record in response to recent Senate hearings on Predatory Lending. We commend you for holding these hearings to bring attention to abusive lending practices and encourage the Committee to continue exploring effective deterrents to such practices.

Habitat homeowners appear to be particularly vulnerable to such practices, as they are often first-time homebuyers, have low-incomes and have spent most of their lives beyond the reach of the economic mainstream. HFHI submitted comments on March 6, 2001, supporting the Federal Reserve Board's proposal to strengthen the Home Ownership and Equity Protection Act regulations (see attached). We believe that adopting the federal proposal in its entirety is an important step towards protecting homeowners and hope that the Committee will work to strengthen and expand HOEPA regulations to prohibit abusive practices not currently addressed in the law.

HFHI also believes that Congress can reaffirm its commitment to economic justice, equal access to capital, and the importance of homeownership by pursuing stringent enforcement of current law *and* expanding current protections to curtail abusive, yet legal, practices such as flipping, fee packing, and equity stripping through legislative remedies. It is also essential to ensure borrowers have access to fair and judicious review of their grievances, currently limited by mandatory arbitration clauses. Stronger federal laws governing mortgage lending would help close loopholes and enable the subprime market to deliver credit to underserved areas in responsible ways.

Thank you, Mr. Chairman, for your attention to this important matter and for your commitment to strengthening families, neighborhoods, and communities through homeownership. Please do not hesitate to contact us if we may be of any assistance.

Sincerely,

Tom Jones
Managing Director
HFHI/Washington office

Amy Randel
Director of Government Relations
HFHI/Washington office

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Habitat for Humanity® International

THE WASHINGTON OFFICE
Thomas L. Jones, Managing Director

Building houses in partnership with God's people in need

March 6, 2001

Ms. Jennifer Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Dear Ms. Johnson,

Re: Regulation Z; Docket No. R-1090

On behalf of Habitat for Humanity International, I would like to provide comment on Docket No. R-1090, regarding proposed amendments to the provisions of Regulation Z that implement the Home Ownership and Equity Protection Act (HOEPA).

I would first like to thank the Board for using its authority under HOEPA to address issues relating to abusive mortgage lending and refinancing practices. The security and wealth created through homeownership is being undermined by these predatory lending practices.

Habitat for Humanity strongly supports the proposal—under section 129(1)(2)(B)—that would prohibit creditors in the first five years of a zero interest rate or low cost loan from replacing that loan with a higher rate loan. As you may know, loans made by Habitat for Humanity to our partner family homeowners would be covered under this rule, as all of our homes are sold to families at no profit and financed with no-interest loans.

To my dismay, there is evidence that some lenders practicing predatory tactics have targeted Habitat homeowner families. In spite of extensive homeowner counseling by Habitat affiliates and procedures to prevent refinancing, some homeowner families have been taken advantage of by lenders and been persuaded to take a higher cost loan. As a result, some of these families—most of whom are first-time homeowners and far beyond the reach of the economic mainstream—have lost their homes. Habitat homeowners, like many low-income and minority buyers, appear to be especially vulnerable to such abuses in the subprime market.

Habitat for Humanity also strongly supports additional provisions designed to curtail equity stripping techniques. In particular, we support the inclusion of financed single-premium credit insurance under the HOEPA "points and fees" test. I understand that the exclusion of credit insurance from points and fees has enabled

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unscrupulous lenders to circumvent HOEPA limits, excluding borrowers from HOEPA protections.

Habitat for Humanity International would like to thank you for your efforts to help curb the egregious tide of predatory lending and for taking steps to ensure that all homeowners are protected from these abusive practices. It is my hope that the Board's proposed revisions to HOEPA will help close the gaps that currently enable unfair lending practices to occur.

Please do not hesitate to contact representatives in Habitat for Humanity's Washington Office if you have any questions relating to this letter. You may call Tom Jones or Amy Randel at (202) 628-9171. Thank you, in advance, for your consideration of these comments.

Sincerely,

Millard Fuller
Founder and President

Cc: U.S. Senator Paul Sarbanes
U.S. Senator Phil Gramm
David Williams

A Prudent Approach To Preventing "Predatory" Lending

By

Robert E. Litan
Vice President and Director, Economic Studies Program
The Brookings Institution

Washington, D.C.
February 2001

A Prudent Approach To Preventing "Predatory" Lending

By

Robert E. Litan[1]

One of the hallmarks of the U.S. financial system is that it has become increasingly "democratized." Encouraged by government policies and spurred by market forces, financial institutions and markets over time have gradually expanded credit to borrowers who in earlier times could not have qualified for credit. In mortgage markets especially, the government has played an important catalytic role: creating a secondary market in mortgages through various "government-sponsored" enterprises, extending federal insurance to mortgages for low- and moderate- income (LMI) homebuyers, and by imposing "community reinvestment" obligations on depository institutions that are aimed at encouraging lending to LMI borrowers and residents of LMI geographic areas. In the 1990s, the growth of the "subprime" lending market – among lenders and the investment banks that have "securitized" the loans – has led to a major increase in mortgage lending to low income households, and especially minorities. As a result, approximately two-thirds of Americans now own their own homes – the highest rate of homeownership in our history.

Nonetheless, increasing attention has been paid in recent years to various abusive practices in the subprime lending market that have been collectively labeled as "predatory lending." Although the term itself has not been precisely defined, it has come generally to refer to mortgages extended under terms that are more onerous to borrowers than if they were more fully informed about the loans themselves and the alternative sources of finance that may be open to them. In response, the Congress has enacted legislation cracking down on certain especially unfair lending practices, while imposing reporting obligations on both depository and non-depository lenders designed to shed sunlight on the extent of high-cost lending. In November and December 2000, the Federal Reserve – the principal federal regulator charged with collecting and publicizing this information – issued two proposals to expand the coverage of these reporting requirements.

This report highlights the potential danger to the populations thought to be most victimized by predatory lending – minority and low-income individuals and families generally – of already enacted or proposed state and local ordinances or states that extend beyond federal law. In effect, these regulatory provisions constitute a new type of "usury" statutes, which once were prevalent throughout the country, but have since been abandoned – except in this new guise as an attack on predatory lending. Moreover, the implicit connection drawn in some of these laws (or their preambles) between "high cost" lending, which appropriately reflect the risks of lending to customers outside the prime market, and "predatory" lending, which is inherently abusive and already punishable under federal law, is simply incorrect.

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[1] The author is Vice President and Director, Economic Studies Program at the Brookings Institution. He has prepared this report on behalf of the American Bankers Association. The views are his own and not those of the Brookings Institution, its trustees, officers or staff.

While the motivation behind added legislation aimed at predatory lending is understandable and commendable, *the fact is that virtually all of the practices complained of are already against federal law.* Furthermore, federal law contains numerous disclosure requirements relating to mortgage loans generally, and especially high-cost loans. *Additional statutory measures at the state and local level at this point run a significant risk of unintentionally cutting off the flow of funds to creditworthy borrowers.* This is a very real threat and one that should be seriously considered by policy makers at all levels of government, especially in light of the multiple, successful efforts that federal law in particular has made to increase lending in recent years to minorities and low income borrowers.

The more prudent course is for policy makers at all levels of government to wait for more data to be collected and reported by the Federal Reserve so that enforcement officials can better target practices that may be unlawful under existing statutes. In the meantime, *Congress should provide the federal agencies charged with enforcing existing statutes with sufficient resources to carry out their mandates, as well as to support ongoing counseling efforts to educate vulnerable consumers about the alternatives open to them in the credit market and the dangers of signing mortgages with unduly onerous terms.* There is also an encouraging new development from the private marketplace – the voluntary release of credit scores – that potential borrowers will be able to use in improving their ability to compare mortgage terms before they assume such debt. More information provides an important market-driven way to help level the playing field between lenders and otherwise uninformed borrowers.

This report is structured in the following manner. Section I begins by documenting the growing importance of subprime lenders to underserved borrowers, as well as the efforts by the federal government to encourage lending to such borrowers – efforts that recent evidence suggests have paid off.

Section II next describes certain lending abuses in this market that have occurred or are alleged to have occurred in recent reports on predatory lending. In the process, it highlights how these abuses generally already are prohibited under existing federal law. Section II also identifies reporting requirements that now apply or that have been proposed for lenders in the subprime market. The section concludes by making clear that subprime or high cost lending – to borrowers of greater risk than prime borrowers – should not be routinely equated with "predatory" lending.

Section III summarizes some of the current and proposed local ordinances that have gone beyond federal law, and that currently or would penalize lenders for extending mortgages on terms that would not be unlawful or that would require reporting under federal law. Such legislation threatens the availability of credit to precisely those borrowers thought to be most victimized by predatory lending, and thus entail the risk of reversing the progress that federal law has made in encouraging the flow of credit to these borrowers.

Section IV concludes by suggesting that the prudent course for policy makers at all levels of government is to enforce existing law and examine the data that lenders must report before taking any further action that might threaten the availability of credit to riskier, but still creditworthy, borrowers.

I. The Importance of the Subprime Mortgage Market

In the days when deposit and lending rates were regulated or limited – as recently as 1980 – credit was rationed. Good or prime borrowers got credit, others didn't.

One of the major financial innovations over the past two decades, and especially in the 1990s, has been the development of credit rating tools that measure the relative risks of potential default of different borrowers. These credit scores are now used by a wide range of lenders, depository and non-depository institutions alike, to help determine interest rates and other terms to offer to borrowers that take account of the risks of non-payment.

In particular, borrowers with a history of always paying their utilities, credit card, and other bills on time often qualify as "prime" borrowers, and thus are eligible for credit on the most competitive terms available. Many borrowers, however, do not have perfect payments histories; others may not have significant assets to fall back upon; and others may be self-employed and have wide fluctuations in their annual incomes. Although borrowers in each of these categories may thus not qualify for credit in the prime market, they may well be eligible for credit in the "subprime" market, where because of the greater risks, interest rates and up-front fees are higher and loan amounts are typically smaller than those available in the prime market. As discussed further below, the leading credit scoring company – Fair Isaac – will be releasing credit scores to borrowers beginning in March 2001.[2] This is an important development that should enhance the competitiveness of the subprime mortgage market, to the benefit of borrowers who seek credit in that market or who will now learn that they deserve to receive credit as a prime borrower.

As it is, however, risk-related pricing of loans already has led to a considerable expansion in credit to borrowers who may once have been rationed out of the credit altogether. Many of the borrowers in the subprime market are minorities or families or individuals with low incomes – borrowers who could not in the past and still cannot qualify for credit in the prime market. The development of the subprime market has changed all that. As Federal Reserve Governor Edward Gramlich has recently noted, between 1993 and 1998 conventional mortgages extended to Hispanic-Americans and African-Americans increased by 78 and 95 percent, respectively – far outdistancing the economy-wide 40 percent increase in such lending [Gramlich, 2000].

Gramlich concludes that much of this increase is attributable to the expansion of the subprime market. As shown in Chart 1, during this same period, the number of subprime loans increased roughly ten-fold, from about 80,000 to nearly 790,000. Chart 2, indicates that from 1994 to 1999, the dollar volume of subprime mortgage originations increased by nearly a factor of five, from $35 billion to $160 billion, in the process climbing as a share of all mortgage originations from 4.5 percent to 12.5 percent.

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[2] The Fair Isaac & Co. scores are commonly referred to as "FICO" scores.

Chart 1
Number of Subprime Refinance Loans
Reported Under HMDA*

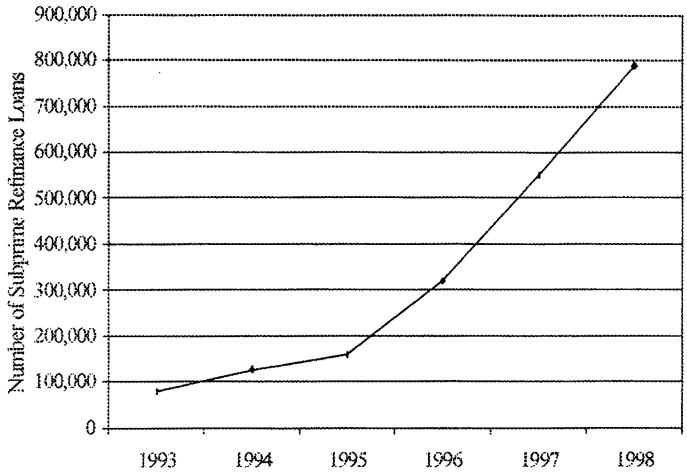
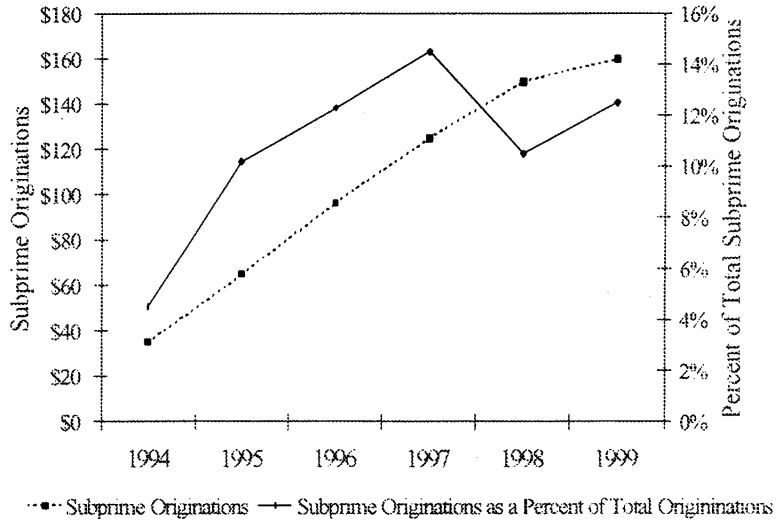


Chart 2
Subprime Mortgage Originations*

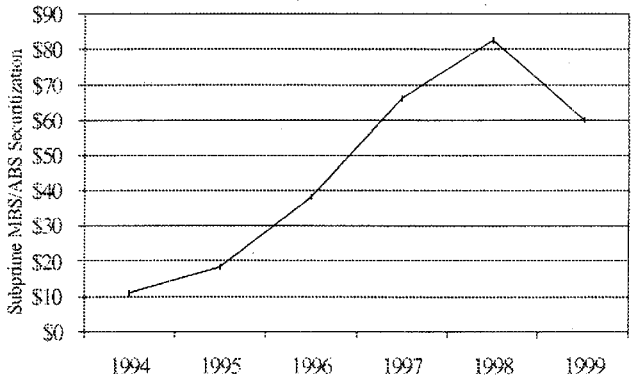


* Source: U.S. Department of Housing and Urban Development and U.S. Department of Treasury. June 2000. *Curbing Predatory Home Mortgage Lending: A Joint Report.*

Subprime loans are extended primarily by non-depository institutions, such as finance companies, that are not regulated by state or federal agencies for safety and soundness and other purposes. Depository institutions or their affiliates nonetheless have incentives under the Community Reinvestment Act, which obligates depository institutions to meet the credit needs of their local communities, to extend credit to subprime borrowers, who tend to be the LMI borrowers and residents of LMI areas whom the CRA was designed to benefit. Since 1997, there has been a small, but noticeable increase of subprime mortgage lending by depository institutions or their affiliates [Belsky, et al.].[3] Furthermore, although the two major housing government-sponsored enterprises – Fannie Mae and Freddie Mac – are not currently significant participants in the subprime market, both have begun to purchase mortgages in the upper reaches of that market (A- loans, for example) [HUD/Treasury Report, at 46]. Indeed, in June 2000, Fannie Mae announced a new product, its Timely Payment Rewards Mortgage, which is eligible to A- credits and entails an interest rate that starts out 2 percentage points below the subprime rate and drops automatically if the borrower makes 2 years' of payments on time [Raines].

Chart 3 shows that subprime lending has also been facilitated by the "securitization" of such loans – the packaging of loans into securities that are bought by institutional investors and, to some extent, by individuals.

Chart 3
Subprime MBS/ABS Securitization, 1994-1999



* Source: U.S. Department of Housing and Urban Development and U.S. Department of Treasury. June 2000. *Curbing Predatory Home Mortgage Lending: A Joint Report.*

[3] The Final CRA Report by Treasury indicates that the proportion of mortgage loans extended by CRA-covered institutions to prime borrowers fell from 99 percent in 1997 to 93 percent in 1999 [Belsky, et al].

The volume of securitized subprime loans jumped by more than seven-fold between 1994 and 1998, before falling back a bit in 1999. By enlarging the pool of potential investors in subprime loans, securitization has helped lower interest rates in this market just as it has in the market for conventional prime mortgage loans.

II. Abuses in the Subprime Market

The benefit of the subprime market is that it has widened access to credit for many who previously could not qualify for it. However, according to recent reports, certain subprime lenders have taken advantage of some borrowers, inducing them to agree to mortgages with onerous terms that the borrowers cannot realistically meet. When the borrowers do default, they lose the equity in their homes to the lenders. Moreover, since the abusive practices appear to be targeted at the elderly and residents of minority and low-income communities, a pattern of defaults can destroy property values and lead to increased crime in affected areas [HUD/Treasury Report, at 24-25].

These "predatory lending" practices are easier to condemn than to define, however. As the joint HUD/Treasury report noted in its analysis [at 17]:

"Defining the practices that make a loan predatory, however, is a problematic task. Any list of predatory practices is destined to be incomplete because bad actors are constantly developing new abusive practices, sometimes to evade government regulation. Furthermore, a list does not consider the context in which the alleged abuse has occurred. Some practices may be considered abusive in the context of high-cost subprime loans; other practices may be deemed unacceptable in all contexts; and others – while not necessarily abusive for all high cost borrowers – are abusive in the borrower's situation or because the borrower was misled or deceived."

The joint report nonetheless identifies four specific practices that seem to be characteristic of predatory lending:

- Loan flipping, or the repeated refinancing of loans in a short period of time in order for the lender to earn high fees (loan flipping is often accomplished through large balloon payments required over short maturities);
- Excessive fees, including large up-front charges and prepayment penalties, which are not related to the risks posed by the borrowers;
- The extension of unaffordable loans based on the assets, and not the income, of the borrower, a practice that frequently leads to default and foreclosure;
- Outright fraud or deception designed to conceal the true, onerous nature of the loan contract, typically from unsuspecting or unsophisticated borrowers.

In short, predatory loans are those that would not have been made in more competitive markets and where borrowers are more fully informed about the credit alternatives available to them. Put differently, borrowers are more likely to be victims of one or more of the practices

just listed in geographic areas where there may be relatively few lenders and where the borrowers themselves are not financially sophisticated and thus relatively easy prey for unscrupulous lenders.

It turns out, however, that most of the practices that are identified with predatory lending are already illegal under federal law. In addition, although there is anecdotal evidence that these practices have occurred, there is no evidence indicating how frequent they are and how effectively enforcement of existing laws is addressing any problem.

A. Current Laws Governing Predatory Lending Practices

It is easy to overlook the fact that most, if not all, of the practices associated with predatory lending *already are against federal law or are being addressed by the Federal Reserve.*

The broadest federal response is reflected in the Home Ownership and Equity Protection Act (HOEPA), enacted by Congress as part of the Riegle Community Development and Regulatory Improvement Act of 1994. Beyond the disclosure requirements embodied in HOEPA that are discussed below, the Act also prohibits certain terms in mortgage loans covered by the Act: those carrying an annual percentage rate (APR) of more than 10 percentage points above the yield of Treasury securities of comparable maturity or points and fees exceeding 8 percent of the loan amount or $400, adjusted for inflation since 1994.[4] In addition, covered loans may not: (1) contain certain onerous prepayment penalties;[5] (2) charge an interest rate after default that is higher than the rate prior to the default; and (3) in most cases, require a balloon payment on a loan with a maturity less than five years. Furthermore, a lender may not engage in a pattern of extending loans covered by HOEPA ("HOEPA loans") that do not take account of the borrower's ability to pay (income); and where a home improvement contract is involved, the creditor may not pay the contractor directly.

HOEPA also gives the Federal Reserve Board broad regulatory authority to prohibit additional practices it finds to be unfair or deceptive, not just for HOEPA loans but all consumer mortgage loans. In late 2000, the Fed outlined a series of major regulatory proposals pursuant to its HOEPA authority. The proposals would ban loan flipping within the first twelve months of a HOEPA loan (unless refinancing is in the borrowers' interest); prohibit lenders from replacing a zero or low cost loan with another higher cost loan (unless the refinancing is in the borrowers' interest); strengthen the existing prohibition on loans based on homeowners' equity (rather than income) by establishing a rebuttable presumption against the creditor if it doesn't document and verify the borrowers' income; and prohibit lenders from including "payable on demand" or "call provisions" in HOEPA loans.

In short, apart from outright fraud or misrepresentation – which already is punishable by state law – *federal law either addresses or proposes to address each of the elements of*

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[4] The current dollar threshold is about $465. As discussed below, the Federal Reserve Board may adjust the APR threshold up or down by 2 percentage points.

[5] A prepayment penalty may be imposed only if the borrowers' total monthly debt payments are less than 50 percent of his or her income; the prepayment is not made with funds borrowed through a loan made by the same creditor or its affiliates; the penalty does not apply more than five years after the mortgage was taken out; the prepayment amount at closing does not exceed two periodic payments; and the penalty is not prohibited by any other law.

predatory lending listed above and cited by the joint HUD/Treasury Report and other critics of predatory lending practices. A key challenge, therefore, as the joint HUD/Treasury Report recognizes [at 113], is for the Administration and the Congress to provide the federal agencies with responsibility for enforcing HOEPA and other related mortgage laws – the Federal Reserve Board, the Departments of Justice and Housing and Urban Development, and the Federal Trade Commission – with sufficient resources to carry out their mandates. In this regard, it is noteworthy that the FTC in particular has worked with the Justice Department to bring and successfully settle a number of cases in the past two years alone against various unscrupulous lenders for violating HOEPA and the Equal Credit Opportunity Act (ECOA), which bans discrimination aga inst applicants for credit on the basis of their age, race, sex or other prohibited factors [Medine].

B. Disclosure and Reporting Requirements Designed To Expose Predatory Lending

Federal law not only prohibits certain practices associated with predatory lending, but also contains numerous disclosure and reporting requirements relating to mortgage loans generally and to subprime HOEPA loans in particular.

The disclosure requirements are designed to make consumers aware of the true cost of credit so that they can better comparison shop among alternative providers of credit. The Truth in Lending Act (TILA), for example, requires all lenders of closed-end credit, including mortgage loans, to disclose, among other things: the annual percentage rate (APR) charged on the loan, the amount of the loan itself, and the total of all payments required. TILA, which is administered by the Federal Reserve Board under its Regulation Z, also gives borrowers a right to rescind certain mortgages, generally within three days of closing, and authorizes individuals to recover actual or statutory damages. The Real Estate Settlement Procedures Act (RESPA) supplements the TILA disclosures with a requirement that lenders of "federally-related" mortgage loans disclose settlement costs when borrowers are applying for a loan and again at the time of closing. RESPA also prohibits kickbacks and referral fees.

Federal law also requires mortgage lenders to provide information about their loans to the federal government, which enable it and the press to shine a spotlight on potentially onerous lending. Notably, HOEPA requires mortgage lenders to disclose information about their loans if they have an APR greater than 10 percentage points above the Treasury rate for loans of comparable maturity, or the points and fees paid by the borrower exceed 8 percent of the loan amount, or $400 (adjusted annually since 1994 for inflation). HOEPA gives the Federal Reserve Board, which is charged with collecting the data, the authority to vary the APR reporting trigger 2 percentage points either way. In late 2000, the Fed proposed lowering the HOEPA reporting trigger by the maximum amount, to 8 percent, as well as mandating that lenders alert consumers in advance of loan closing that the amount they borrow may be substantially higher than requested (due to the financing of insurance, points, and fees).

One criticism of the HOEPA reporting requirements is that the "APR trigger" is too high. As the HUD/Treasury report indicates (at 85-86), very few subprime loans at least as of late 1999 – less than 1 percent – exceeded the statutory reporting requirement, loans with an APR in excess of 10 percentage points above the comparable Treasury rate. Based on the same

data, this percentage would go up substantially, to roughly 5 percent, under the 8 percentage point trigger proposed by the Fed.

Those urging that the reporting threshold be lowered still further should recognize that the Federal Reserve already, as a practical matter, has addressed this issue with its recent proposal unveiled in November 2000 to amend its Regulation C, issued pursuant to The Home Mortgage Disclosure Act (HMDA). Among other things, this proposal would require an expanded group of mortgage lenders (both depository institutions and covered non-depositories) to report the APR on *all* their mortgage loans and whether the loans are covered by HOEPA. [6] With this information, the Board will be able to identify and report the distribution of mortgage loans by interest rate, so that policymakers, citizens and advocacy groups will have a clearer idea of how many high-cost mortgage loans are being made. The enforcement agencies should also be able to use this information to better target their investigation efforts against those lenders with a consistent practice of making very high cost loans (and thus where predatory lending may exist).

C. Subprime Lending is *Not* the Same as Predatory Lending

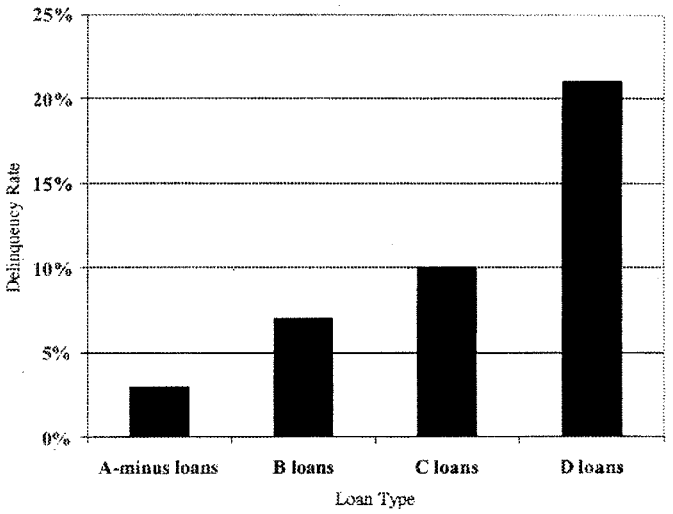
Recent reports on predatory lending have documented that subprime lending is concentrated among minority and low-income borrowers [HUD/Treasury Report, at 46-47; ACORN; U.S. Department of Housing and Urban Development]. Because the practices said to constitute predatory lending are concentrated among subprime lenders, a strong inference of these reports is that minority and low-income borrowers are disproportionately the victims of unscrupulous lending practices.

While this inference may be true, it is also important for policymakers and citizens *not to equate subprime or high cost lending with predatory lending*. The same joint HUD/Treasury study that highlighted the abuses among some subprime lenders also documented that, as a class, subprime mortgages *are more risky* than prime loans or mortgages insured by the Federal Housing Administration (FHA) – which is the reason they are subprime. In 1998 and 1999, for example, subprime mortgages were 5 times more likely to be delinquent (loan payments past due) than prime mortgages (13.5 percent versus 2.8 percent) [HUD and Treasury, 2000, pp 34-35]. Similarly, Chart 4 shows that the "serious" delinquency rate (loans past due 90 days where foreclosure proceedings have started) rises significantly as credit scores decline, underscoring a central feature of the subprime lending market: *that interest rates reflect the risks posed by borrowers with different financial characteristics.*

In fact, federal banking regulators have warned banks about the risks inherent in subprime lending. In an interagency guidance released in March 1999, the four federal regulators -- the Federal Reserve, the FDIC, the Office of the Comptroller of the Currency and the Office of Thrift Supervision -- noted that "due to their *higher risk*, subprime loans command higher interest rates and loan fees than those offered to standard risk borrowers. These loans can be profitable, *provided the price charged by the lender is sufficient to cover*

[6] Under current Board regulations, a non-depository lender is covered by the HMDA reporting requirements if its home purchase originations (including refinancings) equaled or exceeded 10 percent of its total loan volume. The proposed rule retains the 10 percent test but adds an alternative test: if the total annual volume of mortgage lending exceeds $50 million. Since the average dollar amount of a mortgage loan reported under HMDA is about $120,000, this dollar threshold applies to institutions that originate between 400 and 500 loans per year.

Chart 4
Serious Delinquency Rate for Subprime Borrowers,
Third Quarter 1999



* Source: U.S. Department of Housing and Urban Development and U.S. Department of Treasury. June 2000. *Curbing Predatory Home Mortgage Lending: A Joint Report.*

higher loan loss rates and overhead costs related to underwriting, servicing and collecting the loans." (emphasis added) [Board of Governors of the Federal Reserve System, et al.]. On January 31, 2001, the federal banking agencies officially recognized this fact by imposing significantly higher capital requirements on depositories that have above-average concentrations of subprime loans, or those with qualifying subprime loans collectively greater than 25 percent of the institution's Tier I capital (essentially shareholders' equity). These institutions must hold capital that is 1.5 to 3 times higher than the amount typically required for prime loans [Blackwell, 2001].[7]

[7] According to the new regulatory guidelines, a subprime loan is one which a borrower has a FICO score of 660 or below; at least two 30-day delinquencies in the past year; a debt service-to-income ratio of 50 percent or more; a declaration of bankruptcy within the past five years; or a foreclosure, repossession, or chargeoff in the preceding 24 months.

III. Recent Local and State Initiatives Aimed At Preventing Predatory Lending

Notwithstanding the panoply of federal laws that already deal with predatory lending, a number of local and state governments have adopted ordinances and statutes aimed at the problem. Although these interventions have many common elements, they differ in key respects, which not only complicates the legal landscape for national lenders, but increases uncertainty in the market, to the potential detriment of the *very population of minority and low income individuals* these local and state laws are designed to protect. This danger is especially worrisome given the evidence indicating the positive effects that federal antidiscrimination laws and the Community Reinvestment Act have had on lending to minorities and low income households and neighborhoods [Litan, et al, 2000; Belsky et al, 2001].

Generally speaking, the state and local provisions apply or propose to apply stiff penalties – fines, imprisonment, and prohibition of city or state business with the offending institution – for either "high cost" or "predatory loans", which are defined by a combination of some numerical threshold (based on APR and points/fees) plus at least one specifically identified practice. Table 1 summarizes the thresholds and the penalties in some of the currently enacted and proposed statutes. Table 2 provides a list of offending practices, which most (but not all) of the laws and proposals identify. As illustrated by the asterisks in Table 2, virtually all of the practices punishable (now or potentially) at the state and local level are already prohibited under federal law.

What is the harm in having state and local governments add their own enforcement efforts to those of the federal government? Aren't these lower levels of government supposed to be "laboratories of democracy", where different and potentially innovative practices can be tried out, so that perhaps federal policymakers can learn from best practice and then copy?

In many areas of policy, these arguments for devolution are quite valid, especially where the problems being addressed vary in nature across the country. But in other areas of social policy – social insurance, broad areas of regulatory policy, energy and transportation policy, among others – federal policy predominates, and often appropriately so. Market failures that are common across the country may deserve a uniform response. Varying state and local responses can also drive up costs of addressing social problems where they interfere with the functioning of national markets.

There are several reasons why an exclusive federal response is appropriate for dealing with predatory lending. First, as is highlighted in Table 2, virtually all of the lending practices that the states and localities have condemned or would condemn, already are punishable by federal law. The "laboratory" argument, therefore, does not apply in the case of predatory lending. The "experiment" has been run at the federal level and federal laws have been passed and agencies have been charged with their enforcement.

Table 1

Key Features of State/Local Ordinances on Predatory Lending

Location	APR and Point/Fee Trigger	Penalty
Ordinances Enacted:		
Chicago	APR >6% above Treasury for first mortgages; APR >8% over Treasury for second mortgages; or Points/fees >5% of loan if $16,000 or greater; or $800 otherwise	No business with the city
North Carolina	Points/fees >5% of loan if less than $20,000; otherwise >8% of loan amount or $1000 (whichever is lower)	
Ordinances Proposed:		
Baltimore	APR >6.5% over Treasury; or Points/fees >4% of loan; or $800 (if loan < $20,000)	Fine/imprisonment No city deposits/investments with offending institution
Philadelphia	APR >6.5% over Treasury for first mortgages; APR >8% over Treasury for second mortgages; Points/fees >4% of loan or $800	Loss of business license and any city business
Oakland	APR >8% above Treasury; or points/fees >6% of loan amount	No business with offending institution
Washington, D.C.[8]	APR substantially greater than that justified using borrowers' credit score and underwriting criteria of the federal housing GSEs or other agencies; or points/fees >2% of the loan, or $400	Damages; reformation of the loan; punitive damages; other penalties

[8] At this writing, the D.C. Council had passed and the Mayor had signed an ordinance addressing predatory lending, but the Congress had not yet voted on the measure (as it is required to do for laws enacted governing the District of Columbia).

Table 2

State and City Predatory Lending Offenses, Proposed or Enacted
(* Denotes Practice is Addressed or Proposed to be Addressed Under Federal Law)

* Unfair and deceptive practices

* Prepayment penalties above some threshold

* Balloon payments at less than certain maturities
  Baltimore: 15 years
  New York: 7 years
  Oakland: 7 years
  Washington, D.C.: 7 years, 3 months

* Loan flipping

Single premium credit life insurance (already unlawful if not disclosed to the borrower*)

* Loans to borrowers without regard to capacity to repay (typically, statutes presume a borrower's ability to pay if his or her total debt repayments are less than 50% of monthly income)

* Loans with proceeds going directly to home contractors

Even so, not much is known about the true extent of remaining predatory practices, beyond the anecdotes that have been provided in testimony that have served as the basis for various reports. The federal disclosure rules, both under HMDA and HOEPA, should change that. If it eventually emerges that the predatory lending problem is more extensive or is of a different nature than currently envisioned, then history demonstrates that a federal response – either from regulators acting under existing law or from Congress – will be forthcoming.

Second, various state and local ordinances in the meantime can chill legitimate subprime lenders from channeling credit to the borrowers in that market, which as the critics of predatory lending have noted, are disproportionately minorities or low income households. This is especially the case where the triggers defining predatory lending are vague and the penalties for engaging in the practice – however state and local officials may define it – are severe. A good example is the Washington, D.C. ordinance, whose proposed trigger is an APR that is higher than one justified by the borrower's credit score, using the underwriting criteria of the federal housing GSEs (Fannie Mae or Freddie Mac) or other federal agencies. Such a verbal test, by definition, contains no bright lines, and therefore can easily discourage perfectly

legitimate lending, especially given the harsh penalties lenders would face for violation – actual and punitive damages, and fines.

Third, even bright line tests can have the same chilling effect – discouraging perfectly lawful lending. A staff memorandum prepared for the Federal Reserve's Board of Governors, for example, noted in connection with the Board's recently proposed lowering of the HOEPA reporting trigger that while covering even more loans under the Act would extend the Act's protections, "greater coverage could have a chilling effect and raise regulatory costs in a segment of the subprime mortgage market. This might deter interest of some predatory lenders in the market. *It seems unlikely this effect would be restricted to predatory lenders alone, however, and it could cause some potential legitimate competitors to forego entry into this market where competition currently is alleged to be low.*" (emphasis added) [Durkin and Canner, at 3-4]. In fact, one major subprime lender – Countrywide Credit – withdrew from the North Carolina market in January, citing the state's law against predatory lending [Bergquist]. Another major lender – EquiCredit, a subsidiary of Bank of America that is the largest bank-owned subprime lender in the United States – told the Federal Reserve during the summer of 2000 that the North Carolina statute would reduce its lending volume by roughly 30 percent in the state and predicted that the Chicago ordinance could cause as much as a 60 percent drop in its lending in that city [Eggers, 2000].

There is a danger that other ordinances – especially those with lower numerical thresholds than those proposed by the Federal Reserve for reporting under HOEPA – could also ration out creditworthy borrowers, especially those to whom federal law (through the Community Reinvestment Act) now encourages depository lenders to serve. After all, usury laws used to be widespread in this country until policymakers realized that limits on lending interest rates had the effect of rationing credit. With securitization of subprime lending having become a national market, subprime lenders have thus far been able to expand the supply of credit to those borrowers by developing uniform products that apply equally to borrowers wherever they live. A balkanization of laws affecting the subprime market – with differing standards on the fringes of that market, predatory loans – threatens that uniformity and should make it more expensive for national lenders to extend credit in a perfectly legitimate way to subprime borrowers.

Finally, there is an implicit assumption running through some of the local ordinances that high cost lending, by itself, is somehow predatory. As already shown, subprime loans carry interest rates that are higher than those that are charged prime borrowers because subprime borrowers are riskier. This is not only recognized in the marketplace, but federal regulators have cautioned banks about such risks in subprime lending and required depository lenders with high concentrations of such loans to maintain higher capital than other banks, precisely because of the risks involved. It is therefore a mistake for policymakers to equate high cost lending with predatory lending.

Fortunately, not all localities that have considered or are considering predatory lending ordinances are doing so in ways that threaten the availability of subprime credit. A resolution in Cleveland, for example, while reflecting similar sentiments against predatory lending as have been expressed in other existing or proposed ordinances, departs from the emerging pattern by urging more education of consumers about predatory lending practices and more

cooperation between local officials and community based organizations to accomplish that objective. Such an approach complements existing efforts at the federal level.

IV. Recommendations and Conclusion

There is already ample federal legislation on the books aimed at exposing and curbing predatory lending. The great danger now is that further measures, before the dimensions of any remaining problems are known and however well intentioned such additional steps may be, could nonetheless impede the normal flows of credit to the very borrowers who are claimed to be most vulnerable to predatory practices. In particular, the proliferation of different state and local lending rules threatens to balkanize the lending market and make it very costly, and potentially impossible, for lenders to offer nationally uniform mortgage loan contracts. If lenders are unable to do so, their costs will be higher and those costs are certain to be passed on to the consuming public, especially underserved borrowers.

Under these conditions, the prudent course is for governments at all levels to refrain from adopting additional legislation until the data the Federal Reserve collects under HMDA and HOEPA can be fully analyzed. This will permit an assessment of both the prevalence of high-cost lending and the effectiveness of existing enforcement efforts against predatory lending. A cautious approach to predatory lending does not counsel inaction, however. Congress and the states should appropriate sufficient funds to ensure that the agencies charged with enforcing existing statutes designed to stop specific predatory lending practices have the financial means to do so. The same is true for counseling efforts to continue educating consumers about their credit alternatives and the dangers of entering into mortgage loans that have terms characteristic of predatory loans.

The market for subprime loans is also about to become significantly more competitive because the leading credit scorer, Fair Isaac, has announced plans to make available individuals' scores over the Internet, together with interpretations of their meaning, beginning in March 2001 [Kingson]. The disclosure of credit scores will help level the playing field when borrowers apply for mortgage credit. In the process, it should go a long way, if not all the way, toward eliminating the practice of lenders failing to channel qualified borrowers into the prime market. Furthermore, armed with their credit scores, borrowers will be better able to comparison shop before they sign any mortgage.

In sum, federal law is now about to be reinforced by market forces to help curb predatory lending practices. Moreover, federal policymakers have put in place a data reporting and collection system that will shed light on the workings of the mortgage market. It is vital that policymakers, therefore, not rush to judgment and enact "laws of unintended consequences" that will harm the very group of people they are most trying to help.

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Testimony of

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Neighborhood Assistance Corporation of America (NACA)

Regarding

Predatory Mortgage Lending
The Problem, Impact and Responses

Banking Housing and Urban Affairs Committee
United States Senate

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Introduction:

This is a response on behalf of the Neighborhood Assistance Corporation of America (NACA) to the invitation made to us by Chairman Sarbanes to contribute our perspective on the issues brought up during the Senate Banking, Housing and Urban Affairs Committee hearing entitled "Predatory Mortgage Lending, The Problem, Impact and Responses."

NACA has been in the forefront of the fight against predatory lenders and their exploitative lending practices. NACA with offices throughout the country provides the best mortgage program in America, and has set the standard for providing affordable mortgages to working people who would be subject to subprime and predatory lenders. NACA has commitments with major lenders totaling $4.3 billion: no down payment, no closing costs, no fees, no points and a below market interest rate. Participants are not required to have perfect credit. Through the NACA program, working people, who otherwise would be subject to subprime exploitative terms, have been able to purchase a home on extremely affordable terms. NACA's refinance program allows individuals whose existing loans contain predatory rates and terms to refinance into a low rate loan with no fees. In effect, NACA provides prime loans for sub-prime borrowers.

NACA has a unique perspective on Predatory Lending and on what type of legislation is needed in order to address predatory lending. NACA spearheaded the enactment of the Home Ownership and Equity Protection Act of 1994 (HOEPA). The HOEPA legislation was a direct consequence of NACA's campaigns against predatory lenders including our campaign against Fleet Bank's predatory lending. This campaign and the subsequent disclosure of Fleet's practices before committees of congress led directly to the passage of HOEPA. While NACA is proud of its support for HOEPA and believes that its passage has lessened the number of predatory loans made by lending institutions, NACA believes that under HOEPA as implemented many predatory practices have either not been or have only partially been prohibited. Further, NACA believes that even where certain practices have been forbidden enforcement has been lacking. Since passage of the legislation, NACA has on many occasions lobbied hard both to get new state and federal legislation to strengthen HOEPA's protections and to persuade the Federal Reserve Board and other regulatory agencies to exercise their full powers under the Act to fight against predatory lending.

Because of NACA's long time concerns regarding predatory lending, we welcome the opportunity to make our views on the subject known. In particular we would like to comment on the legislation known as the Predatory Lending Consumer Protection Act of 2001 introduced in the House by Congressman LaFalce (HR1051). We understand that this legislation, which is substantially similar to that proposed by Senator Sarbanes last year (S. 2415), is likely to be

the model for legislation currently being prepared by Senator Sarbanes. To the extent relevant to issues raised by the Act, NACA would also like to comment on HOEPA regulations that have been proposed but not implemented by the Federal Reserve. (We have attached detailed comments on these regulations, which have already been submitted to the Federal Reserve, to this document).

Preventing Flipping:

Lending Institutions make profits on high rate loans through a number of practices, most significantly through flipping, the practice of refinancing their own loans. This practice both exploits the homeowner and the investor. While the devastating impact of high fees, unaffordable rates and abuse terms are well known the investor aspect has not been well established. This practice constitutes a multi-billion dollar ponzi scheme in that predatory lenders deceive and defraud their investors by overstating their net income and the value of their investments.

The lender refinances their own loan prior to default and then uses an accounting technique, sometimes known as Gain-On Sale Accounting, to make their profits appear higher as a result. The refinancing prevents the loan from defaulting over the short-term while inflating the short-term profits. The long-term question of whether the loan will ultimately be paid back becomes irrelevant in the quest for short-term profits. An example is described below. On the initial loan, the fees and points charged to the borrower must be amortized over the expected term of the loan. Thus if a borrower obtained a $100,000 loan and was charged ten (10) points, the $10,000 would likely be booked to income of $1,000 each year for ten years. Yet, if the lender refinanced the loan, the total of $10,000 would immediately be booked to net income. Thus the lender's financials would show a $10,000 net profit even though there is no actual money coming in. The lender is providing high returns to their investors and in the above scenario is able to book to net income the points and fees that were that were charged on the refinanced loan. This method of accounting considerably overstates net income with the lender paying themselves while the likelihood of the borrower making complete and timely payments is very unlikely.

The LaFalce bill devotes little attention to the practice of Flipping. Although certain of the proposed changes, particularly in regards to financed points, might serve to deter Flipping, there are no specific sections of the bill that address flipping in and of itself. The Federal Reserve's new rules do address flipping specifically. However, they only touch the surface of the problem. For example, while the new rules against flipping begin to address the issue by only allowing refinancing of high cost loans where it is in the consumer's interests to do so, by limiting this prohibition to high cost loans refinanced within one year of the initial closing and that can be shown to be against the consumer's interest, the Board failed to address the majority of instances where predatory lenders repeatedly refinance or flip loans. It is unclear why the Board considers refinances that are

against the consumer's interest only to be unfair and deceptive when the loan already meets its definition of high cost or why these refinances are deceptive within one year but not within two or three years. Congress should mandate and the Federal Reserve should enforce rules that state that all refinancing that is against the consumer's interest be made a prohibited practice and not simply limit this to high cost loans or refinanced loans within one year. There should also be clear criteria for determining when a refinance is against the consumer's interest.

Forbidding certain accounting practices that make flipping appear profitable would cause lenders to limit the practice. It would also end a fraud on investors which over the longer term could have a devastating impact. Congress should address these deceptive accounting techniques which impact both the consumer and investor.

Prohibiting Loans a Borrower Cannot Afford to Pay back:
Lending institutions are aware that many of their customers will not be able keep up with their payments if they are charged exorbitant rates and fees or if other conditions are included in the mortgage. However, since the institutions are making significant profits on high rate loans, even where these loans are unlikely to be paid back, they do not change their practices. While HOEPA forbids making loans that a buyer cannot afford to pay back, at present consumers and regulators are only able to enforce this restriction when there is a demonstrated pattern or practice by the lender making such loans and even this remedy is limited to high cost loans. It is very difficult to prove a pattern of this type of lending and further current law and regulation are very unclear on the criteria that would determine the borrowers ability to pay. As a result, high rate loans are often made to those who do not have the ability to pay them back.

The LaFalce bill proposes to strengthen protections against these inherently predatory loans by creating federal standards that a lender must follow in order to determine that the borrower is able to repay the loan based on criteria in federal regulations. It also expands the right of rescission in a foreclosure proceeding. NACA strongly supports this proposed change. However, NACA questions why it is limited to borrowers who have had their loans already defined as high cost under this legislation. If a 16% loan is considered high cost and a 14% loan is not, but neither borrower has the ability to repay it based on their current income and expenditures, is one any less deceptive than the other? Both borrowers are likely to lose their home. Further, NACA believes that any individual who receives a loan that they can't afford should be able to take individual action for rescission and damages regardless of whether there is a foreclosure proceeding. While NACA favors a less restrictive definition of High Cost Loans (see below), no matter what the trigger is set at, lending institutions will continue to make loans regardless of the ability to repay as long as these loans are profitable and they are not prevented from doing so.

Preventing Predatory Rates and Fees:
NACA believes that Congress needs to act to prohibit predatory interest rates and fees. One way to restrict predatory lending is to expand the definition of what constitutes a high cost loan under HOEPA. The LaFalce bill reduces the Annual Percentage Rate necessary to trigger HOEPA's protection to six points above the yield on Treasury securities and reduces the percentage of the total loan amount necessary to trigger HOEPA from 8% to 5%. The Federal Reserve, using its powers under the existing statute, has proposed but not implemented new regulations that define a high cost loan under HOEPA at eight percentage points above Treasury securities. The Federal Reserve has not proposed any change with regard to the fee trigger although it did propose making its definition of fees more inclusive.

While NACA would certainly support and work hard to win passage of any bill or regulation making HOEPA more inclusive, we note that even under the LaFalce bill many predatory loans would not be considered high cost. We further note that designating a loan high cost does not in and of itself prevent that loan from being originated; it simply puts it under HOEPA's restrictions. Under the Federal Reserve's proposed eight-point trigger, if the Treasury security rate is 6%, it is possible for a lender to charge an APR of up to14% and fees as high as 8% and not even have the loan be considered high cost. Under the Sarbanes and LaFalce bill, the APR could be as high as 12% and fees as high as 5%. For a homeowner, who is of low or moderate income or who has had savings diminished through accident, injury, or prior credit problems, an interest rate that high would likely to cause them to eventually fall behind on their payments and lose their home.

Congress through a series of legislative actions in the early eighties, in particular the Depository Institutions Deregulation and Monetary Control Act of 1980, repealed and preempted state usury laws that once protected citizens from predatory loans. Since Congress created the problem through eliminating absolute limits on rates and fees, it would seem that the best way to solve this would be to restore these limits. While the LaFalce bill does not have absolute prohibitions on usurious rates and fees, it does take the positive step of forbidding lenders of high cost loans from financing directly or indirectly any charges payable to the creditor or any third party in excess of 3% of the total loan amount. This restriction will provide lenders with a disincentive to make high cost loans and to flip these loans.

Prohibiting Yield Spread Premiums:
The practice of some Mortgage lenders of paying fees to mortgage brokers based on a higher interest rate and/or points beyond what the customer would qualify for, commonly known as Yield Spread Premiums, is not addressed in the LaFalce bill or in the Federal Reserve's proposed regulations. Regulatory action (mostly originating from the Department of Housing and Urban Development) has focused on whether the mortgage broker had properly disclosed his payment

from the lender and whether the payments in question are for actual services done for the lender without regard to whether the costs and services are reasonably related. Brokers who the customer believes are working in their best interest to get them a loan at the best possible rate have an inherent conflict of interest when they are paid more by a lender to get them a loan at a higher rate. Congress should unambiguously ban any practice in which brokers are paid a higher fee based on how high the rates or points they convince the customer to agree to accept.

Protection Against Predatory Practices for all Borrowers:

The LaFalce bill bans or severely restricts a number of predatory practices. To a lessor extent the Federal Reserve's proposed regulations also restrict these practices. However, these restrictions are only applied to high cost loans. For example the LaFalce bill limits prepayment fees or penalties to three percent of the total loan borrowed for all high cost loans. Where financed fees are involved the prepayment penalty is further reduced. Additionally, lenders are only permitted to charge prepayment penalties in the first two years. None of these protections, however, affects individuals whose loans are not within the HOEPA trigger and whose loans therefore are not considered high cost.

Similarly, the LaFalce bill bans the clearly predatory practice of encouraging default on existing loans prior to refinancing. However, the practice is only banned for the recipients of high cost refinancing. The obvious reason why lenders encourage default is so that borrowers will get behind on their original loan so they will not be able to refuse refinancing even if terms or conditions change prior to closing. Regardless of the motivation of this practice, it clearly constitutes an irresponsible tactic that does not benefit the borrower in any way. There is no reason then why this ban should be limited to high cost loans.

Further, both the LaFalce bill and the Federal Reserve Regulations expand the definition of points and fees to include financed credit life insurance making it more likely that loans that include expensive credit life insurance policies would be considered high cost loans. While any restriction on financed credit life, including voluntary restrictions agreed to by a number of the major lending companies, represents a step in the right direction, Congress needs to go further. Credit insurance covers loan payments in the event of death and disability. Predatory lenders add credit insurance to the loan amount, often without the knowledge of the borrower. Financed credit insurance can equal between 10 to 20 percent of the loan amount. This is exorbitant, considering that life insurance products can be obtained outside of the loan transaction that are much cheaper for the borrower. It is also inherently deceptive because by financing the insurance as part of the loan the real cost of the single premium is masked. Because of its abusive nature, NACA believes that legislation should prohibit the

financing of single-premium credit insurance for all classes of borrowers not simply those with high cost loans.

While HOEPA certainly should be expanded to include many more individuals, all of the practices described above and others do not become less predatory when the rates and fees fall below the current limited threshold for high cost loans or even the expanded threshold set out in the LaFalce bill. If a practice leads borrowers to obtain loans that they would never have taken had they known the facts or had more reasonable options that practice is predatory regardless of the rates and points charged.

Conclusion:
Neither the Federal Reserve nor the courts have proven capable of significantly addressing predatory lending practices. Comprehensive legislation to widen and strengthen HOEPA is the best method for accomplishing this goal. Senator Sarbanes and Representative LaFalce have filed such legislation. However, this legislation needs to encompass Flipping, expand the definition of high cost loans, and not just limit prohibited practices to high cost borrowers.

Sincerely,

Bruce Marks /BMa

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Enc: NACA comments to the Federal Reserve.
Wall Street Journal Article dated August 1, 2001

February 24, 2001

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Washington, DC 20551

RE: Docket No. R-1090

Dear Ms. Johnson,

Introduction: This response to the Federal Reserve Board's (the Board's) request for comments on proposed changes to Regulation Z is made on behalf of the Neighborhood Assistance Corporation of America (NACA). NACA supports the new direction indicated by these changes; we firmly believe, however, that the Board's previous implementation of Regulation Z has allowed abusive and predatory lending practices to continue apace, and we urge the Board to fully utilize the regulatory powers granted to it by the Home Ownership and Equity Protection Act (HOEPA) to protect families and their communities.

NACA's unique perspective on HOEPA owes to the investigative research it began over a decade ago into predatory lending rackets and second mortgage scams. Our extensive campaign against Fleet Bank led to the exposure of these predatory practices before Congressional committees and was instrumental in passing the HOEPA legislation. NACA helped push the legislation through Congress despite opposition from the Board, and has frequently petitioned the Board to carry through on the promise of the legislation by using the full mandate granted to it to combat predatory lending.

In particular, NACA believes that the Board has failed to uphold its obligations under Section 129(l)(2) of HOEPA, which states that:

> The Board, by regulation or order, shall prohibit acts or practices in connection with—
>
> (A) mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section; and
>
> (B) refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower.

The proposed revision of Regulation Z represents the Board's first attempt to make use of these powers and as such it is welcome. Even with these new regulations, however, the Board has neglected to prohibit, or fully prohibit, many predatory practices.

Unconscionable Rates and Points: NACA believes that Section 129(l)(2) grants the Board the authority to restrict loans with APRs that deviate significantly from the conventional industry standards and are unconscionable. For low and moderate-income homeowners with limited savings these high APR loans often lead to financial devastation and/or the loss of their home. Lowering the HOEPA trigger to 8 points above comparable-term Treasury securities (cf. § 226.32(a)(i)) is a positive step but does not prevent lenders from continuing to make unconscionable loans. Lending institutions and investors are fully aware that many of their customers will not be able to sustain their payments at the rates charged. Even when customers are unable to make their payments, the lenders can make significant profits, e.g. by flipping (see comments below), and are therefore unwilling to change their practices.

Although HOEPA forbids making loans that a buyer cannot afford to repay, this offers limited protection to consumers. First, it does not apply to loans that slip beneath the HOEPA bar, even when they are predatory. Secondly, the restriction is only subject to enforcement when there is a demonstrable pattern or practice by the lender. Because such a pattern is difficult to establish, especially given the difficulty of proving that a lender *knew* the customer would default, Section 129(h) is insufficient to prevent predatory lending.

Loans that are unlikely to be repaid or are usurious are unfair and, as such, fall under the Board's regulatory powers. Given the burden of proof to establish malicious intent by lenders, the Board's best recourse for preventing these predatory lending patterns is to prohibit loans with unconscionable rates or points. Lenders have argued that their rates reflect the risk of lending to "subprime" borrowers, and that further rate cuts would create shortages in the credit market. We offer two points in rebuttal. First, the success of NACA's mortgage program, which offers low cost, market-rate loans to "subprime" borrowers, clearly demonstrates that these borrowers can repay *affordable* loans. By charging usurious rates, subprime lenders create the "risk" that fuels their high profit margins. Secondly, the social cost of reducing the number of high-interest rate loans available to the few people who could actually benefit from them is far outweighed by the costs incurred by the vastly greater number of people who now unwittingly sign themselves over to financial ruin.

Because predatory lending practices change with time, Congress gave the Board the power to monitor the mortgage industry and prohibit those practices that it discovers are linked to predatory lending. Since the passage of HOEPA, the Board should have uncovered a clear link between loans with unconscionable rates and points and the predatory

practices of extending credit without regard to the payment ability of the consumer. The Board should use its regulatory powers to prohibit such loans.

Strengthening Rules Against Flipping: The Board has neglected until now its responsibility under Section 129(l)(2) to curb refinancing practices that are abusive and not in the interest of the borrower, and the currently proposed regulations are inadequate to the task. Flipping engenders the worst kind of loan abuse and goes hand-in-hand with unconscionable rates. Because lenders can *de facto* make unaffordable loans (see previous section), they can use repeated refinancing to generate fee income and strip homeowner equity.

Some lenders refinance their own loans prior to default and use deceptive accounting techniques to mislead their investors. Fees that would ordinarily be amortized over the life of the loan are booked immediately as profit when the loan is refinanced, allowing the lenders to overstate their performance. Although these fees will probably never be repaid in full, the paper gains inflate the value of these lender's stocks and securities.

The proposed rule in δ 226.34(3) offers limited protection to consumers and suffers from major shortcomings. Section 129(l)(2) of HOEPA specifies that the Board shall prohibit refinancings of *all mortgage loans* that are not in the interest of the borrower. The Board has chosen to implement this by prohibiting refinancings *in the first twelve months, by the original creditor, of loans subject to δ226.32* that are not in the borrower's interest. Lenders are thus licensed in all other circumstances (after 12 months, non-HOEPA loans, different creditor) to deceive and manipulate borrowers into entering transactions that are against their interests.

NACA proposes that the Board prohibit fees on refinancing by the original creditor (and affiliates) on all loans where the new loan has a rate higher than the Fannie Mae 15 or 30-year rate. We believe these restrictions do not create a significant competitive disadvantage for the original lender because the lender is already familiar with the borrower, reducing the processing costs and the need to charge points. Although the measure would restrict some instances of legitimate refinancing, especially where the borrower wishes to buy down the rate, the borrower can always turn to a different lender for the buy-down option. NACA believes that the costs of any inefficiency created are far outweighed by the efficacy this rule would have for both eliminating the abusive practices of flipping and the incentive to make unaffordable loans.

Should the Board persist with the benefits strategy, NACA is concerned not only with the narrow scope of its proposed application above, but with

the potential abuse of the phrase "in the borrower's interest." If a predatory lender makes a HOEPA loan that the borrower is unlikely to be able to repay (as discussed above, relying on the repayment clause is problematic), the borrower might need to refinance or default after six months. In these circumstances, the lender could plausibly argue that refinancing (with new fees) is in the interest of the borrower. Instead, the total relationship between that borrower and lender should be evaluated. The Board must develop guidelines that would prevent these types of evasions.

Prohibiting Yield Spread Premiums: Some lenders pay fees to mortgage brokers based on the spread between what a borrower should be charged and the loan that they actually buy from the broker. These fees encourage brokers to use deceptive high-pressure sales tactics to sell borrowers unnecessarily expensive loans, a problem that is exacerbated by the fact that borrowers often think that the broker works for them. From a different perspective, yield spread premiums create market inefficiencies that rely on misinformation, and put honest brokers at a competitive disadvantage. Under Section 129(l)(2), the Board therefore has the authority to prohibit these practices as deceptive and unfair, and should do so.

Prohibiting Financed Single Premium Credit Life: Including credit insurance in the fee trigger is a positive step, but the Board should go further. Predatory lenders often add credit insurance to the loan amount without the knowledge of the borrower. Financed credit insurance can equal between 10 and 20 percent of the loan amount, an exorbitant figure considering that life insurance products can be obtained outside of the loan transaction at significantly lower costs. The lenders misrepresent the price of the single premium insurance by financing it into the loan. Because of the excessive abuse of financed single premium insurance products, NACA believes that the Board should prohibit them.

Prohibiting Refinancing Low Cost Loans: NACA approves of the prohibition in δ 226.34(b)(1) against refinancing a no-interest or substantially below market rate loan in the first five years. Given that there is a "borrower's interest" exemption, however, the protection should extend for the full term of the low-rate loan. Additionally, many if not most of the predatory loans in question are second mortgages rather than refinances or consolidations of the first mortgage. To prevent predators from taking advantage of affordable mortgage programs, the Board should prohibit second mortgages that exceed conventional rates for homeowners with low-rate loans.

Credit Counseling: The Board has asked for comments on credit counseling and other educational efforts. NACA agrees that such counseling can redress the information gap between well-served and poorly served communities and reduce the amount of predatory lending in underserved communities. NACA is in general agreement with restrictions imposed by some states that require mandatory counseling for some high cost loans. We believe that any mandatory counseling must be accompanied by restrictions on the relationship between credit counseling and the mortgage industry so that counselors truly act in the interest of the borrowers. NACA is also concerned that counseling may be offered as a substitute for the promulgation and enforcement of predatory lending regulations, such as those recommended above. Neither counseling nor improved disclosures can remedy difficulties associated with inherently abusive loan terms and conditions.

Conclusion: The Federal Reserve Board needs to demonstrate to the public and the mortgage industry that it has overcome its initial opposition to HOEPA and is now ready to uphold its obligation under HOEPA to combat predatory lending practices. The proposed regulations represent an insufficient move in the right direction. Only by taking full advantage of the powers it has been given under HOEPA, including and in particular the power to restrict inherently unfair and deceptive practices, can the Board fulfill the responsibilities assigned to it.

Sincerely,

Bruce Marks
CEO
NACA

Background: NACA has been in the forefront of the fight against predatory lenders and their exploitative lending practices. NACA's offices throughout the country provide the best mortgage program in America, and set the standard for providing affordable mortgages to working people who would be subject to subprime and predatory lenders. NACA has commitments with major lenders totaling $4.3 billion for no down payment, no closing costs, no fees, no points, below market interest rate loans. Participants are not required to have perfect credit. Through the NACA program, working people, who otherwise would be subject to subprime lenders with exploitative terms, have been able to purchase or refinance a home on extremely affordable terms. In effect, NACA provides prime loans for sub-prime borrowers.

THE WALL STREET JOURNAL.

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Home Bound

Nasty Surprise Haunts Some Folks' Mortgage: A Prepayment Penalty

It Stalls Refinancings, Sales For Subprime Borrowers, And Critics Take Aim

Irbys Have to Sell, but Can't

By JOHN HECHINGER
Staff Reporter of THE WALL STREET JOURNAL

All over the U.S., homebuyers are reaping a bonanza in one of the biggest mortgage-refinancing booms ever. Taking advantage of lower interest rates, they are slashing their monthly mortgage payments or extracting tens of thousands of dollars in equity for new cars, vacations or their children's education.

But many low-income consumers are missing the party: "subprime" borrowers with blemished credit, a spotty employment record or a lot of debt. Increasingly, these homebuyers are finding that if they want to pay off their loan early to get a better deal, they are socked with thousands of dollars in fees.

These prepayment penalties, all but gone from the mortgages taken by average homebuyers, are alive and well among those who don't qualify for conventional financing. About 80% of mortgages in the subprime market carried prepayment penalties in mid-2000, up from 50% in 1997, according to a Standard & Poor's survey.

The penalties often assess borrowers 5% of the loan amount outstanding if they pay the mortgage off within its first three to five years for any reason, whether to refinance, consolidate debts or sell the home. Lenders say they need such a provision because of the high costs they incur in making subprime loans.

Growing Criticism

But some consumer advocates and politicians contend that borrowers aren't being adequately informed of the prepayment penalties, which critics characterize as a "predatory" lending practice aimed at low-income people who may not fully understand loan terms. "Prepayment penalties rip money out of people's pockets," says Lisa Donner, a coordinator with the Association of Community Organizations for Reform Now, or Acorn, a nonprofit and activist group that often targets housing issues. "Owning a home goes from being a source of wealth into a constant drain."

Lisa and Mark Cabral of Mount Vernon, Wash., say they didn't know they were getting locked in. Four months ago, the Cabrals took out two new home loans from Household International Inc.: a $102,000 loan at a 13.99% interest rate and a $10,000 line of credit at 21.9%. They weren't planning to stay in their manufactured home for much longer. In fact, one reason they borrowed was to fix it up so they could sell it and move to a bigger place.

Can't Afford to Move

The work is finished, but the Cabrals say they can't afford to move, having recently realized that the bigger loan carries a penalty of about $7,000 if it is paid off within five years. "We didn't know a lot about these kinds of things," says Mrs. Cabral, 36, a medical administrator who earns $24,000 a year.

Mrs. Cabral and her husband, a construction-company superintendent, have sued Household. Their suit, in state court in Skagit County, Wash., claims Household didn't adequately disclose the prepayment penalty and some other terms of the loan, and alleges fraud and deceptive trade practices. "They took advantage of us, and now we can't sell our home," Mrs. Cabral says.

Household denies the allegations. "We don't believe we've done anything wrong," says a spokesman, Craig Streem, who adds that the company levies prepayment penalties on most of its loans and always discloses them.

Higher Expenses

Household incurs higher expenses than conventional lenders, Mr. Streem says, partly because it does more creditworthiness research and partly because it has to shell out more for collections on past-due loans. Subprime lenders don't collect their origination fees upfront but wrap them into the loan amount. So if a borrower refinances after just a few months, Mr. Streem says, "you eat your own costs." Hence the prepayment penalties.

About 35 states have laws that ban or restrict prepayment penalties, many enacted to protect consumers during the high-interest 1970s. It was these laws, together with lending competition, that prompted lenders to drop the penalties in most conventional mortgages.

Subprime lenders have found a way to retain the penalties even in the restrictive states. The device is an obscure federal law called the Alternative Mortgage Transaction Parity Act. Passed in 1982 to help lenders avoid the hassle of varying state restrictions, the law allowed them to subject "alternative" home financing—such as adjustable-rate mortgages—to oversight by the federal Office of Thrift Supervision. The OTS doesn't restrict prepayment penalties.

In 1999, Virginia noticed growing numbers of loans showing up with prepayment penalties larger than the state cap, which is 2% of the loan amount. The state's bank-

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ing regulator warned lenders they would be cited for violations. But a trade group sued in federal court, arguing that subprime loans were alternative mortgages under the 1982 law and thus could be covered by the OTS, not the state. The group's suit has prevailed at both the district and appellate level. Virginia is seeking Supreme Court review.

At the OTS, Director Ellen Siedman has voiced concern about lenders using the federal exemption to dodge states' restrictions on lending practices. But she says states can still go after many practices by using consumer-protection laws.

Subprime home loans carry interest rates three to six percentage points higher than conventional mortgages. Household's generally charge 9% to 13%, at a time when conventional 30-year mortgages are running about 7%. Household also charges fees of about five "points," or 5% of the loan amount. Conventional loans may entail no points or several. They average about one.

Offsetting the Risks

Household and other subprime lenders say they need these terms to offset the risks they take. At the end of last year, 2.73% of subprime mortgages were delinquent by 90 days or more—about 10 times the level for conventional loans—according to market researcher Mortgage Information Corp.

Willie Irby

The fairness issue has taken on greater importance because of explosive growth in subprime lending. The volume of subprime mortgages grew fourfold from 1994 to 1999, according to the trade publication Inside Mortgage Finance, before falling about 12% last year as some lenders faced financial problems after making bad loans. About 13% of mortgages originated last year were subprime.

The Senate Banking Committee held a hearing last week on subprime practices, including early-payoff penalties. The Treasury Department and the Department of Housing and Urban Development have urged restrictions, such as barring prepayment penalties when the borrower is selling the home. And a House bill introduced by Rep. John J. LaFalce, Democrat of New York, would cap prepayment penalties at 3% of loan amounts and limit them to the first two years of a mortgage.

A few savvy borrowers turn prepayment penalties to their advantage. If they know they will be living in their homes for several years, they can choose to be subject to a penalty in exchange for a lower interest rate. The better-off customers in the "prime" market occasionally agree to them. But regulators and advocates say many uneducated borrowers don't understand the tradeoffs. And they say the penalties often are disclosed only in the fine print of loan documents.

Nonprofit groups often work with banks to funnel loans to low-income neighborhoods. Boston-based Neighborhood Assistance Corp. of America often tries to refinance borrowers out of high-interest loans. Prepayment penalties can block this strategy, says NACA's chief, Bruce Marks, though he adds that he sometimes can get a lender to drop the penalty after threatening a lawsuit or a protest.

'I Knew It Was a Bad Deal'

Jacquelyn Ali heard from a friend about a NACA program, funded by Bank of America Corp., that would allow her to refinance her 10.99% subprime loan with a lower-rate mortgage. But Ms. Ali, who lives in suburban Atlanta, had to wait until a $3,000 prepayment penalty expired this year to take the deal because she couldn't afford the penalty. The original $73,000 loan was made in 1998 and was held by the CitiFinancial unit of Citigroup, one of the biggest subprime lenders.

"I knew it was a bad deal," says Ms. Ali, a divorced mother of two who works as an office manager at Morehouse School of Medicine. "But I knew I had to wait to get out." Her monthly bill has dropped roughly by half with the new 6.2% mortgage.

Leah Johnson, a Citigroup spokeswoman, says the company has "heard the concerns voiced, and we're responding." Citigroup this year started offering subprime borrowers a choice of opting out of a prepayment penalty at the outset, in exchange for a higher interest rate. It also has agreed to limit prepayment penalties to three years. A week ago, Household said it, too, would limit the duration to three years.

Many subprime homeowners need to borrow so much that they have little equity when they first buy their homes. Then, selling the house while a prepayment penalty is still in force can eat up much of whatever equity they've managed to accumulate. A refinancing, either to lower the interest rate or to draw out some cash, can cause a new prepayment penalty to kick in after the first one has expired.

In March, Willie Irby, his left leg stiff from a stroke, walked to the front door of his Washington, D.C., home, collected the mail and ripped open a long-dreaded letter from his mortgage company. "Foreclosure is imminent," read the notice, demanding $6,155.24 in back payments. "If you wish to save your property, you must act now."

A Painful Decision

To satisfy the debt, Mr. Irby and his wife, both in their 70s, made the painful decision to sell the home they had bought as newlyweds. But they soon discovered that their mortgage was blocking their escape. It carried a prepayment penalty of $13,791. The Irbys say they didn't have the money, and the proceeds from selling the house wouldn't cover it after they paid the mortgage.

The Irbys found themselves in dire straits even though the house they bought in 1959 for $16,950 was now valued at about $350,000. Over the years, they had loaded it up with high-cost debt, mostly to remodel it and to pay medical expenses. The amount they owed on it also grew as lenders' fees were wrapped into the debt. Last November, the Irbys took out a new mortgage with Option One, a unit of H&R Block Inc., believing they could lower their monthly payments and extract another $45,000 for medical expenses. The mortgage climbed to $314,000.

As his debt against the house skyrocketed, Mr. Irby had an uneasy feeling. "I thought maybe I was borrowing more than I can afford," he says. But he believed he had no choice.

The new loan's interest rate was 10.99%. According to a complaint the Irbys subsequently filed with HUD against the lender, monthly payments on the mortgage they took out in November were just under $3,000, while their monthly income is about $2,750. Option One executives, while declining to discuss specifics of the case, say the file shows that the Irbys had enough income to qualify for the $314,000 mortgage.

This spring, the Irbys agreed to sell the house to pay off their loan. They moved into a cramped one-bedroom apartment and decorated it with pictures of politicians and world leaders, mementos from Mr. Irby's work in the mailroom of the Department of Energy. The couple gave away half their furniture as well as their washer and dryer when they moved.

When they learned about the penalty for prepaying their mortgage, the Irbys had to pull out of the sale. "All I wanted was enough money to sell the home and pay the people off," says Mr. Irby, 77.

The would-be buyers, Mary and Dennis Kivlighan, joined the Irbys and the National Community Reinvestment Coalition, a Washington nonprofit group, in the fair-housing complaint with HUD.

Late last week, after a reporter began looking into the case, Option One reached an agreement with the Irbys. It allowed the sale to go through, with the lender waiving about $23,000 in fees and interest, according to Option One. Still, the lender's chief operating officer, Steve Nadon, defends prepayment penalties, saying that without them, interest rates for all subprime borrowers would have to rise and some would be shut out of the market. The Irbys' fair-housing complaint is still pending with HUD.

On a recent day, Mr. Irby, his jeans still flecked with paint from home-improvement projects, reminisced as he toured his now-empty home, walking past the paneling and wallpaper he had hung himself. "We were here for 40 years," he says. "My kids grew up here. We had good times here. Now, it's gone. Once you're behind, you can't catch up."

NATIONAL ASSOCIATION OF REALTORS®

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July 25, 2001

The Honorable Paul Sarbanes
Chairman, Senate Banking Committee
534 Dirksen Senate Office Building
Washington, D.C. 22510

Dear Mr. Chairman:

On behalf of the NATIONAL ASSOCIATION OF REALTORS® I want to take this opportunity to applaud your efforts to address abusive and predatory lending practices. The hearings your committee will be conducting are important ones. We are well aware of your longstanding concern about abusive, predatory or fraudulent lending practices. NAR shares your concern and supports your efforts to assure that consumers are protected and fully armed with the knowledge to empower them to use mortgage credit wisely and protect homeowner equity.

The NATIONAL ASSOCIATION OF REALTORS® opposes abusive or predatory lending practices that deceive homeowners about the true nature of the loan and result in the stripping of equity, diminished personal credit standing, or violations of federal or state consumer protection statutes and regulations. The majority of predatory lending victims are women, the elderly and minorities. As an association, NAR is working hard to break down the barriers to homeownership, especially those facing minority populations. Minority homebuyers are significantly more likely than white homebuyers to use an FHA or higher-cost subprime loans when buying a home. This underscores the need for a healthy subprime market. Taking steps to tighten the lending rules for these loans in order to protect the consumer is an admirable goal. The challenge will be to craft a solution that will successfully decrease the opportunities for unscrupulous behavior while at the same time preserve the availability of credit for subprime borrowers. We look forward to working with you to find that necessary balance.

Seeking solutions to predatory lending is consistent with NAR's overall public policy priorities. Every day, REALTORS® work hard to build strong communities and a better America by assisting families and individuals in their pursuit of the American Dream of homeownership. We are committed to preserving and promoting federal mortgage finance and assisted housing programs to help close the gap in homeownership rates for minorities and to meet the demand for affordable rental housing. As advocates for consumers, we have dedicated ourselves to defeating

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the proposed Federal Reserve Board and Treasury Department rule that would allow banks to engage in real estate brokerage and management activities.

We also proudly support legislation recently introduced by Senators Charles Schumer and Wayne Allard that would require the disclosure of credit scores to consumers, along with the key factors that were used to determine those scores and additional information that puts the credit score into context. Consumers would know their score and thus increase their opportunities to qualify for the most cost effective mortgage. It will keep consumers from being swept into needlessly expensive mortgage products with unsuitable terms. Consumers are best protected with the most comprehensive and clear disclosures prescribed by law and regulation.

There is no doubt that additional regulation of the mortgage lending industry will be met with much resistance. Lenders argue that simply enforcing current laws will rid the marketplace of those who act in bad faith. They instead offer a proposal to reform RESPA and TILA, two key consumer disclosure statutes as a solution to predatory lending. It is not that simple. Daily news headlines report increasing incidents of abusive and deceptive lending practices, consumer privacy violations and other questionable actions by financial institutions. There is no doubt this is a widespread problem. We are greatly troubled because these are the same entities seeking additional powers to enter the real estate brokerage business. We strongly encourage you not to be distracted by their objections and to continue to move forward in the manner you have laid out to address this very important issue.

REALTORS® spend countless hours putting people in homes. We would like to see them stay there and not be the victims of actions that ultimately result in foreclosure and financial ruin. We congratulate you again for holding these hearings on the growing problem of abusive and predatory lending and look forward to being part of the solution.

Sincerely,

Richard Mendenhall
President
NATIONAL ASSOCIATION OF REALTORS®

cc: Banking Committee

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Senator Paul Sarbanes
United States Senator
Chairman, Senate Committee on Banking,
Housing & Urban Affairs
309 Hart Building
Washington, DC 20510

Dear Chairman Sarbanes:

We at The Reinvestment Fund ("TRF") in Philadelphia wish to extend our appreciation to you and your Senate colleagues for holding the recent hearings on *predatory lending*. Jonathan Miller of your staff, upon learning of our research, contacted us and asked that we provide a summary of our findings for placement in the public record.

Approximately 18 months ago, TRF obtained a grant from the Ford Foundation to study predatory lending using the City of Philadelphia as our laboratory. Our study has two complementary tracks: one that is qualitative and another, quantitative. The purpose of the qualitative analysis is to gain a thorough understanding of the predatory lending process and to both inform and illuminate the quantitative work. To that end, we conducted systematic interviews with: borrowers, brokers, settlement attorneys & clerks, title insurers & underwriters, appraisers, lenders & mortgage bankers, representatives of the Pennsylvania Association of Mortgage Brokers, representative of the Pennsylvania Association of Mortgage Bankers, President of the National Home Equity Mortgage Association, State Banking Officials (PA and NJ), State Housing Finance Agency Officials (PA), a Federal Trade Commission attorney and several legal advocates and scholars.[1] These interviews helped us gain a broad understanding of the industry, how it has evolved, and how predatory lending practices have emerged. By interviewing members of the sub-prime industry, we developed a comprehensive understanding of what distinguishes legitimate sub-prime business practices from predatory lending practices.

Our quantitative work is novel. Most research to date has simply tabulated HMDA data records based upon a characterization of lenders as prime or sub-prime. While useful to a degree, the shortcomings of this approach are several (e.g., not all lenders report under HMDA nor are all sub-prime loans predatory). We felt that to really

[1] We have also taken the opportunity to review our approach and findings with representatives of the U.S. Department of Justice (Civil Rights Division) and Freddie Mac, both of which have expressed support for the reasonableness of our approach and findings.

capture the essence of the equity lost to homeowners over a period of time, we needed to find a database that offers an opportunity to examine the sale and lien histories of properties. From these property histories, our strategy for identifying indicators of predatory lending necessitates a careful review of each and every property for which multiple factors are coded to reflect the nature of the lien history and patterns we believe to be predatory.[2]

We created several samples of mortgage histories. Our control sample has approximately 450 residential properties drawn from all areas of the City of Philadelphia. Other samples consist of all the residential properties in selected Philadelphia Census tracts. These tracts were chosen for in-depth analysis because they represented an array of *potential vulnerability* - per our classification. These data sets will ultimately provide the statistical basis upon which we intend to conclusively estimate the nature and extent of predatory lending across the City of Philadelphia.

The phrase *potential vulnerability* requires some explanation. Interviews and previous research on this topic suggest that those most vulnerable to predatory lending tend to be: (1) of more modest means; (2) older; (3) with equity in homes (i.e., equity that can be used by the lender). Accordingly, we identified areas in the City of Philadelphia that had lower housing values, higher percentages of homeowners aged 55 and above, and higher percentages of homes owned free-and-clear.

Our analysis shows that, generally speaking, areas that have higher *potential vulnerability* to predatory lending manifest: (1) lower levels of income; (2) greater population decline during the 1990's; (3) higher percentages minority – especially African American; and (4) lower levels of education. Our analysis of the selected sample tracts suggests that highly vulnerable areas also manifest: (1) substantially higher percentages of sub-prime lending; (2) higher percentages of homes sold at Sheriff Sale; (3) greater likelihood of refinancing prime to sub-prime loans (as opposed to refinancing prime to other prime loans, as occurs in lower vulnerability areas); and (4) more frequent patterns of lending suggestive of predatory lending (i.e., a series of small often consumer discount loans refinanced into large first liens by sub-prime lenders).[3] Credit repair, a term used by the sub-prime industry to justify making sub-prime loans to credit impaired borrowers who could theoretically make

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[2] We have also characterized each lien as originating with a prime or sub-prime lender. Our basis for this characterization is the HUD Sub-Prime lender list with our own in-depth search of various market sources and consultation with individuals who have expertise in knowing the nature of the lenders' business.

[3] We are also exploring the nature and extent of a racial connection to these predatory patterns of lending. While we observe an undeniable spatial relationship between predatory lending and the racial composition of areas, we do not yet feel that we have sufficient data to identify race as is a causal factor.

regular payments and then refinance into a prime product, does not occur to any great extent in the most vulnerable areas.

An Evolving Understanding of the Problem:

Our analysis shows that there are areas of the City of Philadelphia that have historically had vastly different access to mainstream financial institutions. Through our interviews we recognize that these areas are home to people whose familiarity and experience with mainstream financial institutions is severely limited. Even today, an analysis of the HMDA data show that people residing in the lower income and minority areas of Philadelphia obtain credit from a largely different set of institutions than those residing in higher income White areas; there is greater sub-prime activity in the lower income minority areas. For many of the people residing in these communities, the majority of whom are of modest means, situational needs for credit have been filled by finance and consumer discount companies rather than banks or credit unions.

Federal legislation, titled the Depository Institutions Deregulation and Monetary Control Act of 1980, exempted financial institutions from State usury laws if first lien positions were taken against a property. The state exemption, taken together with the proliferation of private mortgage securitization in the early to mid-1990s, put pressure on lenders to convert borrowers' financial needs previously met by small second loans into large first liens.[4] This was accomplished by refinancing all sorts of debt (e.g., existing mortgages, revolving debt, utility bills, etc.) into new first liens against the borrower's property. Borrowers were convinced that the lower monthly bill and/or the tax advantage of deductible home mortgage interest outweighed the cost of the transaction.[5] [6] Through our interviews we have seen and heard of instances where people refinanced low interest federally insured mortgages into high interest sub-prime loans. Reports have come to TRF that residents of the Philadelphia Nehemiah homes, financed by TRF, have been approached to refinance *soft second* liens (representing security for the subsidy used to construct the home) to

[4] Estimates are that private mortgage securitizations of sub-prime loans rose from approximately $10 billion in 1994 to $90 billion in 1997. Cathy Mansfield, 2000. "The Road to Subprime "HEL" Was Paved With Good Congressional Intentions: usury deregulation and the subprime home equity market." South Carolina Law Review, 51, 3.

[5] Obviously for some, reducing the monthly payment was necessary to alleviate a difficult financial circumstance. However, for others the substitution of short-term debt with long-term debt was economically irrational. This irrationality is particularly stark when the refinanced debt could not have threatened the borrower's equity in their home.

[6] In order to reap the benefit of deductible mortgage interest, a taxpayer/borrower would have to itemize their income tax returns. Many lower income people do not itemize deductions on their tax returns and so the benefit is lost.

get small amounts of cash. It is important to recognize that these people were persuaded to convert loans they would not have had to pay back into real debt – in some instances totaling over $20,000 – in order to borrow one or two-thousand dollars.

The 1990's witnessed a remarkable expansion of a sub-prime credit market. At the beginning of the decade, estimates are that sub-prime credit constituted less than 1% of the mortgage market. By the end of the 1990's, estimates are that sub-prime lending overall constituted about 9%, with sub-prime more active in the refinance market (i.e., 10.9%).[7] In the prime market there was little variability in risk (or cost) because of the fairly uniform and stringent underwriting guidelines adopted by most prime lenders – in part driven by the GSEs. This conservative assessment of risk meant that the credit needs of those whose credit was flawed went unfulfilled. In the sub-prime market, the price a borrower paid was ostensibly commensurate with risk. While the mainstream financial institutions focused their activity on low-risk borrowers, sub-prime lenders were making credit available where it was not plentiful before by charging more to risky borrowers. The argument was (and remains), that although sub-prime loans were more costly, the alternative was no loans at all.

Sub-prime lenders tend to be non-depository and thus are largely un- or under-regulated. By this we mean that unlike national banks, for example, that receive routine safety and soundness (and CRA) reviews, these lenders operate without the sort of financial oversight that would tend to catch or limit abusive and fraudulent practices.

It is our conclusion that many economically irrational loans are made because of those involved in the transaction – except for the borrower and the ultimate holder of the note – none truly have a stake in the outcome of that transaction. Lending in the sub-prime world is an extraordinarily fragmented process. Thus, if loans go into default or foreclosure, while the borrower and note holder may suffer a consequence, neither the lender nor the broker or anyone else in the process suffers a loss. In an interview with an appraiser we were told that there is constant pressure on appraisers to inflate values. He reported that the appraisal has evolved from a vitally important document that existed to protect borrower and lender, to an obligatory document necessary in the loan file in order to get through a lender's quality control. If the value is overstated, it doesn't matter. One lender expressed the pressure of competing interests of meeting lending quotas versus quality control of applications. He stated that when the pressure is on to meet lending quotas, quality control "takes a back seat."

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[7] See for example: Glen Canner, Wayne Passmore and Elizabeth Laderman. 1999. "The Role of Specialized Lenders in Extending Mortgages to Lower-Income and Minority Homebuyers." Federal Reserve Bulletin, November 1999. Anthony Pennington-Cross, Anthony Yezer and Joseph Nichols. 2000. "Credit Risk and Mortgage Lending: who uses subprime and why?" Research Institute for Housing America, Working Paper No. 00-03.

Moreover the sales force that many of the wholesale lenders within this industry employ (i.e., mortgage brokers) functions with little or no oversight. Licensing in the Commonwealth of Pennsylvania is purely bureaucratic and involves filling out a form and sending the Commonwealth a check for $500; at this time, there are no training, education or continuing education prerequisites for a license. There is little chance that the State Banking Commission will effectively enforce the Mortgage Bankers and Brokers Act. This reality is not lost on brokers acting outside the parameters of that law.[8] [9]

Interviews with brokers, borrowers and others clearly point to the aggressive tactics with which the sub-prime products are marketed. Some of the aggressive marketing behaviors (e.g., knocking on someone's door and telling them that their roof looks like it needs work and they can do the repair and arrange financing) stand in direct contrast with how the more mainstream financial institutions operate. Target marketing is not *per se* bad. It is however a problem when you exploit a vulnerability to sell a damaging, inappropriate financial product. One of the strategies for marketing described to us involved obtaining lists of names of potential borrowers from an internet market research firm. A database of names of individuals who meet certain criteria (e.g., female, over the age of 65, likely homeowner, likely living alone, etc.) can be purchased for pennies-a-name. These names can then be cross-checked against the same data we are using to examine lien history to see who had existing sub-prime or consumer discount loans. The ability to query the publicly available databases by lender name makes purchasing lists of homeowners redundant for many brokers. In fact, a former consumer finance lender described how his customers were target marketed by predatory brokers, ultimately putting him out of business.

In short, because of the fragmentation of the lending and loan funding process, the lax regulatory environment within which many of the actors operate, the push to get the money on the street, pent up demand for credit, and unsophisticated borrowers, predatory lending as we know it was born and flourishes.

With this as background, we are able to cautiously project that there are areas in the City of Philadelphia where predatory lending is essentially non-existent. On the other hand, there are areas where perhaps as much as 25% of the transactions have indications of predatory lending.

Future Ford Foundation funded research by TRF on this topic will have us reviewing the HUD-1 settlement sheets for a sample of loans so that we can see "where the

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[8] Interestingly, broker trade associations recognize this problem and are recommending that the bar be raised for entry into the profession and that the State take a more proactive role in regulating brokers. They are also recommending continuing education classes and some self-policing powers.

[9] In an environment where the Assistant Secretary of Banking (in PA) expressed his question about the extent of predatory because they had so few complaints to their Department, one needn't wonder how those who operate in violation of the law might feel comforted.

money went" in some of these transactions. We are also studying foreclosure and Sheriff Sales for linkage to predatory lending. And finally, we will be extending our work to areas beyond the City of Philadelphia. Programmatically, on an initial pilot basis, TRF is going to be making its own capital available to individuals who have been exploited in predatory transactions. This program is a partnership between TRF, Community Legal Services, Inc. (an entity that represents victims of predatory lending) and the Housing Counseling Association.

TRF as a highly respected member of the CDFI community prides itself on being able to conduct high quality public policy research that intersects with our poverty alleviation mission. In this instance we view developing and communicating a better understanding of predatory lending as supportive of that mission. TRF supports your attempts to broaden the coverage of the HOEPA and tighten its triggers. We also support the attempt to outlaw certain products and practices mentioned in your bill that oftentimes are found in what we might all agree are predatory loans. TRF would also support an expansion of the HMDA to include a larger universe of lenders and information reported so as to facilitate public monitoring of the sub-prime market. To the extent that we can provide additional assistance to you and the other members of the committee, please do not hesitate to call upon us.

Very sincerely yours,

Jeremy Nowak,
President & CEO

Ira Goldstein
Director, Public Policy
& Program Assessment

Enclosures

STATEMENT OF JEFFREY ZELTZER

EXECUTIVE DIRECTOR, NATIONAL HOME EQUITY MORTGAGE ASSOCIATION

JULY 26, 2001

Chairman Sarbanes and Committee Members, I am Jeffrey Zeltzer, the Executive Director of The National Home Equity Mortgage Association ("NHEMA").[1] I appreciate the opportunity to provide NHEMA's views on how to stop inappropriate mortgage lending practices that many now call "predatory lending." NHEMA abhors abusive lending and wants it stopped. We advocate a multitrack strategy for stopping these abuses: (1) tougher enforcement of existing laws; (2) voluntary industry self-policing by such things as adopting "Best Lending Practices" Guidelines; (3) greatly enhanced consumer education programs; (4) broad-based reform and simplification of RESPA and TILA requirements; and (5) targeted legislative reforms where appropriate to address specific abusive practices. Subsequently, we will comment further on each of these areas.

Subprime consumer mortgage lenders are performing an extremely important service by making affordable credit available on reasonable terms to millions of Americans who otherwise could not easily meet their credit needs. Before the subprime market became well established over the past decade, consumers in many underserved markets often found it difficult, if not impossible to obtain credit. Today, virtually every American has the opportunity to obtain mortgage credit at fair and reasonable prices. We are very proud that our industry has played a key role in democratizing the mortgage credit markets and in helping so many consumers. We also are deeply troubled both by the continued existence of abusive lending practices in the subprime marketplace and by the unintended adverse consequences that are likely to arise if corrective measures are not drafted with extreme care.[2] NHEMA is committed to helping eradicate such lending abuses that are harming too many of our borrowers and undermining our industry's reputation. We commend Chairman Sarbanes and the Committee for focusing attention on this problem, and we pledge to work constructively with you to help stop the abuses.

Although there is little quantitative data to document the prevalence of such problems, we know that some abuses are occurring, and NHEMA believes that they must be stopped. None of our borrowers should be preyed upon and risk losing their homes by even a few unscrupulous mortgage brokers, lenders, and home improvement contractors. Having devoted a great deal of time and resources to addressing these concerns, we are convinced that there is no single, simple "silver bullet" solution to prevent abusive or improper practices that some parties are perpetrating on unsuspecting and often unsophisticated borrowers. Before discussing our five part strategy for preventing mortgage lending abuses, we want to first share some general information and observations that we believe will be helpful to the Committee's

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[1] Founded in 1974, NHEMA serves as the principal trade association for home equity lenders. Our current membership of approximately 250 companies employs tens of thousands of people throughout the Nation and underwrites most of the subprime consumer mortgage loans.

[2] Federal Reserve Board Governor Gramlich recognized many of these points in a recent speech at the Board's Community Affairs Research Conference: "Studies of urban metropolitan data submitted under the Home Mortgage Disclosure Act (HMDA) have shown that lower-income and minority consumers, who have traditionally had difficulty in getting mortgage credit, have been taking out loans at record levels in recent years. Specifically, conventional home-purchase mortgage lending to low income borrowers nearly doubled between 1993 and 1999. . . . Much of this increased lending can be attributed to the development of the subprime mortgage market. Again using HMDA data, we see a thirteen-fold increase in the number of subprime home equity loans and a sixteen-fold increase in the number of subprime loans to purchase homes. The rapid growth in subprime lending has expanded homeownership opportunities and provided credit to consumers who have difficulty in meeting the underwriting criteria of prime lenders because of blemished credit histories or other aspects of their profiles. As a result, more Americans now own a home, are building wealth, and are realizing cherished goals. . . . However, this attractive picture of expanded credit access is marred by those very troubling reports of abusive and unscrupulous credit practices, predatory lending practices, that can strip homeowners of the equity in their homes and ultimately even result in foreclosure. . . . Though we have held discussions on the different categories of subprime loans, the credit profiles of vulnerable borrowers, and the marketing and underwriting tactics that predatory lenders employ, we find that the absence of hard data inhibits a full understanding of the predatory lending problem. Exactly what are the most egregious lending practices? How prevalent are they? How can they be stopped? Absent the available data and the analysis and relationships they reveal, rulemakers and policymakers are challenged to ensure that their actions do not have unintended consequences. We are mindful that expansive regulatory action intended to deter predatory practices may discourage legitimate lenders from providing loans and restrict the access to credit that we have worked so hard to expand. . . ."

understanding of the predatory lending issue and the subprime segment of the mortgage market.

Background

What is "Predatory Lending?" While there is no precise definition of the term "predatory lending," it is generally recognized as a term that encompasses a variety of practices by home improvement contractors and mortgage brokers and lenders that are abusive, grossly unfair, deceptive, and often fraudulent. These practices include such things as unreasonably high charges for interest rates, sales commissions (points) and closing costs, imposing loan terms that are unfair in particular situations, and outright fraudulent misrepresentations. In recent years, the label "predatory" has been used in recognition of the fact that some of the perpetrators literally prey upon the elderly, the less affluent, and more vulnerable homeowners, including in some cases, minorities.

"Subprime Lending" vs. "Predatory Lending" While abusive practices do in fact occur to some extent in all types of consumer credit transactions, including the so-called "prime" or "conventional" mortgage market, it appears some abuses are concentrated more heavily in the subprime market segment. Regrettably, this occurrence has undoubtedly caused some people to confuse "subprime" and "predatory" lending. It is critically important that Congress fully understand that subprime mortgage lending should not be equated with "predatory." Subprime loans are a wholly legitimate and an absolutely vital segment of the broader mortgage market. Between 10 percent to 15 percent of all U.S. mortgages fall within the subprime category. Roughly 50 percent of subprime loans are originated through mortgage brokers, with the remainder coming from retail sales by lenders.

"Subprime" is the term that generally is used to refer to loan products that are offered to borrowers who do not qualify for what are called "prime" or conventional products. Prime mortgage borrowers have more pristine, "A" grade credit, are considered less risky and accordingly qualify for the lowest available rates. Borrowers whose qualifications are below the "prime" requirements are usually referred to as "subprime" and have to pay somewhat higher rates as they are viewed as being higher credit risks. Most subprime mortgage loans are made to people who have varying degrees of credit impairments. We want to emphasize, however, that many borrowers with "A" grade credit do not automatically qualify for prime mortgage rates because credit is not the only factor considered in underwriting a loan. Other issues, such as the amount of equity that the borrower has to invest in the property (the "loan-to-value ratio"), nonconforming property types, one's employment status or the lack of adequate loan documentation often prevent borrowers from qualifying for a prime mortgage product.

Unlike the relatively limited number of prime loan products, there are a wide variety of subprime products and rates, which reflect the more customized, risk-based pricing underwriting of the subprime market segment. Lenders in the subprime market usually offer mortgages in categories broadly described as "A-minus," "B," "C," and "D." (Many lenders have numerous subcategories with graduated prices within each of these general categories.) The majority of subprime loans, roughly 60–65 percent, fall into the "A-minus" range and have interest rates only moderately higher than prime loans. Another 20–25 percent qualify as "B," which have a few more credit impairments and slightly higher rates to reflect more risk. The remaining 10–20 percent tend to be mostly "C" grade loans, which have substantially more credit defects, and a small percentage of "D" loans, which present the highest credit risks.

It is important to understand that while subprime borrowers present higher risks, and accordingly must be charged higher rates to reflect those risks, they still generally are good customers who remain current in their mortgage payments. They do, however, require a higher level of loan servicing work to help keep them on track, and this also entails higher costs to the lenders, which must be reflected in loan pricing.

Who are the subprime borrowers? Many media stories relating to abuses in the subprime market have left people with a misimpression that most subprime borrowers are elderly, minorities, very poor, and likely to be unable to repay their loans, and therefore are destined to lose their homes in foreclosure. In fact, the typical subprime customer is totally different from this stereotype. The overwhelming majority of subprime borrowers are white, not minorities. They are mostly in their 40's, with only a small percentage over 65 years old. And, their incomes typically range between $50,000 and $60,000 per year. Most repay in a timely manner, and the foreclosure rate is only somewhat higher than that for prime loans. The subprime borrower's profile is basically that of a "prime" borrower, and it is one's credit record, not age or race, that is the main distinguishing factor. NHEMA com-

missioned a study last year by SMR Research, which is one of the Nation's leading independent mortgage market research and analysis firms, to review subprime lending. SMR's report, which we are providing to the Committee's staff, offers additional details regarding our market segment and customer characteristics.

Protecting Borrowers' Access to Credit

In sharp contrast to legitimate subprime or prime lending, some unethical loan originators do engage knowingly in abusive lending practices and many of these abuses are now often lumped together in the term "predatory lending." These abusive practices include a variety of improper marketing practices and inappropriate loan terms. Sometimes it is quite easy to identify predatory lending, but it often is much more difficult to determine whether abuses are occurring. Moreover, a number of the loan terms being attacked are not *per se* improper, but can sometimes be used improperly.[3]

To illustrate this point, we want to highlight several loan terms typically help consumers and are not *per se* abusive, yet many consumer advocates now often seem to be alleging these terms are inherently predatory:

- Prepayment Fees—Many subprime loans contain terms that impose a prepayment fee or penalty if the borrower pays off the loan before the end of the agreed upon loan period. Some critics are strongly attacking prepayment fees as predatory and unfair, and some legislators have proposed prohibiting such fees. Are prepayment fees abusive? Most of the time, absolutely not. Prepayment fee clauses actually provide a major benefit to most consumers because they allow the borrower to get a significantly lower rate on the loan than they would get without the clause. Prepayment provisions are very important in keeping rates lower and helping make more credit available in the subprime market. Loans are priced based on the assumption that they will remain outstanding for some projected time period. If a loan is paid off earlier, the lenders or secondary market investors who may buy the loan cannot recover the upfront costs unless they address this issue in the terms of the loan. Instead of charging a higher interest rate or higher initial fees, lenders know it is usually fairer and better for the borrower to have an early payment fee to protect against losing these upfront costs. On the other hand, it is certainly possible to have an abusive prepayment clause that imposes too much of a penalty and/or that applies for too long a time. The point here is that most of the time the consumer benefits and the provision is not abusive. Sometimes, however, this otherwise wholly legitimate provision can be applied in an abusive manner. Again, the challenge for all of us is to find ways to prevent the abusive application of such provisions without denying the consumer the benefit of the provision, which applies in most cases. With regard to prepayment provisions, this benefit can be easily accomplished (for example, requiring that the borrower be given an option of a product with and without the fee and limiting the fee amount and the time it is applicable).
- Arbitration Clauses—Some parties contend that loan terms that require disputes between the lender and borrower to be arbitrated are inherently oppressive and abusive. We strongly disagree with such a general characterization of arbitration clauses. Yes, it is certainly possible to structure a clause so that it is unfair. For example, if a national lender operating in California required that the arbitration always be conducted at the lender's headquarters in New York, we think this is obviously unfair (and a court would probably not enforce such a loan clause). On the other hand, appropriately structured arbitration generally is recognized by courts as an acceptable, fair alternative dispute resolution procedure that frequently can benefit all parties. Arbitration allows disputes to be resolved much more quickly and with less expense than litigation. Arbitration clauses that meet certain safeguards, such as restricting venue to where the property is located and compliance with the rules set forth by a nationally recognized arbitration organization, should not be deemed inherently abusive.

In addition to preserving such loan terms that are legitimate, NHEMA wishes to emphasize that attacks on certain lending practices are unjustified. In particular, some consumer advocates criticize the financing of points and fees by subprime

[3] Governor Gramlich, in a speech to the Fair Housing Council of New York, aptly pointed out how wholly legitimate terms and practices can be misused: ". . . The harder analytical issue involves abuses of practices that do improve credit market efficiency most of the time. . . . Mortgage provisions that are generally desirable, but complicated, are abused. For these generally desirable provisions to work properly, both lenders and borrowers must fully understand them. Presumably lenders do, but often borrowers do not. As a consequence, provisions that work well most of the time end up being abused and hurting vulnerable people enormously some of the time."

lenders. We strongly believe that their criticisms are not valid. Most subprime borrowers do not have extra cash readily available to pay closing costs, so they voluntarily elect to finance them in connection with the loan. Prime borrowers often do the same thing. Subprime borrowers should not be discriminated against and should be allowed to continue to finance such costs. Why should they be forced to borrow money from other sources, typically at higher, unsecured rates, to pay such necessary costs? In many cases, it could prove very difficult, if not impossible, to obtain the funds needed to pay such costs.

Legislators and regulatory officials have a difficult task in balancing the competing and often conflicting considerations that arise in this area. While wanting abuses stopped, NHEMA cannot overemphasize the importance of moving very carefully and deliberately in addressing the abuses because there is a great danger that new restrictions would limit terms or practices that are generally helpful and desirable for most consumers.

NHEMA believes that this Committee can make a tremendous contribution by demonstrating how thoughtful legislators can sort through the complexities involved and develop truly workable provisions to the extent that additional legislation is needed as part of the overall solution.

How Best Can Abusive Lending Problems Be Addressed?

Although NHEMA does not believe that abusive or predatory practices are pervasive in the subprime mortgage sector, and we know that some alleged problems are not necessarily real abuses, we recognize that there are legitimate areas of concern. For example, "loan flipping," which involves repeated refinancing of a mortgage in a relatively brief period of time with little or no real economic benefit to the borrower, does occur to some degree, and it should be stopped. Likewise, far too many borrowers are victims of home improvement lending scams. Others are required to pay excessive loan origination fees to mortgage brokers or loan officers. Industry, regulators and legislators must work together to find effective ways to stop such abuses. In doing so, however, we must be very careful not to overreact and adopt inappropriate restrictions that raise the cost of subprime mortgage credit, or curtail credit availability to those who need it.

As mentioned earlier in our testimony, NHEMA believes that a multitrack strategy must be taken to deal with these questions:

(1) Greater Enforcement of Existing Laws and Regulations—A substantial portion of predatory lending abuses involve fraud and deception that are clearly already illegal. In many cases it also appears that some unscrupulous mortgage brokers and lenders are disregarding current laws such as the Real Estate Settlement Procedures Act (RESPA), the Home Ownership Equity Protection Act (HOEPA), the Equal Credit Opportunity Act (ECOA), and the Federal Trade Commission Act, which prohibits unfair and deceptive practices. First, and foremost, we feel that these laws, and related regulations, need to be enforced more vigorously. Many abuses could be handled quite effectively by better enforcement. The FTC has already brought a number of enforcement actions involving most of the recognized predatory lending practices under the existing HOEPA and the FTC Act, and has obtained a handful of settlements. Obviously, the FTC already has broad authority in this area. We hope that the FTC will do much more to enforce these current laws to curtail abuses. In addition, the Federal Reserve Board (FRB) is now in the process of issuing enhanced HOEPA regulations. NHEMA has provided information and comments to these and other regulatory bodies and will continue to work with regulators to help control abuses. NHEMA urges this Committee and the Congress generally to support making whatever additional appropriations are reasonably necessary to help Federal agencies enforce the current laws and regulations more effectively. In addition, we encourage the agencies to request additional funds if they need them. It also is very important to remember that States have various laws and regulations that apply to many of the questionable practices. State regulatory officials and State legislators need to consider how existing State laws and regulations can be better enforced to prevent abusive lending practices.

(2) Consumer Education—Helping Consumers to "BorrowSmart"—Obviously, a key element of the problem is that some borrowers, especially lower-income, less-educated people, do not understand their mortgage loan terms. NHEMA's number one priority is supporting the consumer's right of free and fair access to affordably priced credit. That priority is served by NHEMA's support of consumer education initiatives. Educated consumers are good borrowers. They know how to avoid unethical and abusive lending practices. They know how to get the loan terms that work best for them. And they know how to manage their money wisely and avoid running up new debt after taking out a home equity

loan. To educate consumers, NHEMA created and supports the BorrowSmart Public Education Foundation,[4] a separate organization, which is undertaking a number of education initiatives:

BorrowSmart.org. This website will show consumers how the home equity lending process works, offer tips for avoiding abusive practices, provide borrowers with resources they can turn to if they think they have been a victim of fraud of misrepresentation, educate borrowers about their rights and responsibilities and offer other valuable information.

Consumer Education Materials and Cooperation with Consumer Groups—NHEMA has produced consumer brochures for distribution by our member institutions to inform and educate borrowers about the loan process, and the importance of smart money management. We have distributed CD-ROM's with consumer education materials to all our members so they can easily reproduce and distribute them to their customers. NHEMA also has worked to build education partnerships with consumer groups. For example, we have published a joint brochure with the Consumer Federation of America about the importance of keeping credit card debt in check after taking out a home equity loan to consolidate debt. The BorrowSmart Foundation is now taking over producing such educational materials and in working cooperatively with consumer groups.

In addition, NHEMA conferences, seminars, and publications encourage association members to keep borrowers educated and informed. Our goal is to keep home equity loans available as a financial resource for all homeowners, while ensuring that every borrower understands how to use that resource wisely and effectively.

(3) Voluntary Actions—NHEMA has recognized that there is much that industry can do voluntarily to help raise industry standards and ensure that subprime mortgage lenders follow proper practices. We have taken a proactive posture in this area. In 1998, NHEMA adopted a new, enhanced Code of Ethics to which our members subscribe. We also have adopted new Home Improvement Lending Guidelines (1998) and Credit Reporting Guidelines (2000). Last year, we adopted a particularly significant measure—new comprehensive Fair Lending and Best Practices Guidelines. These guidelines were the product of months of study and analysis, and reflect input from a broad cross-section of our membership. We believe that these guidelines will be very helpful in improving overall industry lending standards and practices. The guidelines provide a useful baseline of what generally should be considered to be appropriate lending practices and procedures.[5]

(4) Comprehensive Legislative & Regulatory Reforms—NHEMA was an active participant in the so-called Mortgage Reform Working Group (MRWG), which began in the spring of 1997 and continued to 1999. This group came together at the urging of key Congressional leaders who wanted industry and consumer groups to try to reach consensus on how the mortgage lending process might be reformed. Participants spent literally thousands of hours considering how mortgage lending might be improved. MRWG participants included basically all relevant national trade organizations and many consumer groups. Representatives from HUD, the FTC, and FRB participated in many of the sessions. Most MRWG participants agreed that there were various problems with the present statutory and regulatory structure as it applies to both prime and subprime mortgage lending. One of the biggest problems identified was that current laws and regulations are overly complex and often very confusing for both borrowers and lenders. This makes it very difficult for many consumers to understand what is occurring and to make proper shopping comparisons. It also poses a host of compliance burdens and uncertainties for lenders and mortgage brokers. A number of the participants, including NHEMA, put forth various reform concepts for discussion by the group, but no consensus was reached, and the process essentially ended without any resolution of the issues. Part of the reason that legislative reforms could not be agreed upon was, and is, that these are complex and difficult issues. For example, as noted earlier in my testimony, many of the loan terms that some parties object to are not necessarily abusive, and it is difficult to craft restrictions that do not do more harm than good. In any case, NHEMA believes that comprehensive reforms of current RESPA and

[4] Additional information concerning our BorrowSmart program and educational materials is contained in Appendix A. Held in Senate Banking Committee files.

[5] Appendix B to this testimony contains a copy of NHEMA's Code of Ethics and our various industry Guidelines. Held in Senate Banking Committee files.

TILA mortgage lending provisions should be seriously considered by Congress, and especially by this Committee. We are certain that changes can be made to encourage more informed comparison-shopping for home equity loans. Moreover, we believe that Federal regulators can use their existing authorities to make significant improvements. In addition to the FRB's ongoing work regarding additional HOEPA regulations, we want to point out that HUD has authority to simplify and clarify many relevant policies and regulatory provisions. We urge this Committee to encourage HUD officials to utilize such authority, particularly as it relates to reducing some of RESPA's burdensome and confusing provisions.

(5) Carefully Crafted Legislation Targeted At Specific Abuses—NHEMA originally proposed new legislative safeguards to protect against particular abuses, such as loan flipping, as a part of its 1997 comprehensive legislative reform proposals.[6] We subsequently recognized that it might be easier to address many of these concerns in a narrower bill focused on particular practices.[7] NHEMA has long said that new legislative safeguards appear to be merited in some cases. On the other hand, we have long voiced serious concern that many of the proposals put forward by legislators have been overly broad and would prohibit or unduly restrict perfectly legitimate lending practices while attempting to limit perceived abuses. The old saying that "the devil is in the details" is perhaps no place so appropriate as in the context of legislation intended to protect against predatory mortgage lending practices. We implore this Committee to be certain that any legislative proposals you may ultimately put forth have been carefully vetted to ensure that they are clear and do not have the unintended effect of curtailing legitimate lending practices instead of being targeted to stop only the abusive ones.

Ten Key Issues for the Committee's Consideration

Given our ongoing efforts to stop abusive lending practices and our knowledge of the subprime marketplace, we believe it is helpful to highlight 10 key questions and considerations that Congress may wish to explore as you grapple with predatory lending concerns:

(1) What loans should be made subject to special protections? The present regulatory approach contained in the so-called HOEPA provisions of the Truth In Lending Act, essentially targets only the most costly loans made to higher risk borrowers. Under HOEPA, loans that have a rate that is more than 10 percent over a comparable Treasury bill rate, or that have certain loan fees and closing costs that exceed 8 percent of the loan amount or a minimum dollar amount, are subject to special protections. These enhanced safeguards include special disclosures and some specific substantive restrictions (for example, no balloons less than 5 years in duration). Typically, most legislative proposals to address predatory lending, including that put forth earlier by Chairman Sarbanes, have proposed lowering the levels of both the rate and the point/fee triggers. In addition, proposals generally would change the definition of what items must be included in calculating the point/fee trigger amount. The effect of this computational change is to cause a dramatic increase in the number of loans that hit this second trigger level. NHEMA recognizes that Congress might conclude that some modest trigger reductions may be appropriate. However, we see no justification for sweeping in essentially all subprime loans (and many prime ones) as is frequently suggested in legislative proposals. Many lenders will not make HOEPA loans, which unfortunately have developed a very negative stigma, due to the very real reputational and legal risks involved. We fear that any significant expansion HOEPA's coverage will result in many lenders withdrawing from offering covered products and this will have a very negative impact on credit costs and availability. Moreover, we believe that abuses tend to be concentrated primarily in the highest risk grades which is where legislation should be targeted.

(2) How might "loan flipping" be prevented? Without question, "loan flipping," which involves the frequent refinancing of a mortgage loan with the borrower receiving no meaningful benefit and typically having to pay significant refinancing fees, is one area where abuse does exist and where existing laws do not appear adequate to prevent it. Various approaches have been proposed to

[6] NHEMA's 1997 comprehensive outline of proposed legislative reforms is attached as Appendix C. Held in Senate Banking Committee files.

[7] NHEMA's staff developed and widely circulated a working draft of a possible model targeted legislative proposal in 1999, a copy of which is attached as Appendix D. Held in Senate Banking Committee files.

remedy this problem. Most suggestions have tended to apply special safeguards when a loan is refinanced within 12 months or some other relatively brief time period. The suggested restrictions include, for example: prohibiting or limiting the amount of sales commissions (points) that can be charged; requiring that the borrower receive a benefit from the refinancing; or allowing points to be charged only to the extent they reflect new money actually advanced to the borrower. NHEMA feels that when considering this issue, legislators need to recognize that many borrowers' views of what constitutes a benefit to them differs from what some of the industry's critics believe. Thus, most borrowers who obtain a loan for debt consolidation purposes consider it to be a very real and often critically important benefit to be able to lower their monthly payment even if they will have to pay more money over a longer period of time. Another important point to note is that some of the tests that have been proposed (that is, requiring a "net tangible benefit") are hopelessly vague and certain to foster costly litigation. Legislators therefore need to develop simple, clear tests in any new provisions.

(3) How should a provision be crafted to ensure a borrower's repayment ability is properly considered before a loan is made? Lenders normally carefully review a borrower's credit record and economic situation to ensure that the borrower can repay the loan. In some instances, however, lenders may make the loan more on the basis of the value of the collateral property than on the borrower's ability to repay without reference to the underlying asset. Such asset based lending can lead to loan flipping and may eventually end in the borrower's losing his or her home in foreclosure. HOEPA currently contains a provision that prohibits lenders from engaging in a pattern and practice of lending without proper regard for repayment ability. If the Committee revises present law by removing the pattern and practice requirement, we urge that it do so in a simple and straightforward manner. Traditionally, many lenders have employed a 55 percent debt to income test, but if any such test is embodied in statute, it is important to make it clear that no presumption of a violation arises merely because such a test is not met. We also do not believe that it is necessary to try to employ some complex formula regarding residual income as some have suggested.

(4) How should single-premium credit insurance be treated? Some lenders have offered customers various credit insurance products that are sold on a single-premium basis where the cost is typically assessed at the time of loan closing and this cost is financed along with other closing costs. While those who sell such credit insurance generally have defended it as a valuable, fairly priced product, many consumer advocates strongly attack such single-premium products. Recently several major lenders have announced that they are ceasing to offer such single pay products. Some have suggested that the continued sale of single-premium insurance should be allowed, provided certain safeguards are met such as: requiring that the borrower be offered a choice of a monthly pay policy instead of a single pay product; requiring additional special disclosure notices relating to the product; and giving the borrower a right to cancel with a full refund for some period of time and thereafter the right to cancel with a refund based on an actuarial accounting method. Many companies believe that if additional restrictions are adopted they should, at a minimum, allow for the sale on credit insurance on a monthly pay basis.

(5) How might safeguards be crafted to ensure certain legitimate loan terms are not misused? Many predatory lending proposals would prohibit or severely restrict certain loan terms. Some of these terms, such as prepayment penalties, are not necessarily unfair or inappropriate. Quite to the contrary, some such terms are most often beneficial to the borrower. Therefore, it is critically important that any new limitations on loan terms be drafted so that legitimate uses of the terms are not prohibited. For example, prepayment penalties can be structured so that the borrower must be given a choice of a loan product with and without a penalty, and the amount of the penalty and the length of time it can apply also can be limited. By applying such balanced and carefully drafted provisions, the consumer can generally gain the significant benefit of lower rates by accepting a penalty provision, while the lender can be protected against loss of expected revenue on which the loan pricing is based. Certain other terms, like balloon payments, could be addressed with similar carefully crafted safeguards. Balloon mortgage payments usually are very helpful for consumers who need lower initial monthly payments for a period of time and who reasonably expect to have higher income to meet higher obligations later. A balloon provision allows many first-time homebuyers to acquire their home. There is nothing inherently wrong with using a balloon payment. On the other hand,

an abusive mortgage originator can structure a mortgage with a balloon payment that some consumers can never expect to be able to meet. This could force the borrower to refinance one or more times, having the equity stripped out of his or her home, and ultimately being forced to sell the home, or face foreclosure. By contrast, still others, such as call provisions or accelerating interest upon default, might be appropriately prohibited outright.

(6) Should restrictions be imposed on subprime borrowers' rights to finance loan closing costs? Mortgage loan closing costs are usually substantial, amounting to several thousand dollars, and many borrowers, especially those in the subprime segment, do not have extra cash readily available to pay such costs. Borrowers therefore generally finance the closing costs and the amount of such costs are rolled into the loan and paid off over an extended period of time. Some parties who have sought to curtail subprime lending have proposed denying consumers' the right to finance their closing costs. NHEMA strongly objects to this unwarranted restriction. Subprime borrowers would be seriously harmed by such discriminatory treatment. Borrowers would have to obtain money to pay closing costs by borrowing from more expensive unsecured sources, or in some cases could not obtain the funds needed to close the loan.

(7) Are more special disclosures needed? Some have suggested adding to the disclosures that currently apply to HOEPA loans. NHEMA basically has no objection to enhancing some present disclosures. However, we do have concerns about continuing to flood the consumer with confusing, lengthy notices that most parties do not read, and would not understand if they did. Again, care must be taken in crafting any further notices (for example, special foreclosure warnings) to ensure that they are clear, simple, and actually helpful to borrowers.

(8) Can home improvement lending scams be prevented? It is well recognized that a great amount of the abuse in the subprime marketplace comes from home improvement lending scams. Vulnerable borrowers are suckered into loan transactions relating to home repairs and other improvements that are never made, or if made are not completed properly. HOEPA requires that home improvement loan disbursements must be made by checks that are payable to both the borrower and the contractor, or at the borrower's option to a third party escrow agent. NHEMA has also issued voluntary guidelines in this area. We urge the Committee to investigate whether there may be other viable restrictions that should be applied to prevent abuses in the home improvement area.

(9) Should customers be forced to submit to mandatory credit counseling? Some parties argue that all subprime customers should be required to submit to counseling sessions with a professional credit counselor. Although NHEMA strongly supports making counselors available to all customers and encouraging borrowers voluntarily to consider meeting both with a counselor, we do not support mandatory counseling in the case of all subprime loans. Mandatory counseling clearly is not necessary for most customers, and many would find it offensive to have to submit to counseling. Moreover, in many areas there is a serious shortage of qualified counselors, so such a requirement would unduly delay the loan process.

(10) What must be done to achieve more uniform nationwide rules against abusive practices?[8] Last, but certainly not least, is the issue of Federal preemption. For most of NHEMA's members, the single biggest concern over predatory lending legislation arises because of the dozens of differing proposals that are constantly being put forth at the State and local levels. This year, we already have differing bills in thirty-odd jurisdictions. We believe that it is critical that Congress recognize that in today's nationwide credit markets, a uniform Federal standard is needed for addressing predatory lending concerns. Compliance with scores of differing State and local rules in this area is impractical and unduly

[8] Although this list is limited as a matter of priority and convenience to 10 items, certain other issues merit the Committee's consideration. For example, industry today typically already reports mortgage payment history data to credit bureaus. NHEMA thus supports requiring lenders to provide such data periodically to the major national consumer reporting agencies. We also have no problem with providing for a modest increase in penalties for violations of an amended HOEPA, but believe provisions should be added to allow lenders to correct unintentional errors. Another concern that the Committee might consider is the question of liability of secondary market participants. It is extremely difficult, and usually practically impossible, for secondary market participants to know if an abuse has occurred unless it happens to be evident on the face of the loan documents, which is rarely the case. An additional issue relates to the degree to which brokers' roles and compensation should be disclosed, and whether better licensing requirements are needed.

burdensome. Federal preemption of differing State and local predatory lending measures is badly needed.

Mr. Chairman, these are difficult and complex issues. NHEMA trusts that this Committee and your House counterpart will give them very careful consideration, and we want to continue working in good faith with you to explore further how to stop abusive lending and related concerns. During this process, we encourage everyone to remember that the democratization of the credit markets that subprime mortgage lenders have helped achieve would be seriously undercut by most of the pending legislative proposals which are well-intended, but which have serious, unintended adverse consequences for needy borrowers. Ultimately, we hope that agreement can be reached on a package of reforms that will include workable provisions targeted to prevent particular abuses, together with some simplification and streamlining of current disclosure requirements and preemption of conflicting State and local laws.

Thank you for this opportunity to present NHEMA's views.

PREDATORY MORTGAGE LENDING: THE PROBLEM, IMPACT, AND RESPONSES

FRIDAY, JULY 27, 2001

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:08 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Paul S. Sarbanes (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN PAUL S. SARBANES

Chairman SARBANES. The Committee will come to order.

Today is the Senate Banking, Housing, and Urban Affairs Committee's second day of hearings on predatory lending—the problem, impact and responses.

Yesterday, we heard some very eloquent statements of the problem from four Americans who worked all their lives to attain the dream of homeownership, to build up a little wealth, only to have it slowly, piece by piece, loan by loan, taken away from them. These people were targeted by unscrupulous lenders, often elderly homeowners who have a lot of equity in their homes.

In the case of one lady from West Virginia, Ms. Podelco, she actually took the proceeds of the insurance policy on her husband's life, $19,000, and paid off the mortgage on her home. She had the home free and clear, in a way a prudent thing to do, although I guess a lot of smart financial people would have said, no, you should have kept the mortgage and invested the money.

But that is, I believe, a standard way of thinking for lower income people. They get their home, it is free and clear, it is theirs. There is nothing owed on it, and then they started approaching her and soliciting her. She had some debts and she wanted to do some improvements on the home. She took out a loan. Then they came along, they refinanced that loan, and then they refinanced that loan. And every time they did it, they packed in the fees and the charges and everything. Her loan obligation rose and, in the end, in just a few years, she lost her home. That is what we are trying to get at. She was refinanced six times in about a 2 years period.

What struck me about these four stories were that many of the practices that harmed the witnesses are legal under existing law. There have also been abuses that are not legal and, of course, I strongly support action by regulators to use their authority under existing law to expand protections against predatory lending. I support stronger enforcement of current protections by the Federal

Trade Commission and others. I applaud campaigns to increase financial literacy.

I want to particularly acknowledge Senator Corzine's leadership in this effort. Chairman Greenspan actually gave a speech just on this issue, and I am hopeful that we will be able to help to put together with the industry, and with the regulators, and with people sitting at this table and others, a good program of financial literacy. I do not think that this alone is the solution to this problem.

I also encourage and welcome industry's effort to establish best practices. There have been a number of important developments in that regard, and we certainly encourage others to follow along.

I think those who take the position that stronger regulatory and/or more aggressive enforcement of existing laws will be adequate, have a special burden to carry, particularly in light of yesterday's testimony, to make sure that regulatory and enforcement tools are adequate to the job.

At a minimum, at the very beginning, I think they should be supporting the Federal Reserve Board's proposed regulation on HOEPA, as Ameriquest, who was here yesterday, has done, and now as some other financial institutions have undertaken to do. We need to support the Fed's effort to gather additional information through an expanded HMDA, and the regulatory enforcement and enforcement agencies, such as the FTC, the Treasury, and HUD, in their recommendations for more effective enforcement.

But, as I said, I do not think stronger enforcement, literacy campaigns, best practices alone are enough. Too many of the practices that we heard about in yesterday's testimony, while extremely harmful and abusive, are legal. And while we must pursue aggressively financial education, we need to recognize that takes time to be effective, and thousands of people are being hurt every day.

I would like to quote what Fed Governor Roger Ferguson said in his confirmation hearing, "Legislation, careful regulation, and education are all components of the response to these emerging consumer concerns." I subscribe to that view.

Before turning to my colleagues who have joined us for their opening statements, and to the witnesses, I just want to take a moment to explain the arrangements here this morning. First of all, we had far more requests to testify than we really could accommodate. A number of groups and organizations and companies asked to come in—the Center for Community Change, the Neighborhood Assistance Corporation of America, the National People's Action, Neighborhood Housing Services, the National Neighborhood Housing Network, the Greenlining Institute, America's Community Bankers, Assurant Credit Insurance Company, Consumer Bankers Association, Consumer Credit Insurance Association, the Realtors, and so forth.

We obviously could not accommodate everyone. I believe that is apparent by the current crowded witness table. We have offered to include statements from all of these groups who wish to submit them in the record, as well as other organizations. As we continue to explore and examine this issue, we may have other opportunities for people to come in and actually appear and to testify. I want to explain to our witnesses, we had considered doing two panels. But it is a Friday. Members have a lot of pressure on them at the end

of the week, including the necessity to get back to their States. We decided that we would just put everyone at the table at the same time. We have tried to mix you up a bit so you get to know people maybe you have not met before.

[Laughter.]

We will encourage some dialogue at the table as a consequence.

You have submitted very thoughtful statements. We appreciate that. The full statements will be included in the record. If each person could take about 5 minutes to summarize and make their major points, we will go through the panel and then we will have a question period. Often what happens, there are a fair number of people around for the first panel. And by the time you get to the second panel, a lot of people have left.

If we do it this way, I hope it will work out. I know it is somewhat crowded at the witness table and I apologize to you for that, but I believe this will work out.

With that, I am going to yield to Senator Miller for any opening statement he may have.

COMMENT OF SENATOR ZELL MILLER

Senator MILLER. I do not have an opening statement, Mr. Chairman but, again, I thank you for holding these hearings and again, welcome to these witnesses.

We look forward to your testimony.

Chairman SARBANES. Thank you. Senator Stabenow.

COMMENTS OF SENATOR DEBBIE STABENOW

Senator STABENOW. Well, thank you, Mr. Chairman. And again, thank you for holding this important hearing. I think yesterday was a very important and moving opportunity to hear from witnesses directly about their experiences.

I will submit a full statement for the record. I just want to welcome all of the panelists. I see a lot of familiar faces. I want to particularly recognize Tess Canja, who hails from my hometown in Lansing, Michigan. Before she was the esteemed head of the AARP, we actually started together—I will not say the date—in working on issues related to seniors and an effort to save a nursing home in Lansing, Michigan, which got me into politics.

We now both find ourselves here in Washington focusing again on seniors and important issues. So welcome, Tess. And to all of the esteemed panelists, I look forward to hearing from all of you about what I think is an incredibly important topic, and I hope that we will have the opportunity to move in a way that makes sense to really address these issues.

Chairman SARBANES. Well, we will consider giving Ms. Canja a couple of extra minutes so that she can tell us about Senator Stabenow in her earlier years, yes.

[Laughter.]

Senator STABENOW. That is all right, Mr. Chairman.

[Laughter.]

Senator CORZINE. You ought to put her under oath on that.

[Laughter.]

Chairman SARBANES. Senator Corzine.

STATEMENT OF SENATOR JON S. CORZINE

Senator CORZINE. Senator Sarbanes, Mr. Chairman, you know how strongly I feel about this issue. The literacy initiatives are one step, and enforcement certainly is. And as you talked about, some element of legislative action I think is necessary.

The stories we heard yesterday, which we must acknowledge are anecdotal, I think are indicative of a serious market problem that we have. And it is something that I hope we can try to cut down to the key elements so that we can be as precise as possible.

It is a difficult issue to define, but it is clearly a problem. And I thank all of the witnesses here. We should have sold admission and we would have had all of our budget taken care of for years. [Laughter.]

Thank you all very much for being here.

Chairman SARBANES. I will introduce the panelists one by one as we turn to you to speak, instead of taking the time to introduce everyone right at the outset.

Our first panelist will be Wade Henderson, who is the Executive Director of the Leadership Conference on Civil Rights, the Nation's oldest, largest, and most diverse coalition of organizations committed to the protection of civil rights in the United States.

The Leadership Conference on Civil Rights has played an active role in increasing awareness of predatory lending practices and its impact on the civil rights community.

We have interacted with Mr. Henderson on many issues that are on the agenda of this Committee and we always appreciate his very positive and constructive contributions.

Wade, we would be happy to hear from you.

STATEMENT OF WADE HENDERSON
EXECUTIVE DIRECTOR, LEADERSHIP CONFERENCE ON CIVIL RIGHTS

Mr. HENDERSON. Well, thank you, Mr. Chairman, and good morning to the Members of the Committee. I am pleased to appear before you today on behalf of the Leadership Conference to discuss this very pressing issue of predatory mortgage lending in America.

Some may wonder why the issue of predatory lending raises civil rights issues. But I think the answer is quite clear. Shelter, of course, is a basic human need—and homeownership is a basic key to financial viability. While more Americans own their homes today than at any time in our history, minorities and others who historically have been underserved by the lending industry still suffer from a significant homeownership gap.

Unequal homeownership rates cause disparities in wealth, since renters have significantly less wealth than homeowners at the same income level. To address wealth disparities in the United States and to make opportunities more widespread, it is clear that homeownership rates of minority and low income families must rise. Increasing homeownership opportunities for these populations is, therefore, central to the civil rights agenda of this country.

Increasingly, however, hard-earned wealth accumulated through owning a home is at significant risk for many Americans. The past several years have witnessed a dramatic rise in harmful home equity lending practices that stripped equity from families homes

and wealth from their communities. These predatory lending practices include a broad range of strategies that can target and disproportionately affect vulnerable populations, particularly minority and low income borrowers, female single-headed households, and the elderly. These practices too often lead minority families to foreclosure and leave minority neighborhoods in ruin.

Today, predatory lending is one of the greatest threats to families working to achieve financial security. These tactics call for an immediate response to weed out those who engage in or facilitate predatory practices, while allowing legitimate, responsible lenders to continue to provide necessary credit.

As the Committee is aware, however, subprime lending is not synonymous with predatory lending. And I would ask each of you to remain mindful of the need for legitimate subprime lending in the market.

Some have suggested, for example, that subprime lending is unnecessary. They contend that if an individual does not have good credit, then the individual should not borrow more money. But as we all know, life is never that simple. Even hard working, good people can have impaired credit, and even individuals with impaired credit have financial needs. They should not be doomed to a financial caste system, one that both stigmatizes and permanently defines their financial status as less than ideal.

Until a decade ago, consumers with blemishes on their credit record faced little hope of finding a new mortgage or refinancing an existing one at a reasonable rate. And therefore, without legitimate subprime loans, those experiencing temporary financial difficulties could lose their homes and even sink further into red ink or even bankruptcy.

Moreover, too many communities continue to be left behind despite the record economic boom. Many communities were redlined when the Nation's leading financial institutions either ignored or abandoned inner city and rural neighborhoods. And regrettably, as I mentioned earlier, predators began filling that void—the payday loan sharks, the check-cashing outlets, and the infamous finance companies.

Clearly, there is a need for better access to credit at reasonable rates and legitimate subprime lending serves this market. I feel strongly that legitimate subprime lending must continue, and therefore, we hope that we will not go back to the days when inner city residents had to flee from finance companies and others who preyed on them.

At the outset, I want to recognize that many persons and organizations have really helped to advance this debate. Yesterday, you heard from Martin Eakes of Self-Help, who is one of the leaders in this effort. Maude Hurd, the President of ACORN and her colleagues, have done a tremendous job. The Nation Community Reinvestment Coalition and others have helped to promote the idea of best practices and encourage the industry to sit at the table. But in truth, they need help. It is simply not enough.

Recent investigations by Federal and State regulatory enforcement agencies, as you stated, Mr. Chairman, document that lending abuses are both widespread and increasing in number. You mentioned the Federal Trade Commission and the good work they

have done. We should also acknowledge the States attorneys general who have taken out after these practices and tried to address them in a significant way, and we encourage the regulators to do more than they have done.

You have talked about the important work of the Fed. You talked about the need for additional data under HMDA. All of those things are necessary. But even if we got all of that, they would still be insufficient.

Over 30 State and local efforts are currently pending and as many as a dozen or more have recently been enacted to address these problems. In my testimony, I list nine States and local jurisdictions that have addressed these issues and I lay out the kinds of steps that they have taken which I think are significant, but, again, inadequate.

Notwithstanding that States have tried to fill the void, we believe that more is needed and that the truth is State legislation under the current scheme is primarily inadequate.

First, State legislation may not be sufficiently comprehensive to reach the full range of objectionable practices. And you mentioned that some of them are still legal on the books today.

For example, while some State and local initiatives impose restrictions on single-premium credit life insurance, others do not. This, of course, leaves gaps in protection even for citizens in some States that have enacted legislation.

Second, while measures have been enacted in some States, the majority of States have not enacted predatory lending legislation. And for this reason, the Leadership Conference supports the enactment of comprehensive Federal legislation, of the sort, Mr. Chairman, that you have introduced here in the Senate.

The Predatory Lending Consumer Protection Act is the standard that we think is necessary. We strongly support it and we urge its swift enactment. Now one last point.

We have made efforts to address these issues on a voluntary basis. We know that the industry is deeply concerned about the problems of predatory lending and they want to disassociate themselves from practices that would mark them as predatory.

So for those good lenders, we have made efforts to work with them voluntarily and believing that there may have been an opportunity for voluntary responses to these issues, several national leaders within the prime and subprime lending industry, also with the secondary market, join civil rights and housing and community advocates and attempted under the auspices of the Leadership Conference to synthesize a common set of best practices and self-policies guidelines.

We achieved a lot of consensus on many issues. However, the truth is, in the end, we failed to get consensus on some of the most difficult issues which are now being discussed and being addressed today, like credit life insurance.

And one of the reasons that we failed to get that consensus is because many in the industry believe they could be insulated politically from any mandatory compliance with Federal legislation.

They were not fearful that the Congress would enact a bill of a comprehensive nature and therefore, they were unwilling to grapple with their own practices, even though they knew they were

questionable and created hardship on many communities. As a result, our view is that only Federal legislation will be sufficient.

I am going to end my testimony where I began—why subprime lending? Why is its evil twin, predatory lending, a civil rights issue? The answer can be found in America's ongoing search for equal opportunity. After many years of difficult and sometimes bloody struggle, our Nation and the first generation of America's civil rights movement ended segregation. But our work is far from over. Today's struggle involves equal opportunity for all and making that a reality. Predatory lending is a cancer on the financial health of our communities and it must be stopped.

Thank you, Mr. Chairman.

Chairman SARBANES. Thank you very much. You made reference to the State attorneys general and I should just note that we had Tom Miller, the Attorney General for the State of Iowa, here with us yesterday. He heads up the attorney general's special task force on predatory lending and gave some very strong testimony.

Two-thirds of the States' attorneys general have interceded with the Federal Reserve in support of the regulation which the Federal Reserve now has under consideration with respect to this issue.

Next, we will hear from Ms. Judy Kennedy, the President of the National Association of Affordable Housing Lenders.

I ought to note that over the past 11 years, the NAAHL has worked quite successfully to infuse private capital investment into low- and moderate-income communities by pioneering a number of innovative community investment practices.

Ms. Kennedy, we are pleased to have you here.

STATEMENT OF JUDITH A. KENNEDY
PRESIDENT, NATIONAL ASSOCIATION OF AFFORDABLE HOUSING LENDERS

Ms. KENNEDY. Thank you, Senator. I am delighted to be here.

As you pointed out, NAAHL's members are a cross-section of the pioneers of community investment—banks, loan consortia, financial intermediaries, pension funds, foundations, local and national nonprofit providers, public agencies, and allied professionals.

In 1999, we held a conference in Chicago where Gail Cincada and others informed us about predators' activities in that city. We came to the conclusion then that if NAAHL is not part of the solution to predatory lending, we will be part of the problem. It is clear that while we are committed to increasing the flow of capital into underserved communities, we must be equally concerned about access to capital on appropriate terms.

So in March of this year, we sponsored a symposium that brought together experts on this issue—regulators, researchers, advocates, for-profit and nonprofit lenders, and secondary market participants. We are issuing today that report and I hope you have it before you—*Juntos Podemos, Together We Can.*

Our goal was to accelerate progress in stopping the victimization. As the Mayor of Chicago succinctly puts it, "It is all down the drain if we cannot stabilize the communities that were stable until these foreclosures started to happen."

Our findings are as follows, first, you can profile predatory lending. It is clear.

Second, more needs to be done at the Federal level. More, of course, is being done this year, in part, thanks to your attention, Senator Sarbanes. But as Elizabeth McCaul, the New York State Banking Commissioner, and you have emphasized, it is critical to balance the need for credit with the need to end abuses. NAAHL members have a history of tailoring credit to the unique needs of low income households in underserved communities. But as the Federal Reserve has pointed out, a significant amount of mortgage lending is not covered by a Federal framework. For example, Governor Gramlich reported that only about 30 percent of all subprime loans are made by depository institutions that have periodic exams. Some estimate that as low as 15 percent of originators of subprime loans have any reporting and examination. Even if the Fed were to do periodic compliance exams of the subsidiaries of financial holding companies, that would only increase the number to, at best, 40 percent.

It is not surprising, then, that of the 21 completed Federal Trade Commission investigations into fair lending and consumer compliance violations, none were Federally examined. If the Fed's recent proposal to expand reporting under the Home Mortgage Disclosure Act to more lenders is adopted, it will still encompass only those whose mortgage lending exceeds $50 million per year. Many of the other proposed changes to HMDA that the Fed proposes which we supported will simply make the playing field even less level by putting additional burdens and costs on the responsible lenders while the worst lenders go unexamined.

To stop the predators, the symposium confirmed, we need to close the bar doors on examination and reporting of mortgages in America. A level playing field in enforcement and reporting is key. Right now, the institutions that you talk about that have best practices in the subprime lending market do extensive due diligence of their brokers to ensure fair lending practices. They maintain data on those loans. They are rigorously examined by the bank regulatory agencies. But the majority of lenders in this market are not subject to regulatory oversight, do not have the same level of compliance management, and often do not even file HMDA reports. In a town with no sheriff, the bandits are in charge. Unscrupulous brokers who are rejected by legitimate lenders simply go to others who have no knowledge of the loan terms or reputation or compliance concerns about funding predatory loans.

Third, our symposium also confirmed that subprime lending is an important source of home finance, and I think we agree on that.

Fourth, we heard that vigorous enforcement at all levels of Government works. We heard from people actively involved in combatting predatory lending on the State and local level and we think all of this will help to eradicate predatory lending.

Fifth, consumer education is key. We know that many initiatives in the last year, some as a result of your attention and some that preceded that, are making a difference. But increased Federal resources for targeted counseling in neighborhoods vulnerable to predators could greatly extend the efforts of the private sector. As Martin Eakes points out, ". . . the Department of Education says that 24 percent of adult Americans are illiterate." But targeted counseling could go a long way.

Overall, our symposium confirmed once again that it is a complex issue requiring a multifaceted solution. But as our closing speaker, HUD Secretary Martinez, pointed out—juntos podemos—together, we can.

As president of an organization whose members have spent their careers trying to increase the flow of private capital into underserved communities, I say, together we must.

Chairman SARBANES. Thank you very much. I simply want to note, I thought the symposium that you held out of which this report emanated was a very important contribution toward a deepening understanding of this issue.

Ms. KENNEDY. Thank you, Mr. Chairman.

Chairman SARBANES. I will now turn to Tess Canja, who is President of the Board of Directors of the American Association of Retired Persons, the AARP, which has for quite sometime now taken a very strong campaign against predatory mortgage lending, which disproportionately impacts seniors. Seniors are clearly, from some of the statements that have been received from people who work in the industry, a very heavily targeted group.

I might note that only yesterday, in *Roll Call,* the AARP, as part of its campaign against predatory lending, had this ad—"They Didn't Tell Me I Could Lose My Home." And then it details here being subjected to these pressure tactics and high-cost loans that strip equity and then lead to foreclosure.

Ms. Canja, we would be happy to hear from you.

STATEMENT OF ESTHER "TESS" CANJA
PRESIDENT, AMERICAN ASSOCIATION OF RETIRED PERSONS

Ms. CANJA. Thank you, Senator, and good morning. Good morning to all of the Members of the Committee.

Thank you for showing that ad from *Roll Call* because we are involved in a very big educational campaign and that is exactly what we are calling it—They Didn't Tell Me I Would Lose My Home—which is exactly what happens with predatory lending.

AARP appreciates this opportunity to bring into greater focus one of the most troubling forms of financial exploitation—namely, making unjustifiable, high-cost home equity loans to older Americans. For most Americans, it takes time to accumulate home equity. For many, it is a working lifetime, so that equity become highly correlated with age. The most abusive loans for older Americans are often refinancing loans and home modification loans because they target the equity value of the home. Equity in a home is frequently the owner's largest financial asset. Abusive lending is particularly devastating when the older homeowner is living on a modest or fixed income.

In AARP's view, loans become predatory when they take advantage of a borrower's inexperience, vulnerabilities, and/or lack of information; when they are priced at an interest rate and contain fees that cannot be justified by credit risk; when they manipulate a borrower to obtain a loan that the borrower cannot afford to repay; and when they defraud the borrower.

Older homeowners are often targeted for mortgage refinancing and home equity loans because they are more likely to live in older homes in need of repair, are less likely to do the repairs them-

selves, are likely to have substantial equity in their homes to draw on, and they are likely to be living on a reduced or fixed income.

AARP's efforts to address these problems are directed at improving credit market performance, not at limiting consumer access to credit for those with a less-than-perfect credit history. We believe that our, and other, consumer financial literacy campaigns are very important. These public- and private-sector efforts aim to make consumers their own first line of defense. However, while consumer education and counseling programs are necessary, they certainly are not enough.

AARP believes there is a need to strengthen and expand HOEPA's loan coverage. This upgrade will help to ensure that the need for credit by subprime borrowers will be fulfilled more often by loans that are subject to HOEPA's protections against predatory practices. In this context, AARP has urged the Federal Reserve Board to issue the final HOEPA amendment as soon as possible.

Chairman Sarbanes, and Members of the Committee, the problems associated with abusive home-equity-related lending practices are complex and to date, agreement on a comprehensive reform of the more mortgage finance system to address these problems has proven elusive. We are, therefore, encouraged by the Committee's continued efforts to call attention to predatory mortgage lending and to establish effective deterrence. AARP is committed to working with this Committee, Congress, and the Bush Administration to address the problems posed to the elderly by these devastating lending practices.

We thank you, and I will try to answer any questions you may have later.

Chairman SARBANES. Thank you very much. We appreciate your testimony and we always appreciate working with AARP.

Our next witness will be John Courson, who is the President and CEO of Central Pacific Mortgage Company in Folsom, California, and the Vice President of the Mortgage Bankers Association of America.

The Mortgage Bankers Association represents companies involved in real estate finance, including mortgage companies, mortgage brokers, and commercial banks. And this Committee deals with a whole range of issues that encompass the concerns of the Mortgage Bankers Association.

Mr. Courson, we are pleased to have you with us here today. We look forward to hearing from you.

STATEMENT OF JOHN A. COURSON, VICE PRESIDENT
MORTGAGE BANKERS ASSOCIATION OF AMERICA
PRESIDENT AND CEO
CENTRAL PACIFIC MORTGAGE COMPANY
FOLSOM, CALIFORNIA

Mr. COURSON. Thank you. Good morning, Mr. Chairman, and Members of the Committee. Let me begin by saying that the Mortgage Bankers Association and, indeed, all legitimate lenders, unequivocally oppose abusive and predatory lending practices. There is no hiding from the fact, however, that certain rogue lenders continue to prey on our most vulnerable populations.

We all agree that a significant problem exists and we all share in the responsibility to address the problem. In searching for answers, we should not focus on band-aids that merely cover up the harms. Rather, we must work together to find lasting solutions that will truly protect even the most vulnerable consumers.

I know from the outset that predatory lending is not a new problem. In fact, it has traditionally been referred to as mortgage fraud. And I stress that those consumer laws that are currently on the books—TILA, RESPA, HOEPA—are all aimed at curing problems of fraud and abuses in lending. We must recognize that these laws have existed for years and yet, predatory lending has managed to survive. The fact that we are holding this hearing today should wake us up to that reality.

MBA believes predatory lending is a problem that has a number of sources. We believe there are *three* keys to effective and lasting solutions. These are: enforcement, education and simplification.

First, MBA believes that a general lack of enforcement has done much to create an environment for unscrupulous lenders to operate. Mortgage lending is among the most regulated of all activities. It is subject to pervasive Federal and State regulation.

For these laws to be effective, they need to be enforced. We have long held and reaffirm our belief here that predatory lenders gouge the public through techniques that constitute outright fraud—concealment, forgery, deceptive practices, and nondisclosure. We would note that these activities are against the law in every single State. It is essential that we enforce these laws to the maximum extent possible. Due to a current lack of enforcement, there are often no consequences for those who engage in predatory lending and we urge the allocation of additional resources for enforcement.

Second, we believe that consumer awareness and education are among the most effective tools for combatting predatory lending practices. Simply put, consumers who have an understanding of the lending process and who are aware of counseling and other options are far less likely to fall prey to unscrupulous lenders.

MBA is currently working on new programs designed to educate consumers about the mortgage loan process. In particular, we are developing interactive tools that will empower borrowers confronted with predatory lending practices. These tools will include important information advice, provide typical warning signs of predatory lending, and have direct links to State and Federal regulators that are able to assist possible victims of abusive lending.

And third, the complexity of the current mortgage process needs to be addressed. We need to streamline and simplify the laws that govern consumer disclosures and protections, RESPA and TILA.

Any consumer that has been through the mortgage process knows how bewildering it is. No less than HUD Secretary Martinez, who is not only an attorney, but a housing attorney, has commented publicly that he was overwhelmed by the complexity of the process that he went through when and his family bought a house in Washington earlier this year.

Disclosures provided in the mortgage process are so cryptic and so voluminous, that consumers do not understand what they read or what they sign. This complexity is the very camouflage that al-

lows unscrupulous operators to hide terms and conceal crucial information from unsuspecting consumers.

Partly because of his personal experience, Secretary Martinez has made simplification and regulatory reform in this area a priority. I hope that Congress will also address this very important piece of the predatory lending issue.

In summary, MBA believes that we must address predatory lending on three fronts—a commitment to full enforcement, robust education, and simplification of existing laws. Nothing short of that will suffice.

Thank you for the opportunity to appear this morning and I look forward to answering your questions.

Chairman SARBANES. Thank you very much, Mr. Courson. We appreciate your coming.

We will now hear from Mr. Irv Ackelsberg, who is the managing attorney at the Community Legal Services of Philadelphia. Mr. Ackelsberg is recognized as one of the leading public interest lawyers in the country, and he has been involved, of course, in this predatory lending issue.

He is testifying today not only on behalf of his own organization, but also the National Consumer Law Center, Consumers Union, Consumer Federation of America, National Association of Consumer Advocates, and U.S. Public Interest Research Group.

Mr. Ackelsberg, we would be happy to hear from you.

STATEMENT OF IRV ACKELSBERG
MANAGING ATTORNEY, COMMUNITY LEGAL SERVICES, INC.
TESTIFYING ON BEHALF OF
THE NATIONAL CONSUMER LAW CENTER
THE CONSUMER FEDERATION OF AMERICA
THE CONSUMER UNION
THE NATIONAL ASSOCIATION OF CONSUMER ADVOCTAES
U.S. PUBLIC INTEREST RESEARCH GROUP

Mr. ACKELSBERG. Chairman Sarbanes and Members of the Committee, thank you so much for this invitation. This is actually my first time doing this, so I am really thrilled to be here.

Chairman SARBANES. We put you right in the middle, as it turned out.

[Laughter.]

Mr. ACKELSBERG. Yes.

[Laughter.]

By way of personal introduction, I am a career legal services lawyer. I have spent my entire 25 years as a lawyer with Community Legal Services of Philadelphia, primarily as a consumer law specialist. Because of the extremely high rate of homeownership among low income communities in Philadelphia, most of the work that I have done during the past 25 years has been associated with protecting existing homeowners from loss of their homes.

The predatory lending crisis is so devastating and so widespread, that we are currently using six lawyers who are working almost exclusively on defending predatory lending victims in Philadelphia alone, and we cannot keep up with that demand. There is no question that we are expending more resources than any other legal service program in the country on this problem, and we cannot

keep up with it. We have just set up, with the cooperation of the Philadelphia Bar Association, a special predatory lending panel by which we will be training private lawyers and working with them to teach them how to do this work.

I believe that our office has probably reviewed more of these transactions than any other law firm in the country and it is from the hundreds of stories of victims that I draw most of my experience. But I should also add that I have deposed countless loan officers, brokers, title clerks, and I was the principal trial counsel in the first reported case under HOEPA, called *Newton* v. *United Companies Financial.*

I also, by the way, served on the official creditors committee in the United Companies Lending Chapter 11 proceeding. I believe that I am uniquely qualified to speak to you about the nature of the problem and the legislation needed to remedy the problem.

First, just to supplement the written testimony on the foreclosure explosion that was referred to in the written testimony, just a few bits of data from Philadelphia.

Pennsylvania has a State emergency mortgage assistance program that offers financial help to qualified homeowners facing foreclosures. These are all foreclosures other than FHA's.

In data obtained from the State agency that administers this program, we found that in the year 2000, it received 740 applications for help from borrowers facing foreclosure in Philadelphia. Of those 740 requests for help, 164, or 22 percent, involved threats of foreclosure from a single lender, EquiCredit, the subprime subsidiary of Bank of America, which at the moment, according to what we are seeing pouring into the office, is the biggest problem.

Just this week, we looked at the sheriff's sale listings for the month of August. Every month, there is a list of the sales. There is a monthly sale in Philadelphia. Forty houses are being sold just by EquiCredit in the City of Philadelphia in August. The undisputed explosion in foreclosure is indeed a reflection of the predatory lending crisis. All across our country, we have senior citizens, our mothers, our grandmothers, who are anxious about their credit card debt and bashful about talking about their finances. They are lonely, and they are good, trusting people, all of which combine to make them sitting ducks for a veritable parade of low-life lenders, brokers, and contractors who are seeking to extract what often is the only wealth that they have—their home.

There is a veritable gold rush going on in our neighborhoods and the gold that is being mined is home equity. This bleeding of wealth is not simply the result of market forces. As we describe in our written testimony, there have been critical Federal policies that have fueled the gold rush, particularly the first lien usury deregulation of the 1980's and the changes in the tax code that limited interest payment deductions to only home equity interest.

There are also Federal policies that have undermined the ability of lawyers to defend victims, most notably the Federal Arbitration Act, which has been interpreted by the courts to basically allow wholesale waiver of borrower's access to the courts, and I might add, the restrictions in legal services, which have basically made the work that I do virtually impossible for Legal Services Corpora-

tion-funded programs. And for that reason, we had to give up our funding from the Legal Services Corporation to do this work.

The existing HOEPA triggers are too high, particularly the points and fees trigger currently at 8 points. This allows the predators to make costly loans just under those triggers. Indeed, we are seeing 7 point loans, 7.9 points. We even saw one last week that had exactly 8.0 of points.

But there is an upside to that fact. These loans used to have 10 to 15 points. That means that the basic structure of HOEPA is sound. It is doing good work. It is already functioned to nudge down the cost of credit. Remember that the same lenders who are warning you today that if you bring down the triggers, credit will dry up, said the same thing 7 years ago, that if you enacted HOEPA, there will be no credit.

Subprime credit did not disappear. It just got less costly, and it needs to get less costly still. I hope within the questioning period I will have the opportunity to discuss some of the very specific aspects of S. 2415 which we believe will be very helpful to those of us who are trying to save houses. And in summation, I would just say, and I apologize if the words seem inappropriately too strong, but these words come from 25 years of experience.

I believe that predatory lending is the housing finance equivalent of the crack cocaine crisis. It is poison sucking the life out of our communities. And it is hard to fight because people are making so much money. But we need Government to join the fight with zeal and with smarts. S. 2415 has our unconditional support.

Thank you.

Chairman SARBANES. Thank you very much, sir.

We are being joined this morning by Senator Crapo. Mike, do you have an opening statement?

COMMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you, Mr. Chairman. I do not have an opening statement and in fact, I have to leave in just a few minutes for a live interview. I hope to get back. I have read about half of the testimony already and will read that which I am not able to hear. But I appreciate your holding this hearing. I look forward to working with you on the legitimate problems that are identified and finding solutions that can work for everybody.

Chairman SARBANES. Thank you very much.

We will now hear from Neill Fendly, who is the immediate Past President of the National Association of Mortgage Brokers, NAMB. The NAMB provides education, certification, industry representation, and publications for the mortgage broker industry.

Mr. Fendly, we appreciate your being here with us this morning.

STATEMENT OF NEILL A. FENDLY, CMC
IMMEDIATE PAST PRESIDENT
NATIONAL ASSOCIATION OF MORTGAGE BROKERS

Mr. FENDLY. Thank you. Mr. Chairman and Members of the Committee, I am the Immediate Past President of the National Association of Mortgage Brokers, referred to as NAMB. This is the first time that NAMB has testified in the Senate. We are truly ap-

preciative of the opportunity to address you today on the subject of abusive mortgage lending practices.

NAMB currently has over 12,000 members and 41 affiliated State associations Nationwide. NAMB members subscribe to a strict code of ethics and a set of best business practices that promote integrity, confidentiality and, above all, highest levels of professional service to the consumer.

I would like to focus this testimony on helping the Committee understand the important and unique role of mortgage brokers in the mortgage marketplace and offer the unique perspective of mortgage brokers in examining the problem of predatory lending.

Today, mortgage brokers originate more than 60 percent of all residential mortgages in America. Mortgage brokers are critical to ensuring that people in every part of our country have access to mortgage credit. Almost anyone can usually find a mortgage broker right in their community that gives them access to hundreds of loan programs. Mortgage brokers are generally small business people who know their neighbors, build their businesses through referrals from satisfied customers, and succeed by becoming active members of their communities.

The recent expansion in subprime lending has also relied heavily on mortgage brokers. Mortgage brokers originate about half of all subprime loans. Many mortgage brokers are specialists in finding loans for people who have been turned down by other lenders.

Mortgage brokers often do an amazing amount of work on these loans. I recently completed one such loan that took over 1 year from start to finish. They work with borrowers to help them understand their credit problems, work out problems with other creditors, clean up their credit reports when possible, and review many possible options for either purchasing a home or utilizing existing home equity as a tool to improve their financial situation.

We know that mortgage credit is the least expensive source of credit for those who may have made some mistakes or had some misfortune in the past and now need money to improve their home, finance their children's education, or even start a business. They need to have the widest possible range of choices when they are buying a home or need a second mortgage, and today they do. It is important that Congress be very careful to avoid measures that will deny people choices they deserve and the tools they need to manage and improve their financial situation.

One of the most important choices available to consumers is the no- or low-cost loan which enables people to buy a home, refinance, or obtain a home-equity loan with little or no cash required up front for closing costs. These costs are financed through an adjustment to the interest rate. Both mortgage brokers and retail lenders offer these popular loans. When a mortgage broker arranges a loan like this, the broker is compensated from the lender from the proceeds of the loan. This kind of payment goes by many names, but is often called a yield spread premium. These payments are perfectly legitimate and legal under Federal law, RESPA, so long as they are reasonable fees and the broker is providing goods and services and facilities to the lender. They must be fully disclosed to borrowers on the good faith estimate and the HUD–1 settlement statement, and are included in the interest rate. Retail lenders,

however, are not required to disclose their comparable profit on a loan that is subsequently sold in the secondary market as most mortgages are today.

Despite the great popularity of this loan with consumers, today it is under assault in the courts. Trial lawyers across America are pursuing class action lawsuits claiming such payments to mortgage brokers are illegal and abusive. This is despite Statement of Policy 1991–1, issued at the direction of Congress by the Department of Housing and Urban Development in 1999, which clearly sets forth the Department's view that yield-spread premiums are not, *per se,* illegal and must be judged on a case-by-case basis.

Recently, the 11th Circuit Court allowed a class action to be certified in one of these suits. This has resulted in a flood of new litigation against mortgage brokers and wholesale lenders and has caused a great deal of uncertainty and anxiety in the mortgage industry. The cost of defending these class actions is staggering. The potential liability could run over $1 billion. The prospect of a court deciding that the prevalent method of compensation for over half the mortgage loans in America is illegal is chilling, to say the least.

If these lawsuits succeed, the real losers will be tomorrow's first-time homebuyers, tomorrow's working families, tomorrow's entrepreneurs who will not be able to get a mortgage without paying hundreds of dollars up front. Further down the road, many small business men and women will not be able to stay in business as mortgage brokers without being able to offer these no-cost loans. As competition decreases, all potential mortgage borrowers will suffer higher costs and fewer choices.

Mr. Chairman, this illustrates the unintended consequences that can come from litigation, regulation, or legislation that singles out one part of the mortgage industry, places blanket restrictions on prohibitions of certain types of loans and products, or unreasonably restricts interest rates and fees.

Virtually no loan terms are always abusive, and almost any loan term that is offered in the market today can be beneficial to some consumers. Whether a loan is abusive is a question that turns on context and circumstances from case to case. This is why NAMB and the mortgage industry have opposed legislation or regulation that would impose new blanket restrictions or prohibition on loan terms. We believe such measures will increase the cost of homeownership, restrict consumer choice, and reduce the availability of credit, primarily to low- and moderate-income borrowers.

NAMB believes that the problem of predatory lending is a threefold problem: abusive practices by a small number of bad actors; lack of consumer awareness about loan terms; and the complexity of the mortgage process itself. We believe all three of these areas must be addressed together and with equal forces if the problem is to be solved without unintended consequences that I mentioned earlier. The mortgage industry is working vigorously in all three areas and NAMB wants to continue working with Congress to address all these areas, in particular, reform and simplification of the mortgage loan process.

This part of the solution is one toward which NAMB has put a tremendous amount of effort. This is a comprehensive overhaul of the statutory framework governing mortgage lending. We cannot

emphasize enough to this Committee how badly this framework needs to be changed and how important this is to curtailing abusive lending.

The two major statutes governing mortgage lending have not been substantially changed since they were enacted in 1968 and 1974. The disclosures required under these laws are confusing and overlapping. The laws actually prevent consumers from being as well informed as they could be and put consumers at a decided disadvantage in the mortgage process. As one of the borrowers at yesterday's hearing so eloquently put it, "the problem is the lenders know everything and the borrowers know nothing." It is impossible for consumers to effectively compare different types of mortgage loan products.

NAMB has been engaged from the beginning in efforts to reform the laws regulating mortgage originations and we remain committed to the goal of comprehensive mortgage reform and simplification. We urge this Committee in the strongest terms possible to work with our industry on mortgage reform.

In conclusion, I want to reiterate that NAMB supports measures by the industries and regulators to curb abusive practices, punish those who do abuse consumers, and promote good lending practices. We support legislation that would reform and simplify the mortgage process and believe this is the legislation that is most needed to empower consumers. The problem of predatory lending can only be solved through a three-pronged approach of enforcing existing laws, targeting bad actors, educating consumers, and reforming and simplifying the mortgage process. In considering any new legislation, we urge Congress to apply this fundamental principle: Expand consumer awareness and consumer power rather than restrict consumer choice and product diversity. That should be the goal of any new legislation affecting the mortgage process.

Thank you for this opportunity to express our views and we look forward to working with the Committee in the future.

Chairman SARBANES. Thank you very much, sir.

We will now hear from David Berenbaum, the Senior Vice President, Program and Director of Civil Rights for the National Community Reinvestment Coalition.

For more than 10 years, the National Community Reinvestment Coalition has been a leading force in promoting economic justice and increasing fair access to credit, capital, and banking services for traditionally underserved communities.

Mr. Berenbaum, we are pleased to have you with us.

STATEMENT OF DAVID BERENBAUM
SENIOR VICE PRESIDENT
PROGRAM AND DIRECTOR OF CIVIL RIGHTS
NATIONAL COMMUNITY REINVESTMENT COALITION

Mr. BERENBAUM. Thank you, Chairman Sarbanes, Members of the Committee. We are extremely concerned about the prevalence of predatory lending in our Nation. During the next 5 minutes, I will try to synthesize the remarks included in our over 20 pages of testimony and exhibits. We are clearly in a dual-lending marketplace. Let it be said and let it be heard that the continuation of redlining is in our Nation.

Despite popular belief, or the argument that in fact subprime lending has ended redlining that is argued by some industry associations, in fact, it has put an entirely new face on the issue of redlining, a whole new cast on it.

Before, where overt discrimination occurred, overt consumer denial with regard to access to credit was commonplace, today, we are dealing with a race tax. In fact, if you look at recent HUD-Treasury studies, they report that African-Americans are five times more likely to receive subprime loans than their white neighbors. Other studies document the fact, studies by the GSE's, that 30 to 50 percent of African-Americans who are currently receiving subprime loans should have qualified and been afforded the opportunity to receive prime paper.

This is a major failure. Picture yourself living in an urban community. You approach a retail lender operation. On the front window of that lender is an equal housing opportunity/equal lender logo. You go in and in fact, they give you papers in compliance with the Truth in Lending Act, in compliance with all other consumer protections. And then they try to sell you a product that has four points, fees, single-premium credit life, and that has a balloon note.

Now picture that individual going into a suburban location. In fact, another division of the very same company. And you are told, that you can get a prime note with one point, no single-premium credit. And you have options, you have choices.

In fact, this is not, as was referenced, a rogue lender. It is an example of many corporate lenders in our country right now, having subprime divisions that market themselves exclusively to urban communities while their prime traditional lending banks covered by CRA, in fact, are operating in predominantly white areas.

Included in our testimony, we have maps based on the Home Mortgage Disclosure Act that look at, "minority census lending."

On the board here, we have a map from the Baltimore area. The first map documents subprime lending. You can see the concentration of the dots. These are refinanced loans that were originated in the subprime marketplace in 1999. You see the concentration in the areas that have the darker shading which represent predominantly African-American and Latino areas. The next map looks at prime lending. Look at the strong difference. Prime lending is happening throughout the Baltimore/Metropolitan Washington area.

I submit to you that the prime lending that is occurring in African-American communities is coming from responsible lenders that are living up to their commitments under the Community Reinvestment Act and in partnership with community-based organizations.

Financial modernization, the changing nature of the mortgage marketplace has prompted an atmosphere where many lenders are not falling within compliance reviews, are not falling with existing statutory reviews.

Best practices include the lender marketing their goods in both the urban and suburban areas and where they have agreements. I respectfully say, and I believe in best practices. I believe in financial literacy. NCRC has been a leader in doing "train the trainer" work with regard to financial literacy. We believe in all that.

But with all due respect, it is not simply rogue lenders like Cap Cities Mortgage, right here in Washington, DC, who foreclosed on

85 percent of their loans. It is a systemic problem with race at the background of the issue that we need to address.

The consumer protection bills that have been introduced, in particular, the legislation that you, Chairman Sarbanes, are considering, are critical to address HOEPA. I hope during the questions and answers, I can go into why these changes are necessary.

Best practices are not enough. These are ethical issues. The mortgage practitioner who are stealing homes from seniors, from African-Americans, from people who are not sophisticated borrowers, should lose their licenses.

The companies that are buying these products on the secondary market need additional regulatory oversight. The market is changing. The law needs to be more than a band-aid. We need penicillin.

Chairman SARBANES. Thank you very much, Mr. Berenbaum.

Before I turn to our final three witnesses, we have been joined by Senators Dodd and Carper.

I yield to either of them if they wish to make a statement.

COMMENT OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Mr. Chairman, let us continue with the witnesses. And when the chance comes around for questioning, I will use the time then. But you have been sitting here for a long time.

Chairman SARBANES. Thank you, Senator Dodd.

Senator Carper.

COMMENT OF SENATOR THOMAS R. CARPER

Senator CARPER. I would simply echo the sentiments. And again, to the witnesses, thank you for being with us today.

Chairman SARBANES. Our next witness is Mr. George Wallace.

Mr. Wallace is counsel for the American Financial Services Association. AFSA is a trade organization that represents a wide variety of financial services firms, including market-funded lenders and credit insurance providers.

Mr. Wallace, we appreciate your coming today. We would be happy to hear from you.

STATEMENT OF GEORGE J. WALLACE
COUNSEL, AMERICAN FINANCIAL SERVICES ASSOCIATION

Mr. WALLACE. Thank you, Mr. Chairman, and Members of the Committee.

Chairman SARBANES. I think it might help a bit if you pull that microphone closer to you.

Mr. WALLACE. Am I close enough now?

Chairman SARBANES. That is good, although you are leaning.

Mr. WALLACE. I would like to be heard.

Chairman SARBANES. We want you to be heard.

[Laughter.]

Mr. WALLACE. Some people might not want to hear me, but any way——

Chairman SARBANES. No, no. We want to hear everybody and try to address everyone.

Mr. WALLACE. I am a dissenter today. Today, I want to talk about predatory lending, as everybody else is. Allegations of predatory lending, particularly in the subprime mortgage market, have

received significant attention in recent months. Advocates of increased regulation have claimed that stepped up fraudulent or predatory marketing practices have persuaded vulnerable consumers to mortgage their homes in unwise loan transactions. Some consumer advocates have strongly urged that various loan products and features common to the mortgage market are predatory and should be outlawed.

Extensive new regulation of mortgage credit in the way advocates now urge would dramatically reduce loan revenue, increase the risk and/or increase costs the lender must bear. And I speak for people who have to produce the loans that those who wish to make credit available to lower and moderate income people, we are the ones who have to produce those loans and we are looking at your suggestions and we are seeing that it is going to raise costs.

Initially, the resulting burdens will fall on lenders, in the long term, the effects will most always be felt directly by working American families, either because of decreased loan availability, higher credit prices, or less flexible loan administration.

The resulting reduced credit availability strikes at the very heart of the efforts over the last quarter century by Congress, many States, and the lending industry to make efficiently priced consumer credit available to working American families, including minorities, single-parent families, and others who for so long were unable to obtain credit.

Consumer advocacy have shared this goal. In testimony before this Committee in 1993, Deepak Bhargava, then Legislative Director for ACORN, spoke of a credit famine in low- and moderate-income and minority communities in urban and rural areas, and also about massive problems of credit access in many communities around the country, particularly in minority and low-income areas.

Subprime lenders, spurred on by Congress, have been enormously successful in delivering efficiently priced consumer credit to working American families, regardless of race, ethnicity, or background. Moreover, during the past 5 years, 96 percent of those who have borrowed from AFSA members have used their subprime mortgage loan credit, successfully, 85 percent without any significant delinquency.

Why would Government deny to these deserving Americans access to the benefits of credit that middle-class Americans enjoy? The 96 percent of Americans who use credit extended by AFSA members successfully are not asking for that interference. There are some people who have been victims of fraudulent, deceptive, illegal, and unfair practices in the marketing of mortgage loans. In fact, predatory lending is fundamentally the result of misleading and fraudulent sales practices, as others have said today.

Some advocates have mistakenly focused on loan products and features as the reason for these victims' misfortune, and have reached the faulty conclusion that if regulation just barred certain loan features, the harm would be avoided.

Pursuing this mistaken reasoning, they have tried to label as predatory highly regulated loan products and features, such as credit insurance, prepayment penalties, balloon payments, arbitration, higher rates and fees. However, any legitimate consumer good or service can be marketed fraudulently.

Indeed, the scam artist prefers to use legitimate products like loans as a cover because consumers want and need that product. The illegality comes in the fraudulent marketing of the good or service, not in the good or service itself. We urge the Congress not to confuse the loan features that consumers want and need with the fraudulent marketing practices that some isolated operators have used to prey upon the unfortunate. If fraudulent and deceptive practices are the root of the problem, how should predatory lending be addressed?

First, Congress should do no harm to the present system, which has been extremely successful in delivering consumer credit to America's working families. Such proposals as forbidding such features as balloon payments, financed single-premium insurance, and prepayment fees take away legitimate loan features useful to America's working families without addressing in the slightest way the fraud underlying the predatory practices, and that is an important point to remember.

Second, consumer education should play a major role. AFSA has been a leader in developing educational programs to help meet the enormous need for greater financial literacy. As a founding member of the Jump Start Coalition, a coalition of industry, Government and private groups dedicated to increasing financial literacy, it has for several years pushed strongly for increased efforts to educate Americans about credit.

We urge Congress to support these and other efforts because they hold the greatest promise to help over the long run. We particularly want to thank Senator Corzine for his efforts in obtaining additional support for financial literacy efforts this year.

Third, industry self-regulation plays an important role. AFSA has developed best practices which its member companies have voluntarily adopted. They strike a reasonable balance between limits on controversial loan terms and providing legitimate consumer benefits in appropriate circumstances. A copy of AFSA's best practices are attached to my written statement.

And finally, Government's role is appropriately the vigorous enforcement of deceptive practices in civil rights laws. Any objective analysis of these laws much reach the conclusion that they provide some powerful tools to address both fraudulent sales practices and discrimination.

Strong enforcement is appropriate because it addresses the real problem—the fraudulent and discriminatory practices—without affecting the overall ability of lenders to make loans available to working American families with less than perfect credit.

That is the appropriate policy balance between dealing with the real misfortunes which some borrowers have experienced and the continued availability of credit to working American families.

We urge Congress to encourage that an appropriate balance be maintained. Thank you, Mr. Chairman, and Members of the Committee, for the opportunity to address you today and I look forward to any questions you may have later on.

Chairman SARBANES. Well, thank you very much, sir. I also want to thank you for your statement and for the attachment of the best practices AFSA.

Our next witness is Lee Williams, who is the President of the Aviation Associates Credit Union in Wichita, Kansas, and is the Chairperson of the Credit Union National Association's State issues subcommittee.

Ms. Williams, we would be happy to hear from you.

STATEMENT OF LEE WILLIAMS
CHAIRPERSON, STATE ISSUES SUBCOMMITTEE
CREDIT UNION NATIONAL ASSOCIATION, AND
PRESIDENT, AVIATION ASSOCIATES CREDIT UNION
WICHITA, KANSAS

Ms. WILLIAMS. Good morning, Mr. Chairman, Members of the Committee. It is indeed a pleasure for me to be here and speak to you on behalf of the Credit Union National Association, CUNA.

CUNA represents over 90 percent of the 10,500 State and Federal Credit Unions Nationwide. And as Chair of CUNA's State issues subcommittee, I have had the privilege of carefully considering issues surrounding abusive practices of predatory lending and appreciate this opportunity to present to you some of our findings.

America's credit unions strive to help their 80 million members create a better economic future for themselves and their families. And with that in mind, the credit union system abhors the predatory lending practices being used by some mortgage brokers and mortgage lenders across the country.

Predatory lending is a complex and difficult issue to resolve. My committee, as well as this Committee, has come to that conclusion by hearing testimony of individuals and looking at the current situation with predatory lending. Predatory lending's primary targets are subprime borrowers. These are consumers who do not qualify for prime rate loans because of poor credit history or, in some cases, simply a lack of credit history. This segment of the population is of particular interest to credit unions because, historically, it is this population that has turned to us for our flexibility and our wide range of credit options.

CUNA is concerned that the term predatory has become synonymous with subprime in the minds of some of our policymakers. Consequently, legitimate subprime lending programs could suffer if broad prohibitions on certain lending practices become law.

Credit unions urge policymakers to use a scalpel, not an elephant gun, when drafting legislation to eliminate predatory lending practices. Subprime borrowers need to be served and credit unions do not want to lose their ability to create flexible, subprime loan programs. A growing number of credit unions offer subprime loans to members who do not qualify for a prime rate loan. Subprime loans are offered to members with poor credit histories at rates above prime to offset the higher risk of lending.

Credit union subprime loans are not predatory. They are a vital tool that give borrowers with poor credit history the ability to build and/or rebuild their credit history.

To illustrate some of the alternative subprime lending programs offered by credit unions, CUNA created a task force last February. The task force has recently completed a handbook called, "Subprime Doesn't Have To Be Predatory—Credit Union Alternatives," which is included in my attachment, as you have seen. The booklet

provides a sample of credit union subprime loan programs that are designed to help borrowers actually improve their credit.

There are many positive programs being developed in the subprime lending market by credit unions to assist consumers of all economic circumstances. Credit unions urge policymakers to address the abuse of lending practices rather than complete prohibition of practices that, when used legitimately, would provide flexibility and credit options to meet individual borrower's needs.

America's credit unions support elimination of lending practices that are intentionally deceptive and disadvantageous to borrowers. CUNA and credit unions across the country have been establishing programs to help our members fight back against the effects of high cost and predatory loans.

At Aviation Associations Credit Union, we recently initiated a Take Control program. It provides resources for our members, allowing them to take control of their financial well-being and effectively deter the success of payday lenders and predatory mortgage lenders in our community.

Let me give you an example of that. We have members with high interest mortgage loans acquired from a mortgage broker that have come into our credit union and asked us to refinance these loans because they cannot make the payments. My initial response, being member-owned, is to offer to refinance these loans and to reduce the interest rates. But often, that is no solution. Typically, these type of loans have been initially packed with so many fees, paid up front and financed, that the loan-to-value ratio is often up to 125 percent. Neither my credit union, nor many other lenders, can refinance such a loan. Even in such a dire situation, our Take Control program can improve the member's financial circumstances. Our program does this through member education.

With the help of an on-site consumer credit counselor available twice a week at our credit union, members can learn how to pay down loans faster, obtain lower fees and rates, and even in the grip of predatory mortgage loans, learn how to build equity faster so the credit union can at a later point refinance these mortgages.

This is only a band-aid on a serious injury. When the credit union refinances for the member, the predatory lender wins. At Aviation Associates, we believe our members must never fall victim to predatory lending in the first place. That is why Take Control also offers a significant component that includes education to teach our members how to avoid predatory mortgages in the first place. We are convinced education is a critical tool, although not the only tool, needed for our members to obtain financial independence.

On a national level, CUNA developed mortgage lending standards and ethical guidelines to be adopted by credit unions across the country. These guidelines were designed to help emphasize credit unions' concerns for consumers and further distinguish credit unions as institutions that care more about people than money.

One of the most important programs CUNA is currently promoting to combat predatory lending practices is financial education of our Nation's youth. Credit unions believe that by educating our young people in the area of personal finance, they will learn to make sound financial decisions and choose not to use high cost or predatory lenders.

Through our partnership with the National Endowment for Financial Education and other efforts, we have reached over 130,000 students in over 5,000 schools.

Again, let me say that I am very pleased that you are holding these hearings because I see the effects of predatory lending daily, and it is not a pretty picture. Credit unions are eager to see the abusive practice of predatory lending eliminated. Credit unions have taken positive steps in that direction through our voluntary efforts to educate our members and provide them with fair and sound alternative products. It is our hope that we will have allies in our efforts to assure all consumers have access to credit products that do not unfairly take advantage of their circumstances.

I thank you for allowing me to be here today and I would answer any questions.

Chairman SARBANES. Well, Ms. Williams, thank you very much for the statement on behalf of CUNA.

If you had been here yesterday, I think you would have appreciated and the Members of the Committee were very careful to recognize—and as the witnesses this morning have said right from the beginning with Wade Henderson—that there is a role to be played in the legitimate subprime market. We are trying to get at those people who are abusing that market with these predatory practices.

I was looking at this pamphlet that you told us about and I note that you very clearly try to draw that distinction. And that is one of the things that we are about here today, is to ascertain that line and then knock out what is on the wrong side of that line.

Our last witness this morning is Mike Shea, who is the Executive Director of ACORN Housing.

For over 25 years, ACORN has worked to increase homeownership and community development in low-income and minority communities. The organization has worked successfully with many lenders to develop loan products that provide fair and affordable access to credit for individuals traditionally shut out of the economic mainstream.

Mr. Shea, we are pleased to have you with us today. We look forward to hearing from you.

STATEMENT OF MIKE SHEA
EXECUTIVE DIRECTOR, ACORN HOUSING

Mr. SHEA. Thank you, Mr. Chairman, Members of the Committee. I appreciate the opportunity to appear. I work in many of your States and it is a pleasure to be able to share my insights on predatory lending. I have been Executive Director of the ACORN Housing Corporation since 1986, when the organization was formed to create low-income homeownership opportunities.

We learned early on that to create homeownership in distressed neighborhoods, you have to do two things. First of all, you have to bring private capital back into those communities. FHA lending and Government subsidies on their own will not do the trick. And second, you have to provide consumer education and prepurchase mortgage counseling to potential homeowners so that people living in those communities will actually apply and qualify for loans.

To educate community residents about the home-buying process and how to qualify for a loan, we operate mortgage counseling cen-

ters in 27 cities around the country. I am proud to say that our lender partnerships along with our mortgage counseling and financial literacy efforts have produced home loans for 36,000 first-time home-buyers.

Last month, our largest banking partner, Bank of America, announcedthe amount of home mortgages that have been originated through our partnership with them has reached the $10 billion mark. It is our experience that subprime lenders have not played a major role in the creation of homeownership in this country. The recent increases in homeownership that we have seen in the 1990's was not because of subprime lending.

Of the 36,000 ACORN clients who have become homeowners, only about 1,100 purchased their homes with loans from subprime lenders. And our experience is not atypical according to the 1999 Home Mortgage Disclosure Act data which reported that just 6.6 percent of all home mortgage loans in the United States were originated by subprime lenders, while 82 percent of all first-lien subprime loans are refinances.

In many of the communities that we work, the benefits that families have gained from homeownership are under attack. Increasingly, we find that as soon as one of our clients moves into their new home, they are bombarded with offers from subprime lenders to refinance their mortgage or take out additional debt, receiving three or four letters a week and regular phone calls.

Now, we know that you have heard these numbers before, but it is worth repeating, that half of all refinanced loans in communities of color are made by subprime lenders. When you consider that number in combination with the observations from Fannie Mae and Freddie Mac, that between 30 to 50 percent of borrowers in subprime loans could have qualified for "A" loans, you are clearly talking about a massive drain of equity from these communities, the communities that can least afford it.

At a bare minimum, these numbers indicate that huge numbers of borrowers are paying interest rates 2 to 3 percent higher than they would if they had an "A" loan. Consider, for example, that for a $100,000 mortgage with a 30 year term, a person with a 10½ percent interest rate will pay $65,000 more over the life of the loan than a person with an 8 percent rate. Fannie Mae Chairman and CEO, Frank Raines, recently put it best, and I would like to quote him, "The central question is whether all consumers are enjoying their basic right to the lowest-cost mortgage for which they can qualify." Answering this is critical if we are to close the homeownership gaps facing many groups in America.

Predatory lending is everywhere. Over the July 4th weekend, I visited my mother in Benzig County, Michigan. And as Senator Stabenow can say, Benzig County is a very conservative, rural county in Northern Michigan. When I told her what I was doing, she immediately told me of two of her elderly friends, staunch Republicans from the day they were born, how they had been victimized by predatory lending.

Paul Satriano yesterday testified, and his testimony received extensive coverage in Minnesota. As a result, our office in the Twin Cities has received phone calls from throughout the States of Minnesota, Wisconsin, South Dakota, and even the upper peninsula of

Michigan, two people called who were victimized by predatory loans and looking for ways to get out.

We have to get rid of all the tricks and hidden practices that make it impossible for consumers to know what kind of loan they are getting into. What you have now is a situation where it is difficult for even my best loan counselors to understand all of the damaging bells and whistles embedded in many subprime loans.

That should not be how getting a home loan works. It is not what happens in the "A" market, but that is what is happening every day in the subprime market. We need a strong, clear set of rules that will allow homeowners to navigate the subprime market with some basic assurances of safety.

We often hear the argument that predatory lending can be eliminated with more education and financial literacy. We certainly support financial literacy efforts. In fact, I would venture that ACORN Housing, working together with many of our bank lending partners, has delivered more information to homebuyers about these issues than anyone. Last year alone, nearly 100,000 people attended our bank fairs, workshops, and other events. We held a bank fair recently in Detroit where 3,000 people came.

And Fannie Mae's latest national housing survey found that consumer literacy efforts have already lowered the information barriers to buying a home, with nearly 60 percent of Americans now feeling comfortable with the terminology and process of buying a home. In spite of this increased financial literacy, we see that predatory lending continues to rise.

Part of what we have learned from this experience of providing financial literacy and education is the limits of the approach. First, there is the question of resources. Until we are ready to spend the $1,500 to $2,000 per originated loan that many predators can spend, we will always be playing catch-up.

And second, no advertisement, bus billboard or even workbook is going to compete with a one-on-one sales pitch of a very good salesman who knows more about the process and about the products than the borrower.

We have also heard the argument that all that is needed is better enforcement of existing laws. We see a lot of borrowers in heart-breaking situations and we have tried to use current law to help protect them. This year, we have helped 40 clients in 10 States file grievances with State regulators, and that has not worked.

HOEPA covers only a tiny fraction of loans and it mostly requires disclosures. As long as the right piece of paper was slipped somewhere into the pile, there is often little the borrower can do.

Fraud and deceit are against the law, but they are extremely difficult to prove. It usually turns into a matter of he-said/she-said, and when the lender knows more about the transaction and has the paperwork, and has the lawyers, the borrower loses. And when we hear certain industry groups suggest that the solution is better enforcement of current law, we wonder how they expect that to happen if they routinely include in their loan documents mandatory arbitration clauses which severely limit a consumer's right to seek relief in court.

What we need are some basis rules covering a broader group of high-cost loans that create a level playing field where a borrower in the subprime market, like a consumer in the "A" market, has a set of understandable options to choose between.

Buying or refinancing a home is a lot more like buying medicine than like buying a tube of toothpaste. We do not expect every patient to read the New England Journal of Medicine and evaluate for themselves which drugs are safe and which are not. Instead, Congress and the FDA establishes rules about what is too dangerous to be sold, within those rules, patients and their doctors still can choose what is best for them. In our view, Congress and the Federal Reserve need to make rules about subprime loans in the same way.

Chairman SARBANES. Mr. Shea, we are going to have to draw to a close.

Mr. SHEA. Thank you. I would like to just make one more point. There is a lot of comments by the industry about unavailable data. I would just like to say that Jesus did not need an economic study to convince him of the need to drive the money changers from the temple. He had a moral compass. He knew what was right and wrong, and he had the courage to act on those beliefs.

Thank you.

Chairman SARBANES. Thank you very much, Mr. Shea.

We will go to questions. A number of my colleagues have been here for a while and I want to at least get them started.

Senator Dodd wanted to make a very quick comment.

Senator DODD. Just while my other colleagues are here. Mr. Chairman, thank you for these hearings and thank our witnesses, too. It has been tremendously helpful. We are going to be constrained in time. Our desire here is to make subprime lending more available for people. We do not look to cut that. There are many lenders out there who are doing a very good job, particularly some who have reacted already. As you have just point out, CitiCorp and others have been very helpful.

I thank them for what they are doing, and we are talking about those who engage in predatory practices. Not all subprime lending is a predatory practice, and I think it is important that we state that here.

But to be as emphatic as you, Mr. Chairman that we are determined as a Committee here, I am convinced the Republicans as well as the Democrats, should do everything we can to stop that.

I thank all our witnesses for their your help.

Thank you, Mr. Chairman.

Chairman SARBANES. We have been joined by Senator Santorum.

COMMENT OF SENATOR RICK SANTORUM

Senator SANTORUM. Thank you, Mr. Chairman. I know people have been here longer than me. I just want to associate myself with the remarks of Senator Dodd that I beileve we do have some bad actors out there in the area. But I want to also reiterate the importance of subprime lending and having money available for those who do not have the kind of credit rating that otherwise can succeed. I think we are interested in engaging in something that

is constructive to deal with this issue and I look forward to working with you.

Chairman SARBANES. We do not intend to throw the baby out with the bathwater. But we do intend to throw the bathwater out.

[Laughter.]

The dirty bathwater out, I should say.

[Laughter.]

Debbie, why don't I recognize you for as long as we can go before we have to leave for a vote. I will say to the panel, we will have to recess briefly and go for this vote, and then we will return and continue the question period.

Senator STABENOW. Thank you, Mr. Chairman. I appreciate that and would note that I will not be able to come back because I have to preside at noon. I actually have numerous questions. We will not be able to address all of them. And possibly, we can follow up in writing with the panelists. I appreciate all of your comments.

We have heard and have to address complex issues. We have issues that we heard yesterday of loan flipping and issues on mandatory arbitration, disclosures, prepayment penalties, the definition of what is a high-cost loan, the whole question of regulation, and the effective ways of promoting financial education. There is a lot of different issues that we need to address. I would simply ask Mr. Courson, Mr. Fendly, and Mr. Wallace, whom I will ask first.

You mentioned consumer education being the primary focus. Yesterday, a constituent of mine was here, Carol Mackey, who spoke about the fact that she was given a good-faith estimate in writing several days before the loan closure, and that in fact, when she got there, the interest rate was higher, the payments were higher.

The information she was given on the good-faith estimate was not accurate. So, she was attempting to be educated as a consumer. She is a bright woman. And found herself, when she dug through all the papers, that in fact it was different.

So, I would ask how you feel——

Chairman SARBANES. When she dug through them afterwards, when she went back.

Senator STABENOW. After she settled.

Chairman SARBANES. She really was not in the position to do so at the closing.

Senator STABENOW. That is correct, Mr. Chairman.

She came into the closing with information that she assumed was accurate based on the good-faith estimate, found after she got home and sorted through—and as someone who closed on a home not that long ago and considers myself reasonably intelligent and as a Member of the Banking Committee, I found myself going through pages and pages and pages and trying to make sure that there was not something there that I had not seen before and so on, and know how complicated it was.

I appreciate the issues of simplicity. I think we do have to address that and want to work with you on how we might simplify this process. I certainly agree that it is extremely complicated and difficult to sort through, even when you are very conscientious.

But when we are talking about consumer education and someone has been given information, and later, it was found to be different in the final analysis, how would you correct that through consumer

education? Or do you believe, in fact, that it is appropriate to require that the good-faith estimate be a formal estimate so that it has to be the same 3 days before as it is on the day that you close?

Mr. Wallace.

Mr. WALLACE. Well, I was not here yesterday and I did not hear Mrs. Mackey's statement. But as you describe it, the good-faith estimate is, in fact, an estimate. It has to be given within 3 days of application. Then there is a HUD–1 Statement which does have to be accurate. So, you are describing what appears to be a violation.

Likewise, the Truth in Lending Statement has to be accurate. If it was inaccurate, that would be a violation of Truth in Lending. We do have a legal system already in place which would appear to address the concerns that you are raising.

Senator STABENOW. If I might just say, though, the documents that you are referring to are given on the day of the closing.

Would you support having those documents given to consumers several days in advance in straightforward, simple terms, so that people know exactly what the costs are, the interest rate, the points, the fees, *et cetera*?

Mr. WALLACE. The difficulty with that is it produces a certain degree of inflexibility with regard to borrowers. Borrowers often wish to move straight to the closing. I have been involved in this for 35 years. People have suggested this for many years, and it might be nice to do that. And then you start to work out the practicalities of it and it starts to tie the borrower's hands.

I think in the end what we are trying to do is to develop a regulatory system which deals both with the problems of communicating to people, educating them so that they understand when they are communicated to, and working out a system which can be consistently applied and appropriately managed by creditors without interfering too much with the borrower's flexibility. I believe the objection to your mechanism is, and other people have raised it, is that it starts to interfere with the borrower's flexibility.

That is a policy trade-off that, in the end, one has to deal with.

Senator STABENOW. I appreciate that. Well, let me just say knowing 3 days in advance what you are walking into is not an unreasonable request, and if we are focusing on consumer education, I think we need to make sure that that education and information is accurate.

Mr. Courson, would you like to respond? I know you have spoken in your testimony about early price guarantees.

Chairman SARBANES. Well, I think——

Mr. COURSON. I am sorry, Senator?

Chairman SARBANES. I think if I do not move my colleagues out of here, we are going to miss this vote.

Could you give a brief——

Mr. COURSON. Thirty second answer.

Senator STABENOW. Could you give us a 30 second answer?

Mr. COURSON. Yes. Part of the reform that we are advocating, simplification, is taking the front-end system, the good-faith estimate, which really has no limits in terms of how it can change the closing.

Chairman SARBANES. There is no liability for a misstatement on the estimate.

Mr. COURSON. That is correct.

Chairman SARBANES. Contrary to what I think Mr. Wallace said, that it was illegal. As I understand it, there is no legal penalty for that. Is that correct?

Mr. COURSON. Correct.

Mr. WALLACE. Are you speaking about the HUD–1 or the Truth in Lending?

Chairman SARBANES. No. I am talking about good-faith estimate.

Mr. WALLACE. I was speaking about the Truth in Lending. Truth in Lending, there is clearly liability.

Chairman SARBANES. All right. But when do you provide that?

Mr. WALLACE. The Truth in Lending is what tells her——

Chairman SARBANES. When do you provide that?

Mr. WALLACE. You have to provide that 3 days after application on an estimated basis, and then at closing.

Chairman SARBANES. And is the estimate—are you liable for a misstatement on the estimate?

Mr. WALLACE. On the HUD——

Chairman SARBANES. On the estimate.

Mr. WALLACE. On the estimate, the answer is, at this point, no.

Chairman SARBANES. All right.

Mr. COURSON. Our reform plan envisions, at the time of the application, as opposed to the good-faith and the TILA that someone gets today, they would get one simple disclosure. That disclosure would include really what the customer wants to know. How much cash do I have to bring to closing and what are my payments? Of course, it would have other disclosures on there.

One of the things that we are advocating is that the closing costs that would be included on that disclosure would be guaranteed.

And so, the consumer at three different times through the transaction would see the same disclosure with more specificity as they go through from application to credit approval to closing, with more information completed. But the closing cost guarantee itself would not be a violatation. It would stay. If it did change, it would be a violation.

I heard Mrs. Mackey's testimony yesterday. And it is the fallacy of the system of not giving the certainty to the consumer up front, and then, in fact, when you get to the closing, those guaranteed closing costs must remain the same. That is part of what we have in our reform proposal and in working with Secretary Martinez.

Chairman SARBANES. I believe we need to recess, otherwise we are going to miss the vote.

Senator STABENOW. Thank you very much.

Chairman SARBANES. I certainly will return. We will recess and return after the vote.

[Recess.]

Chairman SARBANES. Let me bring the Committee back into session. The hearing will come to order and we will resume.

Mr. Wallace.

Mr. WALLACE. I wanted to correct my earlier remarks. I thought that Senator Stabenow was asking a question about conventional mortgage loans. I believe she was asking a question about HOEPA loans. Several people have pointed out to me, in a HOEPA loan, there is a requirement, 3 days before closing, to give an accurate

statement. If it is inaccurate, there are civil penalties. There are enforcement provisions that work quite strongly, and you cannot change the good-faith estimate between the closing and the giving of it 3 days in advance.

Indeed, this has been an issue that borrowers have raised because they not only have 3 days advanced disclosure that I just described, but also the 3 day recision period. So, it takes them 6 days to get their money. So, I just wanted to correct my remarks, sir.

Chairman SARBANES. The correction will be noted. Ms. Mackey did not have a HOEPA loan. One of the problems here is that a lot of these loans are not HOEPA loans. That is one of the reasons that the Fed is now addressing what the HOEPA limits are in an effort to include within them more of these loans that are now falling outside of it.

Senator Corzine.

Senator CORZINE. Yes. It was a terrific presentation by all of you and I appreciate the discussion.

I just wanted to make sure that I heard this properly from Mr. Courson. The Mortgage Bankers Association believes this is a problem and a pervasive problem. And that is something that we can count on, your objective view, as we go about debating this as we go forward?

Mr. COURSON. You certainly can, Senator. We have been involved in this debate as one piece of an effort to really reform and simplify the entire mortgage process for over 5 years, and you have our commitment.

Senator CORZINE. I think sometimes there is a debate about whether this is just an anecdotal situation here or there and we fine four people here, or 10 people there.

But my observation, our studies would lead me to believe that this is actually a very pervasive issue and needs addressing. And I believe it is informative that one of the foremost associations underscores that.

I have this curiosity, and I will let anyone respond. But don't most "A"-lenders have lawyers with them at times of closing on mortgages, pretty simple conventional mortgages?

Does anyone want to address that?

Mr. SHEA. Senator, of the 36,000 families that have gotten home loans first to buy a home from our program, we estimate about 25 percent use lawyers at closings.

Senator CORZINE. That is in the subprime market, though.

Mr. SHEA. That is in the prime market.

Senator CORZINE. That is in the prime.

Mr. SHEA. In the prime market, there is enough protections and it is easy to understand what you are getting into ahead of time where you oftentimes do not need a lawyer. We advise people to seek legal counsel and we work with them ahead of time to review the documents. The subprime market, very few people use lawyers.

Mr. BERENBAUM. Could I respond to that on a different level?

The issue of RESPA was addressed. I have to say that the National Community Reinvestment Coalition strongly supports the consumer actions that have been filed in court. Who is empowered in a mortgage settlement or a mortgage closing situation? Who has the power?

The consumer, as has been stated generally, does not understand the action, where fees are going. Disclosure is very important, and part of the problem of predatory lending are the relationships between the players.

In fact, often a realtor may be working in concert with a subprime lender who is a predator. And even the settlement agent may be part of that process. We have even seen where whole separate corporations are bidding on the foreclosure ultimately that are related to this little group of conspirators. And that is why in the Capital Cities case, in fact, there is a claim trying to stretch and use existing law, arguing racketeering.

Senator CORZINE. Sounds like racketeering to me if there is a conspiracy of people working together.

In the "A" market, there is a lot of uniformity, conformity. I think Freddie Mac and Fannie Mae have asked for conformity so that the secondary mortgage market can actually work. Is there room for some improvement in standardization in subprime lending that would allow for that simplicity that is talked about? I understand the need for flexibility, but sometimes flexibility is camouflaged for some of the practices we have talked about.

Does anybody want to comment why and whether we ought to get to more standardization? It certainly would provide more liquidity to the ultimate lender.

Mr. ACKELSBERG. Well, Senator, if I could speak to that.

I believe the first thing you need to do if you want standardization is actually have the rates and the fees available to the public to know ahead of time. You have to understand that everything we talk about in this market is different than your conceptions of what mortgage lending is about.

Number one is, if you start with the assumption that when you are in the market, you go to the newspaper on Sunday and in the real estate or financial section, they list all the mortgages, the prices, the points, and the rates, that does not exist in subprime. Just yesterday, I deposed an area manager of one of the lenders that has been mentioned as a responsible lender within the subprime field. And I said, by the way, can I open the paper and see what your rates are this week? And he says, oh, no, you cannot do that. I said, why is that? Well, subprime lenders do not do that.

Nothing is really the way that we assume it. Brokers that we assume are representing lenders are not representing lenders. They are representing themselves. In fact, they are being rewarded for upselling their own customers.

Applications that we assume are being signed at sometime early on in the process are routinely signed at the closing. You are signing an application at the same time you are signing the mortgage.

And that is done every day. I do not think I have seen a transaction where the application was signed prior to the closing. Everything about this market is different than the notions that we come to the table with, having bought houses ourselves, for example.

Senator CORZINE. But are there lessons to be learned from the "A" market that we ought to be applying to the subprime market, since it works efficiently and relatively securely for the consumer?

Mr. WALLACE. Senator, one of the things to remember is that Fannie Mae and Freddie Mac have withdrawn from the HOEPA

market entirely. Thus, whatever encouragement they could give to standardization does not occur. And if the HOEPA thresholds are lower, presumably they will continue to withdraw from the HOEPA market. They are concerned about risks. They are concerned about the additional liability, I guess, with regard to that kind of paper. But there is something which you could address perhaps with regard to the secondary market, particularly the Government-financed entities not being interested in dealing with subprime paper.

Chairman SARBANES. I understand, though, that 70 percent of the subprime market is what are called "A"-minus loans. And therefore there is a real opportunity, which I gather some institutions are now undertaking to upgrade people into "A" loans. That seems to me a very worthwhile endeavor. And it also seems to me that we need to consider carefully what measures or how you can encourage just graduating people up.

And I am told that there are a fair number of people who are getting subprime loans who really could get prime loans. But it is not happening. Is that correct?

I am sorry, John. I did not mean to interrupt your questioning.

Senator CORZINE. No, no, no. I believe it is going in the same direction here.

Mr. BERENBAUM. There is no question. And what we are dealing with is a blend of civil rights issues, Fair Housing Act issues, as well as consumer issues, whether they be fraud or issues relevant to the subprime market.

There is a new player in town, though. And I would agree with any thought that, in fact, the entry of Fannie Mae and Freddie Mac into the "A"-minus market has been corrected. It absolutely has been. We wish it would have been sooner. Who is the new player in town? It is Wall Street. Who is funding the growth? It is private investors? Who is specializing?

We heard about specialty lenders. Well, these specialty lenders better start developing prime paper because right now, I believe under existing law, they are facing civil rights liability if they do not give an American the loan they are qualified for. And that is what is happening here. The greed factor, as has been mentioned, is playing a role in our financial transactions today.

And yesterday, there were references made to in the old times or in the days when we did things by hand. We are still doing things by hand. There are decisions being made by executives today with underwriting practices and points and how to use credit in a way that is greedy, manipulative, and not covered by law.

And these working-the-law situations are creating the scams. There are responsible subprime lenders and then there are ones who are making mistakes because they are not thinking through their decisions, and then there are predators.

Senator CORZINE. Mr. Fendly, where do you think the regulatory world should actually meet the mortgage broker?

We know the Federal Reserve, the FDIC, and others review the balance sheets and practices of the banking industry. Our thrift industry has a regulator where the public meets creditor. Where would you think, and how would that best be applied in the mortgage brokering business?

Mr. FENDLY. Well, obviously, we should have the same standards applied to us as any other lender would or any other originator would. The only problem is that an awful lot of mortgage brokers are extraordinarily small business people. The majority of them employ less than five people. And I do not think a financial yardstick is what you want to use to analyze their credibility in the marketplace.

When I was talking about mortgage reform and people were talking about the good-faith estimate, that is part of the whole process and should apply across the board to all lenders, all originators, so that people have concise information. The system now encourages fraud and it actually is an uneven playing field for honest businessmen who cannot compete against false good-faith estimates that are changed at closing. That is what we are looking for, is clarity, bright lines, and accountability.

Chairman SARBANES. That is an interesting point because it seems to me that if we find ways of eliminating these bad practices, it is to the benefit of the responsible people in the industry.

And it seems to me that the responsible people, instead of resisting this effort, ought to be supporting it. I know they are concerned about how the line is drawn because they are concerned whether it will impinge upon the legitimate activities.

But assuming the line can be drawn properly, they ought to be supporting it because it will knock out what I guess is potentially an unfair competitive advantage which the bad actor is able to exploit. I just throw that out there as an observation. Go ahead, Jon. I am sorry.

Senator CORZINE. Again, who challenges it? State banking regulators? Is that who is looking at most of the mortgage brokers?

Or is there anyone who looks at their practices? Or is it just voluntary?

Mr. FENDLY. It depends on what kind of business that they do. Most of them have State regulators.

In my particular State, you are audited every 2 to 3 years on all fronts. If you have an entity that is an FHA correspondent, they have to provide a HUD-approved audited financial statement each year. Those individuals that are very small, they are just dealing with their own State regulatory agencies.

Senator CORZINE. And do many of them have audits on their practices, their business and market practices?

Mr. FENDLY. Yes, they do.

Mr. ACKELSBERG. Senator Corzine, I actually would have to disagree with that. Just to use my experience from Pennsylvania, it has been said by many people there that in Pennsylvania, it is easier to get a broker's license than a fishing license. The only difference is that there actually is enforcement from the Fish and Game Commission to make sure that the laws are being enforced.

In our experience, in that one State, as a practical matter, no enforcement. And we sent lots of complaints. They did finally manage, as I understand, to pull the license of someone who had plead guilty to stealing from 16 of his customers. But to the others, for example, the ones where we had a fraud judgment unpaid, that did not seem to rise to the level of regulatory interest.

Senator CORZINE. Mr. Courson.

Mr. COURSON. Senator, I believe that is one of the points that we made.

I would agree. Where is the enforcement? Because it is besmirching our industry, my company, and other lenders like me, if we do not get the enforcement.

And so, I think what the gentleman just said is exactly correct. We have to have the enforcement. If we have the licensing out there and do not enforce it, then there is no reason to have it.

It is very disheartening in our business to find the bad actors who even have actions taken against them, showing up in other companies under other names and other venues, propounding the same practices for which they were eliminated from a different venue. It makes no sense. We have to have that enforcement level.

Senator CORZINE. I do not mean to—please. Go ahead.

Ms. WILLIAMS. I just wanted to add a comment.

Earlier you had made mention of "A"-minus borrowers and opportunities there.

Some credit unions have programs in place now where if the borrower, an "A"-minus or "B"-minus, pays the mortgage as agreed for 1 year, then the rate could be adjusted. That may be something that could be beneficial. It not only encourages the consumer to get on a good plan of making payments on time, but it also offers them long-term relief for paying more for that mortgage.

Now I have had instances where my members have actually said they were told they could get a 12 percent first mortgage now. If they paid as agreed for a year, that mortgage rate could be decreased. Only to find out after a year that their mortgage had been sold to another company and all bets were off.

So that may be a good option to consider, a way to have an option for a consumer to actually pay at a subprime rate temporarily, for a limited amount of time, and then have that rate decreased without a lot of penalties attached to having that done.

Chairman SARBANES. Jon, we were so engrossed here, I do not think we noticed it, but there is another vote on. I am going to have to again recess the hearing in order to vote. I am sure the panel appreciates, we have no control over this process. Actually, those lights and bells go off, Pavlov should have done his experiments here in the Congress.

[Laughter.]

We will return very promptly and then we will try to draw it to a close because I know that people have conflicting engagements.

We will stand in recess.

[Recess.]

Chairman SARBANES. The hearing will resume. And I am hopeful that we will have enough time here to complete. I do not want to hold up the panel unduly.

Mr. Ackelsberg, I want to put a question to you off of something that Mr. Shea said, where he said, the recent increases in homeownership are not from subprime lenders.

Now you have some very interesting material in the opening part of your statement, which, of course, because of the truncated time, you did not present orally. But we should to just touch on that a little bit because lots of assertions are made about this subprime market and what it permits or what it allows that we would regard

as desirable. And of course, we regard homeownership as desirable in every instance in which it really can be warranted. Could you just touch on some of that?

Mr. ACKELSBERG. Yes. As we mentioned in the written testimony, you have homeownership increasing by 2 percent during a period of time that, for example, foreclosures are——

Chairman SARBANES. What is that period of time?

Mr. ACKELSBERG.I believe the table is 1980 to 1999,

Chairman SARBANES. What?

Mr. ACKELSBERG. The period of 1980 to 1999.

Chairman SARBANES. Okay. And it is during that period, of course, more in the 1990's, when the amount of subprime lending increased at a very rapid rate. Is that correct?

Mr. ACKELSBERG. Absolutely, Senator. We attribute that to a number of factors, one being, as I mentioned in my testimony, the Federal policy favoring first-lien mortgage lending, the deregulation of usury for first-lien mortgage lending, basically encouraging lenders to turn—the typical example that we see is someone, for example, wants $5,000 to fix their kitchen. And what instead they get is a $30,000 loan that pays off all their debt, which they did not need being paid off at all. And it is precisely the Federal preemption of usury—the Federal deregulation of State usury laws for first-lien lending that has made that possible.

The other thing I would say, as I mentioned, is the change in the tax laws to favor home equity lending. And finally, the market forces of Wall Street securitizations which have really made this a very profitable enterprise.

Chairman SARBANES. This Figure 1 you have in your statement.

Mr. ACKELSBERG. Yes. It is data from the Mortgage Bankers Association.

Chairman SARBANES. Where you say the sources are the Mortgage Bankers Association.

You should show Mr. Courson this, too.

[Laughter.]

Chairman SARBANES. Is the figure from the Mortgage Bankers or—yes. Is the chart or just the numbers that enabled you to make up the chart?

Mr. ACKELSBERG. No, it is the numbers. Actually, I am not entirely sure. Senator, my understanding is that it is just the numbers that were then put into this chart.

Chairman SARBANES. The graphic form. All right. Now, let me run through these. You say over this period, there was a 2 percent growth in the homeownership rate. Is that correct?

Mr. ACKELSBERG. Yes.

Chairman SARBANES. Then there was a 29 percent growth in mortgages per home. What do you mean by that?

Mr. ACKELSBERG. Well, as it has become more and more attractive in the market for people to use their homes when they are borrowing money, what you have is more and more people doing that.

For example, many people—and I would say primarily in the "A"-borrower kind of universe—we will have a mortgage and then we will also have a home equity credit line. So, it has become very common for people basically to use their homes to access credit.

Chairman SARBANES. And then you have foreclosures per mortgage. That growth was 120 percent.

Mr. ACKELSBERG. Yes.

Chairman SARBANES. What is the significance of that?

Mr. ACKELSBERG. Well, I would also, particularly in the 1990's, add an additional overlay, which is these have basically been good times. You would expect in good times to see foreclosures going down. In Philadelphia, we have seen foreclosures tripling during a period where jobs were actually on the upswing. And we attribute that to the radical change in the nature of mortgage lending, that loans are being made in a fashion that they were never made before.

Chairman SARBANES. And then foreclosures per home went up 184 percent over this period.

Mr. ACKELSBERG. That is correct.

Chairman SARBANES. Meaning, what?

Mr. ACKELSBERG. That is just the ratio. Basically, it is just another way of saying that the foreclosure rate has really exploded during this period of time.

Chairman SARBANES. As I understand it, from this footnote, this understates the problem because this says the data of mortgages and foreclosure at the end of each period studied comes from 130 different lenders and is representatives of approximately one-half of the mortgages in existence.

These numbers are actually grossly undercounted because the foreclosures of mortgages made by finance companies are not included in the statistics compiled by the Mortgage Bankers Association of America, which provides the raw data for the census statistics. Also, foreclosure statistics do not include homeowners who simply turn their home over to the lender to avoid foreclosure. Actually, as bad as this sounds as we run through these figures, the problem is actually worse than that.

Mr. ACKELSBERG. I would spin that another way. You could do the same thing with default and delinquency numbers, Senator. For example, I have looked at default and delinquency numbers, which are very high for some of these lenders. I did a lot of litigation against United Companies Lending that had 15 percent default and delinquency rates. But that radically really underestimates the problem if you are comparing it to an ordinary lender because you are looking at a portfolio that, on average, in that particular example was had loans 18 months old.

When you look at a subprime portfolio that is relatively unseasoned—that is the term, I believe—an unseasoned portfolio, and you see rates that are—even if they are similar and they are far higher than you see in the prime market, you are understating it because you are not talking about a portfolio that has loans as much as 20 years old or 30 years old in that portfolio. You are talking about loans that are 1 year, 2 years, 3 years, often at the most.

Chairman SARBANES. Yes. But aren't some of these lenders, the bad actors, they are making these loans with the purpose of foreclosing and getting the house and taking the equity?

Mr. ACKELSBERG. I think in some cases, that is true. I believe it is more accurate to say that they do not really care one way or the other. It is probably closer to the truth to say, they are making

these loans with the intent of selling them very quickly. And the more points that they can load into those loans, the more revenue they can generate very quickly.

I think that what it is is basically, the loans are being originated by lenders who have no accountability regarding the performance of the loans. They do not really care one way or the other how the loan performs, as long as there is a market out there to buy it from them. And unfortunately, the market is booming, largely fueled, I believe, by Wall Street securitization.

I am convinced that the ultimate consumer in this whole mess is not Ms. Mackey, with her mortgage. The ultimate consumer is my retirement fund, your retirement fund. It is the mutual funds insurance companies that decided, for whatever reason, and that these were good investments.

And they have been layered with layer upon layer of credit enhancements, so the investors really feel like they are not at risk at all, whether it is the insurance on the securitization, whether it is the subordinization structure built into the instrument.

It is very complicated. But in the end, you could look at it as a very sophisticated laundering of money, where the ultimate consumer really has no responsibility for what is going on. In fact, there are law review articles built on—one that I found very enlightening was called "The End of Liability." This is all about structuring things so that no one is responsible for what they are doing.

Chairman SARBANES. Let me ask—and I really throw this open to the panel. This is the joint report of the U.S. Department of the Treasury and the U.S. Department of Housing and Urban Development, which was issued just about a year ago, entitled: "Curbing Predatory Home Mortgage Lending."

I obviously found it a very interesting report and we intend to make heavy use of it. In this report, they have a section discussing mandatory arbitration. And this is what they say, and I would like to get the reaction of the panel to this. In policy recommendations, after they have a discussion of what is the problem, challenges for reform, and so forth.

Prohibit mandatory arbitration for high-cost loans. The most vulnerable borrowers in the subprime market may be the least likely to understand adequately the implications of agreeing to mandatory arbitration. Since they may also be the most likely borrowers to default or be foreclosed upon, it is especially important that they retain the rights afforded them under Federal fair lending and consumer protection laws.

In the high-cost loan market, the difference in bargaining power between lenders and borrowers is particularly acute, making predispute mandatory arbitration an unwise option for these consumers. And I would like to get people's reaction to that.

Ms. CANJA. I will respond to that. In fact, AARP goes even farther. We do not believe that there should be mandatory arbitration in any consumer protection laws because you cannot have a level playing field. You have the very vulnerable people who do not have the experience, they do not have the information. They certainly do not have the resources.

All of those things are all centered on the other side. It certainly is even more apparent and they are even more vulnerable in this

very complex issue of mortgage lending. So, we definitely would support that there should not be mandatory arbitration.

Chairman SARBANES. Yes.

Mr. HENDERSON. Mr. Chairman, the Leadership Conference on Civil Rights, and I think I speak here for the vast majority of organizations in the civil rights community, would strongly support the recommendation of the Treasury report in that regard.

Mandatory arbitration of the kind that we are discussing this morning is a fundamental violation of the right of individuals to protect their own interests by going to court when necessary to litigate issues like those that we are discussing today, particularly where the unequal relationship and power between the consumer and the lending institution is as stark as we see it here, and where the regulatory scheme of protection that exists both at the Federal level and at the State level, is inadequate to protect their interests.

What we are seeing with these loans is that you are forced into an arbitration system. You are in an unequal bargaining position. As a general matter, you do not fully understand the terms and conditions of the loan, particularly in contrast with the lender. You do not have adequate protections at the Federal level. You do not have adequate protections at the State level. And now we are taking the courts away from you to protect fundamental rights. It is an injustice. It needs to be corrected.

Mr. ACKELSBERG. I would also add that the one obvious way that Congress, when it passes law, can see how the laws are functioning is to read the cases that come out of the Federal courts.

You understand, I assume, that these are basically secret proceedings. There is no opinion. Nothing is public. And therefore, there is really no accountability whatsoever for how the laws that this body passes actually are getting enforced.

Mr. BERENBAUM. I would concur with the other consumer advocacy groups, and just add a slightly different wrinkle to it. We have compliance arrangements and I have also served as a consultant to many realtor and real estate companies. What I see is a growing trend of realtors to bring matters forward where they are so concerned about predatory lending impacting on their ability to complete new sales transactions to consummate the deals, and they are frustrated for everyone involved in the transaction—the buyer, the seller, because they see prepayment terms or penalties. It impacts on everyone. And they are frustrated because they see these clauses in the mortgage papers.

Mr. SHEA. Mr. Chairman, if I could add to that. We have found that with our clients who have mandatory arbitration clauses, those serve as a tremendous chilling effect for those clients seeking redress to right wrongs that they feel are in their loans. We found many arbitration clauses, for example, that state that if you lose the arbitration, you have to pay the cost.

Well, if you are a low income person, you are not willing to do that. You are not willing to take that risk often because it could mean the difference between paying the electric bill or not.

Chairman SARBANES. Mr. Wallace.

Mr. WALLACE. If I could speak, I am going to dissent. We found that mandatory arbitration clauses are a substantial benefit to the consumer. It provides a cheap, freely available remedy. What Mr.

Ackelsberg did not point out is that you do get a remedy in the arbitration process. What we are talking about here is whether we are going to have class actions or we are going to have a quick and efficient remedy. The experience with class actions has been, unfortunately, one in which the trial bar is able to earn a fairly good compensation. But in general, the remedies provided to individuals are small.

Chairman SARBANES. But do you think——

Mr. WALLACE. Likewise, most of these cases are fraudulent cases, cases involving fraud. In individual fraud cases, lawyers, individual lawyers, if they are not Legal Aid, find it uneconomic to take the case. In arbitration, a remedy is available. In a class action, you cannot maintain a class action if it is based upon fraud.

So that arbitration provides an important remedy for the consumer. It should be available to consumers and restricting the availability of it certainly raises operating costs and does not necessarily provide a good remedy.

Chairman SARBANES. Well, now, when you say it should be available to the consumer, put forward, as it were, on behalf of the consumer, what would be your reaction to having voluntary arbitration clauses instead of mandatory, so that the consumer, if they made the judgment that agreed with the rationale you have just laid out, could choose to go to arbitration. But if the consumer did not, they would not be precluded or denied their opportunity to go to court. What I referenced were mandatory arbitration clauses.

Mr. WALLACE. Yes, and I was addressing mandatory arbitration as well.

Chairman SARBANES. Oh, you were. Now why? On the rationale you just gave me, why wouldn't you be accepting of having voluntary arbitration clauses?

Mr. WALLACE. Well, the voluntary arbitration clause is no different from no arbitration clause at all. I can always in litigation agree with the other litigant that I want to go into arbitration. That is the effect of a voluntary arbitration clause. A mandatory arbitration clause is binding on both parties. They should be fair. AFSA's standards require that they be fair. There was a question raised about who pays. That needs to be fairly handled. But, nonetheless, they are an important way of providing the consumer a remedy and they are also an important way of managing the very high costs of class-action strike suits.

Chairman SARBANES. If you go to arbitration, as a consumer, and lose, you should pay the cost of the arbitration?

Mr. WALLACE. That would be a possible way in which these should be structured, yes, sir.

Chairman SARBANES. Well, that is the way it is structured now.

Mr. WALLACE. I am sorry. Maybe I did not hear you correctly.

Chairman SARBANES. Do you believe that if a consumer is required with mandatory arbitration, goes to arbitration and loses, that the cost of the arbitration should then be placed upon the consumer?

Mr. WALLACE. AFSA has standards on it. I do not quite remember what the standards are. But in any event, it seems to me that that ought to be fairly administered. I am not prepared to answer that one way or the other. I think it ought to be done fairly.

Mr. ACKELSBERG. Senator, Mr. Wallace suggested that these are reciprocal obligations taken on both parties.

In fact, most of the arbitration clauses out there say that the lenders can use the courts to foreclose, whereas the borrowers have no access to the courts to enforce their rights.

Chairman SARBANES. That is a very important point.

Mr. HENDERSON. Well, that was my point, Mr. Chairman. I think Mr. Wallace, with all due respect, is being very disingenuous to focus on the interests of consumers when, in fact, the relationship, the unequal bargaining position between consumers and the lender is of such a fundamental nature, that to structure a system that effectively precludes the option of going to court, is to guarantee that the consumer has virtually no protection.

We have established here this morning that the level of regulatory inspection and protection out here is deminimus. And the truth is that State laws and local laws have proven to be woefully inadequate.

And we now have the courts being cut off from consumers who are the most vulnerable and most in need of them. And the idea that trial lawyers are being bashed because they choose to represent individuals and to advance their interests, I think is patently unfair.

I really just want to take issue with the concept that forced, mandatory arbitration is in the consumer's interest. This is a situation where let the buyer beware governs the way in which the market operates. And it is not in the consumer's interest to have that kind of forced arbitration clause.

Chairman SARBANES. Is there anyone at the table who would object to the Fed, in changing the standards to determine a HOEPA loan, so that it would actually reach more loans than are now being reached?

That is under consideration now, as you know. Mr. Wallace made reference to the protections that the people get from a HOEPA loan. But the fact of the matter is that most of these loans that we are talking about are not encompassed within the existing HOEPA standards.

One way to start dealing with this problem, presumably, is to change the standards so that more loans are caught by HOEPA and therefore, gain the protections of HOEPA. And I would like to get the reaction to that. First, is there anyone at the table who objects to that, moving in that direction?

Mr. COURSON. Senator, may I respond to that?

Chairman SARBANES. Sure.

Mr. COURSON. The Fed proposal has, as you are well aware, many different facets to it, several different parts, most of which actually the mortgage bankers, in our comments back and discussions with the Fed, certainly support.

In fact, I know there is an antiflipping provision in there. There is a low-cost loan provision. We have had discussions with them on the pattern and practice provision.

The one place where our comment back to the Fed did take issue was, as I will refer to it, the dropping of the triggers or the change of the points and fees test. And our concern was one that we voiced in our testimony before, is one that many lenders, when HOEPA

first was originated, made a decision that as part of their products and loans that they would make available to consumers, not to make HOEPA loans. That was a decision they made.

The concern is, as we drop the triggers, both rates and fees, that there will be more lenders, or those same lenders will actually now not serve another tranche of borrowers that they perhaps probably today are serving. In addition to that, in the secondary market, and we heard about the GSE's being unavailable for HOEPA loans, as we continue to drop those triggers, to that tranche of loans or additional borrowers, if you will, who will be eliminated from the GSE programs.

We have some concerns about that. And we are concerned in that we think that the triggers, *per se,* will not necessarily solve the abusive practices, that is, the enforcement and the education we have talked about that solves that issue. And we are concerned that just moving the terms and conditions of a loan down, which may, in fact, have the effects I have already discussed, will also not eradicate the predatory practices we are trying to solve.

Mr. BERENBAUM. Senator Sarbanes, if I may, I would like to respectfully disagree with the earlier remarks. We think that the points issue and other fees issues being addressed by the Fed do not go far enough. And we think HUD's recommendation in this area should be supported.

Taking it a step further, we believe that the Home Mortgage Disclosure Act should be amended to capture these issues in the reporting, so that we will have indicators, a report card, so to speak, on these subprime issues, which will actually aid the Fed in its current research on the issue.

The reality is, if you look at larger subprime lenders, responsible lenders today, once you are in their pool of customers, you are part of the territory that they, "farm", to use the industry language itself. They will approach you for a home equity line of credit. They will possibly suggest packing of various products. We need to capture these types of real estate guaranteed and unsecured properties in this HOEPA threshold.

Chairman SARBANES. Mr. Wallace.

Mr. WALLACE. Yes, sir. In general, our view is that if you are trying to get at predatory lending, HOEPA is not the tool to do it. That was what my testimony said and I want to reiterate that.

You have fraudulent practices out there. HOEPA does not address fraudulent practices. We said that in 1994. Experience has proved that to be the case. You have fraud. That is the cause of the predatory practices. That statute is not going to deal with it.

Now whether the Fed should drop the thresholds I think is a question of credit availability. I think that some of the advocates who are here today, perhaps, and at least some of the advocates out in the background would just as soon not have credit so widely available. There is a hostility toward it that is perhaps out there.

If that is the goal, well, then, drop the thresholds because that is the effect that is going to have. We think that is a policy question. We think that is one that the Fed can probably make fairly well because they can see the overall effects.

But we do caution that the basic effect of dropping HOEPA thresholds is that the availability of capital for that type of loan

in the past has become more difficult and we expect that to continue in the future.

Chairman SARBANES. Well, of course, at the extreme, and you have to ascertain what the extreme is, even though you want to make credit available and you want people to have the opportunity, you may say, these terms for making credit available in the real world are so abusive, that it is a mirage that is being made available. The person thinks he is getting credit made available, but the next thing you know, it is all gone, and he is in the pit, so to speak. You have to be careful about that because we all want people to have access to credit. I was very struck by Mr. Henderson's statement at the outset, which I thought was very careful to draw that distinction.

But on the other hand, at some point, you can look at this thing and say, you are packing in so many things and engaged in a whole series of practices here, that this is not making credit available. This is all a flim-flam to take this person to the cleaner's, particularly when you are coming in and refinancing the home where someone has built up to these senior citizens that Ms. Canja talked about, built up their equities in their home, and so forth and so on.

I understand that a number of lenders, including some large subprime lenders, actually are supporting reductions of the HOEPA triggers as the Fed now wrestles with this problem. Does anyone else want to add anything on that point?

Ms. CANJA. I will just add that we also support lowering those triggers because there are so many people that just do not—you saw yesterday, I think, that those are the cases that came within the triggers, but there are so many that do not. And so, we support lowering the trigger.

Mr. ACKELSBERG. Senator, as between the two triggers, the rate trigger and the points and fees trigger, I would say the points and fees trigger is by far the most important.

Now under the current legislation, while the Fed has the ability to lower the rate trigger from 10 to 8, it does not have the ability to lower the points and fees trigger. What it does have is the ability to include more items within the definition of points and fees as they are doing with credit life insurance.

But, again, I would reiterate what I said in my oral testimony, that the proof is really in the pudding, in the empirical record since Congress passed HOEPA, which is in fact, we are not seeing less loans. We are seeing less costly loans, precisely as was said, because many lenders are just choosing not to make HOEPA loans because they do not want to have the liability attached to it.

So while, theoretically, you might get to the point where you could take the triggers so low, that you would in fact have an impact on credit, we are certainly far away from that.

When you have lenders making loans at seven points, I do not think there is any economic argument to say that is connected to any aspect of credit access or risk or anything else, other than gouging.

Mr. BERENBAUM. Mr. Eakes' testimony yesterday was extremely probative of the North Carolina experience.

Chairman SARBANES. Yes, I was just going to refer to the North Carolina case. Mr. Courson, let me ask you this question. You

spoke earlier about you are considering an initiative where you would guarantee the fees ahead of time.

You provide people with information about the fees and charges and they would be told, guaranteed that is what they would be at closing. Is that correct?

Mr. COURSON. Yes, sir.

Chairman SARBANES. Now, do you do the same thing for the interest rate?

Mr. COURSON. No sir. On the interest rate issue, it is a two-part process.

Chairman SARBANES. Yes.

Mr. COURSON. At the time of the application, the closing costs would, of course, be guaranteed, the lender's cost of making that loan.

The consumer has a couple of choices, as they do today, to deal with an interest rate. Obviously, interest rates are a very dynamic market. We spent a year arguing and discussing this back and forth as to how you would deal with the interest rate.

Today, as we would under our proposal, a consumer can choose, in fact, to select and, if you will, lock-in or guarantee an interest rate that exists, or they can continue to float.

Our proposal would say, then, once credit is off the table—we have an application. We have a guarantee of the closing costs. Once the credit decision has been made, the lender now has approved the loan, that is the point at which the customer, and now the lender, knowing what they have in terms of risk, product, and so on, can give to the customer the right to accept a guaranteed interest rate, in addition to the guaranteed closing costs, which would be the same because, of course, those costs are fixed to the type of loan, as opposed to the dynamic moving of the money markets.

There would be the second point in the process where the consumer would get the same disclosure they received initially, and this time it would be completed in that it would guarantee an interest rate and points, if they choose to take it. Some may not choose to take it at that point and continue to move with the market, and some of us think that we are smarter than the markets out there, so we float.

But there would be that opportunity at the time of the credit approval for them to accept that guaranteed rate. And then that would be the rate that would be guaranteed when the loan moved on to the closing process.

Chairman SARBANES. Does anyone have any reaction to that, anyone else at the table, about that process?

Mr. BERENBAUM. Again, if the consumer was afforded the choice, the way the consumer should be, the way we all expect to be, that would be fine. The reality is the consumer is not being afforded that choice in our system right now, and there is a need for a correction.

Chairman SARBANES. Well, all of you have been very generous with your time and we appreciate the statements. I think we should draw this to a close. We have been here now for quite sometime. Let me ask this, though. Is there anyone at the table who wanted to give an answer to a question that was not asked?

[Laughter.]

Or get in that last response to something that someone else said. I am going to give you this opportunity so you do not walk away feeling frustrated from this hearing. Does anyone want to—yes, Mr. Shea.

Mr. SHEA. Mr. Chairman, I would just like to make one final point, and that has to do with the reliability of so-called risk-based pricing. I think most people at this table would say that if you could come up with a scheme that would adequately price a person's real risk, that that would be legitimate.

The problem is we too often times see that there is various schemes that are being used to judge a person's risk and they vary tremendously. I have a credit report here from one of our clients. It is a triple-merge credit report. It contains three credit scores. Remember, currently, 620 to 660 is considered a prime "A" lender cutoff, from there and above.

This person has three credit scores on here, one from Fair Issacs is a 505. D, very high risk. It is going to be a high interest rate loan for this person for most lenders. The second one has a credit score of 565 for the same person. The third one has a credit score of 658 for the same person.

This is an inexact science we are dealing with. This is a client, by the way, that made their home payments on time every month for 2 years, and they still have this wide variety of credit scores.

So the subprime industry is an inexact world right now and people get caught up with it and they get trapped in it, which is why many of the features that have been discussed here today, like arbitration clauses, prepayment payments that are lengthy, need to be eliminated.

Chairman SARBANES. Thank you. Anyone else? Mr. Wallace.

Mr. WALLACE. Yes, sir. I just wanted to make one point. There was a discussion between yourself and Mr. Berenbaum about North Carolina. We have studied, and I believe it was mentioned yesterday, we have studied North Carolina. Our data ended 6 months after the North Carolina legislation went in.

We found a very major decrease in subprime loan volume occurring amongst our members, very spectacular. Most lower-income people, people below $50,000. I want to point that out to you. Mr. Eakes, I understand, does not agree with that. I was not here yesterday. But I understand that he does not agree with that.

Chairman SARBANES. No. Mr. Eakes made the point that was one of the objectives of the legislation. Namely, that, as I understand it, some 80 percent of these loans are for refinancing. Is that correct?

Mr. WALLACE. I will take your word for it, sir.

Chairman SARBANES. All right. He said that one of the things that they were trying to get at in passing the legislation was to decrease or reduce the amount of refinancing that was taking place by low income people because it was perceived that was being used to simply strip them of their equity in their home, which, of course, was two of the very poignant examples that were presented to the Committee yesterday.

It is a complicated relationship, and we need to analyze the figures very carefully. But they are subject to a different interpreta-

tion and a different conclusion. And he was very forceful in making that point.

Mr. WALLACE. I understand the point and we can all make value judgments about the basic point.

But if the goal of legislation is to reduce credit availability, that would be an enormous change in the policy of this country, which has been to increase credit availability.

Chairman SARBANES. No, the goal is to prevent abusive practices. That is the goal.

Mr. WALLACE. Yes.

Chairman SARBANES. And I do not accept that in order to get the maximum credit availability, you are going to accept grossly abusive practices. The system ought to be able to do better than that. I mean, America ought to have a better performance standard than that, it seems to me.

Mr. WALLACE. Well, of course. And we all agree with that.

Mr. BERENBAUM. Senator Sarbanes, yesterday, the Home Mortgage Disclosure Act data for 2000 was issued. It is brand new raw data that I am sure everyone at the table is analyzing.

But you should be aware that, unfortunately, last year, there was a 16 percent drop across the board in both prime and subprime lending, loan origination. I am afraid there are issues of our economy, as much as many other issues, impacting on this discussion.

Mr. WALLACE. This was actually compared to two adjacent States and the effect did not occur in the other States.

There is one other point. I would like to commend ACORN in their statement. They indicated that they are somewhat reluctant to see local ordinances dealing with subprime issues and predatory issues. We agree with that point of view.

Mr. SHEA. Whoa. That is taken way out of context.

[Laughter.]

You just got me on that.

Mr. WALLACE. I thought we all agreed together on that.

[Laughter.]

Chairman SARBANES. Why don't you put it in context, Mr. Shea?

[Laughter.]

I think we understand the context.

Mr. SHEA. I think you do.

Chairman SARBANES. Let me say on that point because it is one that runs through a number of issues, I understand the industry argument that they operate nationwide and in 50 States and, therefore, 50 different standards are difficult for them to meet and present administrative problems. Therefore, they constantly are referencing Federal preemption.

But it seems clear to me that if you start to entertain Federal preemption, intimately interrelated with that question is the question of the substantive protections that would be provided under the Federal standard.

The notion of preemption at an inadequate Federal standard I find totally unacceptable. I think that needs to be understood upfront. You really have to address at the same time the question of the standard and how adequately that deals with the problem and protects the consumer.

Otherwise, it seems to me, there is no basis to deal the States out of the picture. Now many of the States feel strongly that they should not be dealt out of the picture in any event. And given that we have a Federal system and the role of the States in our system, that is not a minor question. That is a very important question that would have to be looked at. But the notion that they should be dealt out with a standard that is inadequate to deal with the problem, is seems to me is a complete nonstarter. And I just thought that I would lay that out as we draw the hearing to a close.

Thank you all very much for coming. We really appreciate it.

The hearing is adjourned.

[Whereupon, at 1:15 p.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR PAUL S. SARBANES

Today is the Committee's second hearing on Predatory Lending: The Problem, Impact, and Responses. Yesterday, we heard some very eloquent statements of the problem from four Americans who worked all their lives to attain the dream of homeownership, to build a little wealth, only to have it slowly, bit-by-bit, loan-by-loan, taken away from them.

These people were targeted by unscrupulous lenders because they were elderly homeowners that had a lot of equity in their homes. In the case of one woman from West Virginia, she owned her home free and clear, paid off her mortgage with the proceeds of her husband's life insurance policy, only to end up losing her home altogether because of a series of six or seven flips in the space of less than 2 years.

What struck me about these four stories was that many of the practices that harmed these witnesses—the repeated flipping of the loans, the high points and fees rolled into the loan, and the mandatory arbitration clauses that kept some of them from effectively pursuing a legal remedy—are all legal.

Let me reiterate what I said yesterday. I support actions by regulators to utilize their authority under existing law to expand protections against predatory lending. I support stronger enforcement of current protections by the Federal Trade Commission and other regulators. I applaud campaigns to increase financial literacy and industry efforts to establish best practices. I know a number of witnesses at this morning's hearing will tell us about such efforts.

But those who take the position that stronger regulatory and/or more aggressive enforcement of existing laws will be adequate have a special burden, particularly in light of yesterday's testimony, to make sure that regulatory and enforcement tools are adequate to the job.

To that end, in my view, they should support the Federal Reserve Board's proposed regulation on HOEPA, as Ameriquest has done. They should support the Fed's effort to gather additional information through an expanded HMDA.

And they should support the regulatory and enforcement agencies such as the FTC, the Treasury, and HUD in their recommendations for more effective enforcement. I sincerely hope that today's witnesses will take these positions.

But I want to be clear: neither stronger enforcement, nor literacy campaigns, nor best practices are enough. Too many of the practices we heard about in yesterday's testimony, while extremely harmful and abusive, are legal. And while we must aggressively pursue financial education, we must also recognize that education takes time to be effective, and thousands of people are being hurt every day.

As I did yesterday, I want to recount what Fed Governor Roger Ferguson said in his confirmation hearing: "legislation, careful regulation, and education are all components of the response to these emerging consumer concerns." I ascribe to that view.

Before turning to my colleagues and the witnesses, I want to take a moment to explain that we have had far more requests to testify than we have openings, as I think the tightly packed witness table makes abundantly clear.

We have offered to include statements from these and other organizations in the record of today's hearing.

PREPARED STATEMENT OF SENATOR DEBBIE STABENOW

Mr. Chairman, I am glad to be back for a second day of hearings on the problem of unscrupulous lending practices in the subprime market. Yesterday was a moving and important opportunity to hear from victims of predatory lending. The story of Carol Mackey from Michigan as well as the other hard working people on our panel of predatory lending victims illustrates clearly why we need to act on this problem.

It is my sincere hope that something can be done to rectify the untenable situation these citizens find themselves in. I think that would be an important step by key participants in this debate over predatory lending. Obviously, however, fixing these four terrible lending situations will not address the problems that thousands of other consumers have encountered while trying to get a loan, but it is a start.

Mr. Chairman, speaking of a positive step forward, I should take a moment to note the decisions, over the last few weeks, by some of the major lenders. As many of my colleagues on the Committee pointed out yesterday, the recent decision by some companies to stop selling single-premium credit insurance was significant and a positive step in the right direction.

I have had serious reservations about this product and fear that it is usually not in the best interests of consumers. I am glad to see companies are responding to these concerns; their actions are responsible and appreciated.

Today, we are going to hear from an array of spokespeople representing the civil rights community, consumer interests, seniors, low-income families, as well as some representatives from the subprime industry. I welcome all of them to the discussion we are having here and I know many of them have worked very hard on this issue in different capacities for quite some time.

I am sure that their expertise and differing perspectives will be extremely helpful to our Committee—especially because the issues before us are complex and different parties have different ideas about how to stop predatory lending.

In the months ahead, we are going to have to grapple with such issues as loan flipping, mandatory arbitration disclosures, prepayment penalties, the definition of a "high-cost" loan, the role of regulation, and effective ways of promoting financial education—to name just a few.

In the midst of this forthcoming discussion, working through the details and debating the policy merits of different proposals, I hope we keep in mind what this entire discussion is about. I said it yesterday, and I will say it again today: this discussion is about homeownership and the right for people to build a secure future for themselves and their families. And, as we heard so vividly yesterday, it is about people like Carol Mackey, Mary Ann Podelco, Paul Satriano, and Leroy Williams.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF WADE HENDERSON

EXECUTIVE DIRECTOR, LEADERSHIP CONFERENCE ON CIVIL RIGHTS

JULY 27, 2001

Mr. Chairman and Members of the Committee, I am Wade Henderson, Executive Director of the Leadership Conference on Civil Rights. I am pleased to appear before you today on behalf of the Leadership Conference to discuss the very pressing issue of predatory lending in America.

The Leadership Conference on Civil Rights (LCCR) is the Nation's oldest and most diverse coalition of civil rights organizations. Founded in 1950 by Arnold Aronson, A. Philip Randolph, and Roy Wilkins, LCCR works in support of policies that further the goal of equality under law. To that end, we promote the passage of, and monitor the implementation of, the Nation's landmark civil rights laws. Today the LCCR consists of over 180 organizations representing persons of color, women, children, organized labor, persons with disabilities, the elderly, gays and lesbians, and major religious groups. It is a privilege to represent the civil rights community in addressing the Committee today.

Predatory Lending Is A Civil Rights Issue

Some may wonder why the issue of predatory lending raises civil rights issues, but I think the answer is quite clear.

Shelter, of course, is a basic human need—and homeownership is a basic key to financial viability. While more Americans own their homes today than any time in our history, minorities and others who historically have been underserved by the lending industry still suffer from a significant homeownership gap.

The minority homeownership rate climbed to a record-high 48.8 percent in the second quarter of 2001, Housing and Urban Development Secretary Mel Martinez said yesterday. About 13.2 million minority families owned homes in this period, up from 47.6 percent in the same quarter last year, HUD said. However, the rate for minorities still lagged behind the overall homeownership rate in the second quarter this year, which, at 67.7 percent, tied a high first set in the third quarter of 2000. Nationally, 72.3 million American families owned their homes.

Unequal homeownership rates cause disparities in wealth since renters have significantly less wealth than homeowners at the same income level. To address wealth disparities in the United States and make opportunities more widespread, it is clear that homeownership rates of minority and low-income families must rise. Increasing homeownership opportunities for these populations is, therefore, central to the civil rights agenda of this country.

Increasingly, however, hard-earned wealth accumulated through owning a home is at significant risk for many Americans. The past several years have witnessed a dramatic rise in harmful home equity lending practices that strip equity from families' homes and wealth from their communities. These predatory lending practices include a broad range of strategies that can target and disproportionately affect vulnerable populations, particularly minority and low-income borrowers, female single-

headed households and the elderly. These practices too often lead minority families to foreclosure and minority neighborhoods to ruin.

Today, predatory lending is one of the greatest threats to families working to achieve financial security. These tactics call for an immediate response to weed out those who engage in or facilitate predatory practices, while allowing legitimate and responsible lenders to continue to provide necessary credit.

As the Committee is aware, however, subprime lending is not synonymous with predatory lending. Moreover, I would ask you to remain mindful of the need for legitimate "subprime" lending. We should be careful that it is not adversely impacted by efforts directed at predators.

The subprime lending market has rapidly grown from a $20 billion business in 1993 to a $150 billion business in 1998, and all indications are that it will continue to expand. The enormous growth of subprime lending has created a valuable new source of loans for credit strapped borrowers. Although these loans have helped many in an underserved market, the outcome for an increasing number of consumers has been negative.

On a scale where "A" represents prime, or the best credit rating, the subprime category ranges downward from "A"-minus to "B," "C," and "D." Borrowers pay more for subprime mortgages in the form of higher interest rates and fees. Lenders claim this higher consumer price tag is justified because the risk of default is greater than for prime mortgages. Yet even with an increased risk, the industry continues to ring up hefty profits and the number of lenders offering subprime products is growing.

Some have suggested that subprime lending is unnecessary. They contend that if an individual does not have good credit then the individual should not borrow more money. But as we all know, life is never that simple. Even hard working, good people can have impaired credit, and even individuals with impaired credit have financial needs. They should not be doomed to a financial caste system, one that both stigmatizes and permanently defines their financial status as less than "A."

Until a decade ago, consumers with blemishes on their credit record faced little hope of finding a new mortgage or refinancing an existing one at reasonable rates. Without legitimate subprime loans, those experiencing temporary financial difficulties could lose their homes and even sink further into red ink or even bankruptcy.

Moreover, too many communities continue to be left behind despite the record economic boom. Many communities were "redlined," when the Nation's leading financial institutions either ignored or abandoned inner city and rural neighborhoods. And, regrettably, as I discussed earlier, predators are filling that void—the payday loan sharks; the check-cashing outlets; and the infamous finance companies.

Clearly there is a need for better access to credit at reasonable rates, and legitimate subprime lending serves this market. I feel strongly that legitimate subprime lending must continue. I am concerned that if subprime lending is eliminated, we will go back to the days when the only source of money available to many inner-city residents was from finance companies, whose rates are often higher than even predatory mortgage lenders. It was not long ago that these loan sharks walked through neighborhoods on Fridays and Saturdays collecting their payments on a weekly basis and raising havoc for many families. We do not want to see this again. However, predatory lending is never acceptable, and it must be eradicated at all costs.

Believing that there may have been an opportunity for a voluntary response to the predatory lending crisis, several national leaders within the prime and subprime lending industry, as well as the secondary market, came together last year with civil rights, housing, and community advocates in an attempt to synthesize a common set of "best practices" and self policing guidelines. Although the group achieved consensus on a number of the guidelines, several tough issues remained unresolved. These points of controversy surrounded such issues as prepayment penalties, credit life insurance, and loan terms and fees, which go to the very essence of the practice by contributing to the equity stripping that can cause homeowners to lose the wealth they spend a lifetime building. In the end, we failed to achieve a consensus within our working group largely because industry representatives believed they could be insulated politically from mandatory compliance of Federal legislation.

Given the industry's general reluctance to grapple with these tough issues on a voluntary basis, it seems clear that only a mandatory approach will result in a significant reduction in predatory lending practices.

Direct Action Has Led to Changes, But More Is Needed

At the outset, I think it is important to recognize that many persons and organizations have been actively combating predatory lending practices, and with some success. I give credit to Maude Hurd and her colleagues at ACORN who have been able to persuade certain lenders to eliminate products like single-premium credit life

insurance. I think Martin Eakes of Self-Help, who testified before the Committee yesterday, should also be recognized for his efforts in crafting a comprehensive legislative package in North Carolina, the first such measure among the States. These groups, including the National Community Reinvestment Coalition and others you have heard from in these hearings have forced real change. But they need help.

Recent investigations by Federal and State regulatory enforcement agencies, as well as a series of lawsuits, indicate that lending abuses are both widespread and increasing in number. LCCR is therefore pleased to see that regulators are increasingly targeting their efforts against predatory practices. For example, we note that the Federal Trade Commission (FTC) has taken several actions aimed at predatory actions. These include a lawsuit filed against First Alliance Mortgage that alleges a series of deceptive marketing practices by the company, including a marketing script designed to hide the trust cost of loans to the borrower.

More recently, the FTC filed a comprehensive complaint against the Associates First Capital alleging violations of a variety of laws including the FTC Act, the Truth in Lending Act, and the Equal Credit Opportunity Act. Among other things, the suit claims that Associates made false payment savings claims, packed loans with credit insurance, and engaged in unfair collection activities.

In addition to the activity at the Federal level, various States Attorneys General have also been active in this area and I know the issue is of great concern to them.

Many have observed that certain practices cited as predatory are already prohibited by existing law. I agree, and therefore urge regulatory agencies to step up their efforts to identify and take action against predatory practices. At a minimum, this should include increased efforts to ensure lenders are fully in compliance with HOEPA requirements, particularly the prohibition on lending without regard to repayment ability. In addition, we strongly support continued efforts to combat unfair and deceptive acts and practices by predatory lenders.

State Legislation Has Addressed Some Practices

I think much can be learned from the actions of State legislators and regulatory agencies. At last count, roughly 30 measures to address predatory lending have been proposed and more than a dozen have been enacted. The first of these was the North Carolina statute enacted in July 1999, that Martin Eakes has described to the Committee. Following this statute, a number of other statutes, regulations and ordinances have been adopted, several of which are summarized below.

Connecticut

Connecticut H.B. 6131 was signed into law in May 2001 and is effective on October 1, 2000. The new statute addresses a variety of predatory lending concerns by prohibiting the following provisions in high-cost loan agreements: (i) balloon payments in mortgages with a term of less than 7 years, (ii) negative amortization, (iii) a payment schedule that consolidates more than two periodic payments and pays them in advance from the proceeds; (iv) an increase in the interest rate after default or default charges that are more than 5 percent of the amount in default; (v) unfavorable interest rebate methods; (vi) certain prepayment penalties; (vii) mandatory arbitration clauses or waivers of participation in a class action, and (viii) a call provision allowing the lender, in its sole discretion, to accelerate the indebtedness.

In addition to these prohibitions, the statute addresses certain lending practices by prohibiting: (i) payment to a home improvement contractor from the proceeds of the loan except under certain conditions; (ii) sale or assignment of the loan without notice to the purchaser or assignee that the loan is subject to the Act; (iii) prepaid finance charges (which may include charges on earlier loans by the same lender) that exceed the greater of 5 percent of the principal amount of the loan or $2,000; (iv) certain modification or renewal fees; (v) lending without regard to repayment ability; (vi) advertising payment reductions without also disclosing that a loan may increase the number of monthly debt payments and the aggregate amount paid by the borrower over the term of the loan; (vii) recommending or encouraging default on an existing loan prior; (viii) refinancings that do not provide a benefit to the borrower; (ix) making a loan with an interest rate that is unconscionable, and (x) charging the borrower fees for services that are not actually performed or which are not bona fide and reasonable.

City of Chicago

Chicago's predatory lending ordinance was effective November 13, 2000. It requires an institution wishing to hold city funds to submit a pledge affirming that neither it nor any of its affiliates is or will become a predatory lender, and provides that institutions determined by Chicago Chief Financial Officer or City Comptroller to be predatory lenders are prohibited from being designated as a depository for city

funds and from being awarded city contracts. Cook County also has enacted an ordinance closely modeled to the one in Chicago.

Under the Chicago ordinance, a loan is predatory if its meets an APR or points and fees threshold and contains any of the following: (i) fraudulent or deceptive marketing and sales efforts to sell threshold loans (loan that meets the APR or points and fees threshold to be predatory but does not contain one of the enumerated triggering criteria); (ii) certain prepayment penalties; (iii) certain balloon payments; (iv) loan flipping, that is the refinancing and charging of additional points, charges or other costs within a 24 month period after the refinanced loan was made, unless such refinancing results in a tangible net benefit to the borrower; (v) negative amortization; (vi) financing points and fees in excess of 6 percent of the loan amount; (vii) financing single-premium credit life, credit disability, credit unemployment, or any other life or health insurance, without providing certain disclosures; (viii) lending without due regard for repayment ability; (ix) payment by a lender to a home improvement contractor from the loan proceeds, unless the payment instrument is payable to the borrower or jointly to the borrower and the contractor, or a third-party escrow; (x) payments to home improvement contractors that have been adjudged to have engaged in deceptive practices.

District of Columbia

The District of Columbia has amended its foreclosure law, effective August 31, 2001 or 60 days after the effective date of rules promulgated by the Mayor, to address predatory practices. In summary, the amendment prohibits: (i) making "home loans" unless lenders "reasonably believe" the obligors have the ability to repay the loan; (ii) financing single-premium credit insurance; (iii) refinancings that do not have a reasonable, tangible net benefit to the borrower; (iv) recommending or encouraging default on any existing debt that is being refinanced; (v) making, brokering, or arranging a "home loan" that is based on the inaccurate or improper use of a borrower's credit score and thereby results in a loan with higher fees or interest rates than are usual and customary; (vi) charging unconscionable points, fees, and finance charges on a "home loan"; (vii) post-default interest; (viii) charging fees for services not actually performed or, which are otherwise "unconscionable"; (ix) failing to provide certain disclosures; (ix) requiring waivers of the protections of the Predatory Lending Law; (x) financing certain points and fees on certain refinancings; and (xi) certain balloon payments.

Illinois

The State of Illinois has enacted a predatory lending law that was effective on May 17, 2001. The Illinois law prohibits: (i) certain balloon payments; (ii) negative amortization; (iii) disbursements directly to home improvement contractors; (iv) financing "points and fees," in excess of 6 percent of the total loan amount; (v) charging points and fees on certain refinancings unless the refinancing results in a financial benefit to the borrower; (vi) loan amounts that exceed the value of the property securing the loan plus reasonable closing costs; (vii) certain prepayment penalties; (viii) accepting a fee or charge for a residential mortgage loan application unless there is a reasonable likelihood that a loan commitment will be issued for such loan for the amount, term, rate charges, or other conditions set forth in the loan application and applicable disclosures and documentation, and that the loan has a reasonable likelihood of being repaid by the applicant based on his/her ability to repay; (ix) lending based on unverified income; (x) financing of single-premium credit life, credit disability, credit unemployment, or any other credit life or health insurance; and (xi) fraudulent or deceptive acts or practices in the making of a loan, including deceptive marketing and sales efforts.

In addition, the statute requires lenders to: (i) provide notices regarding homeownership counseling and to forbear from foreclosure when certain counseling steps have been taken; and (ii) report default and foreclosure data to regulators.

Massachusetts

Massachusetts adopted regulations that were effective on March 22, 2001. Those regulations prohibit the following in high-cost loans: (i) certain balloon payments; (ii) negative amortization; (iii) certain advance payments; (iv) post-default interest rates; (v) unfavorable interest rebate calculations; (vi) certain prepayment penalties; (vii) financing points and fees in an amount that exceeds 5 percent of the principal amount of a loan, or of additional proceeds received by the borrower in connection with the refinancing; (viii) charging points and fees on some refinancings; (ix) "packing" of certain insurance products or unrelated goods or services; (x) recommending or encouraging default or further default on loans that are being refinanced; (xi) advertising payment savings without also noting that the "high-cost home loan" will increase both a borrower's aggregate number of monthly debt payments and the ag-

gregate amount paid by a borrower over the term of the "high-cost home loan"; (xii) unconscionable rates and terms; (xiii) charging for services that are not actually performed, or which bear no reasonable relationship to the value of the services actually performed; (xiv) requiring a mandatory arbitration clause or waiver of participation in class actions that is oppressive, unfair, unconscionable, or substantially in derogation of the rights of consumers; (xv) failing to report both favorable and unfavorable payment history of the borrower to a nationally recognized consumer credit bureau at least annually if the creditor regularly reports information to a credit bureau; (xvi) single-premium credit insurance, including credit life, debt cancellation; (xvii) call provisions; and (xviii) modification or deferral fees.

Massachusetts also requires credit counseling for any borrower 60 years of age or more. The counseling must include instruction on high-cost home loans. Other borrowers must receive a notice that credit counseling is available.

New York

In June 2000, the New York State Banking Department adopted Part 41 of the General Regulations of the Banking Board. This regulation, which was effective in the fall of 2000, was designed to protect consumers and the equity they have invested in their homes by prohibiting abusive practices and requiring additional disclosures to consumers. Part 41 sets lower thresholds than the Federal HOEPA statute, covering loans where the APR is greater than 8 or 9 percentage points over U.S. Treasury securities, depending on lien priority, or where the total points and fees exceed either 5 percent of the loan amount.

The regulations prohibit lending without regard to repayment ability and establish a safe harbor for loans where the borrower's total debt to income ratio does not exceed 50 percent. The regulations address "flipping" by only allowing a lender to charge points and fees if 2 years have passed since the last refinancing or on new money that is advanced. The regulations also limit financing of points and fees to a total of 5 percent and require reporting of borrower's credit history. The regulations prohibit (i) "packing" of credit insurance or other products without the informed consent of the borrower; (ii) call provisions that allow lenders to unilaterally terminate loans absent default, sale, or bankruptcy; (iii) negative amortization; (iv) balloon payments within the first 7 years; and (v) oppressive mandatory arbitration clauses.

Finally, Part 41 requires additional disclosures to borrowers, including the statement "The loan which will be offered to you is not necessarily the least expensive loan available to you and you are advised to shop around to determine comparative interest rates, points, and other fees and charges."

Pennsylvania

Pennsylvania has recently enacted predatory lending legislation that prohibits a variety of practices. These include: (i) fraudulent or deceptive acts or practices, including fraudulent or deceptive marketing and sales efforts; (ii) refinancings that do not provide designated benefits to borrowers; (iii) certain balloon payments; (iv) call provisions; (v) post-default interest rates; (vi) negative amortization; (vii) excessive points and fees; (viii) certain advance payments; (ix) modification or deferral fees; (x) certain prepayment penalties; (xi) certain arbitration clauses; (xii) modification or deferral fees; (xiii) certain prepayment penalties; (xiv) lending without home loan counseling; and (xv) lending without due regard to repayment ability.

Texas

Texas has enacted predatory lending prohibitions that are effective on September 1, 2001. Among other things, the Texas law prohibits: (i) certain refinancings that do not result in a lower interest rate and a lower amount of points and fees than the original loan or is a restructure to avoid foreclosure; (ii) certain credit insurance products unless informed consent is obtained from the borrower; (iii) certain balloon payments; (iv) negative amortization; (v) lending without regard to repayment ability; and (vi) certain prepayment penalties.

For certain home loans, the lender must also provide disclosures concerning the availability of credit counseling.

Virginia

Virginia has enacted provisions that are effective July 1, 2001. These provisions prohibit: (i) certain refinancings that do not result in any benefit to the borrower; and (ii) recommending or encouraging a person to default on an existing loan or other debt that is being refinanced.

Federal Legislation Is Necessary

While LCCR commends State and local initiatives in this area, we believe they are clearly not enough. First, State legislation may not be sufficiently comprehensive to reach the full range of objectionable practices. For example, while some State and local initiatives impose restrictions on single-premium credit life insurance, others do not. This, of course, leaves gaps in protection even for citizens in some States that have enacted legislation. Second, while measures have been enacted in some States, the majority of States have not enacted predatory lending legislation. For this reason, LCCR supports the enactment of Federal legislation, of the sort that has been proposed by the Chairman, to fill these gaps.

The Predatory Lending Consumer Protection Act of 2001 contains key protections against the types of abusive practices that have been so devastating to minority and low-income homeowners. They include the following: (i) Restrictions on financing of points and fees for HOEPA loans. The bill restricts a creditor from directly or indirectly financing any portion of the points, fees, or other charges greater than 3 percent of the total sum of the loan, or $600; (ii) Limitation on the payment of prepayment penalties for HOEPA loans. The bill prohibits the lender from imposing prepayment penalties after the initial 24 month period of the loan. During the first 24 months of a loan, prepayment penalties are limited to the difference in the amount of closing costs and fees financed and 3 percent of the total loan amount; and (iii) Limitation on single-premium credit insurance for HOEPA loans. The bill would prohibit the up-front payment or financing of credit life, credit disability, or credit unemployment insurance on a single-premium basis. However, borrowers are free to purchase such insurance with the regular mortgage payment on a periodic basis, provided that it is a separate transaction that can be canceled at any time.

The Leadership Conference strongly supports the Predatory Lending Consumer Protection Act of 2001 and urges its swift enactment.

Conclusion

Let me finish where I began. "Why is subprime lending—why is predatory lending—a civil rights issue?" The answer can be found in America's ongoing search for equal opportunity. After many years of difficult and sometimes bloody struggle, our Nation and the first generation of America's civil rights movement ended legal segregation. However, our work is far from finished. Today's struggle involves making equal opportunity a reality for all. Predatory lending is a cancer on the financial health of our communities. It must be stopped.

Thank you.

PREPARED STATEMENT OF JUDITH A. KENNEDY

PRESIDENT, NATIONAL ASSOCIATION OF AFFORDABLE HOUSING LENDERS

JULY 27, 2001

Good morning. Thank you for the chance to appear before you today. My name is Judith Kennedy. I am President of the National Association of Affordable Housing Lenders, or NAAHL, the national association devoted to supporting private capital investment in low- and moderate-income communities. NAAHL represents 200 organizations, including 85 insured depository institutions and more than 800 individuals. Formed more than 11 years ago, NAAHL's members are the pioneering practitioners of community investment. They include banks, corporations, loan consortia, financial intermediaries, pension funds, foundations, local and national nonprofits, public agencies, and allied professionals.

Ever since NAAHL's 1999 Chicago conference, where we heard about predators' activities in that city, we have been convinced that if we are not part of the solution to predatory lending, we are a part of the problem. It is clear that while we remain committed to increasing the flow of capital into underserved communities, we must be equally concerned about access to capital on appropriate terms.

In March, we sponsored a symposium that brought together experts on this issue: regulators, researchers, advocates, for-profit and nonprofit lenders, and secondary market participants. We were pleased to include as speakers, Martin Eakes of Self-Help, who testified before you yesterday, and Margot Saunders of the National Consumer Law Center. NAAHL's goal was to accelerate progress in stopping the victimization that strips equity from peoples' homes and, all too often, triggers foreclosures. This victimization is not only wrong in itself, but as the Mayor of Chicago succinctly put it: "It is all down the drain if we cannot stabilize the communities that were stable until these foreclosures started to happen."

The symposium was very productive, and today we are releasing the summary of these proceedings which is attached to my statement.[1] Our findings are as follows.

First, a profile of predatory lending emerged. Loan flipping, home improvement scams, asset-based and unaffordable mortgage loans, repetitive financings with no borrower benefit, packing single-premium credit life insurance, and other products into the loan amount, all of these can strip equity and trigger foreclosures.

Second, more needs to be done at the Federal level. More is, of course, being done, and as New York State Banking Commissioner Elizabeth McCaul and Chairman Sarbanes have both emphasized, it is critical to balance the need for credit with the need to end abuses. NAAHL, like many others, has commented on the Federal Reserve's proposals in this area. But as the Federal Reserve has pointed out, a significant amount of mortgage lending is not covered by a Federal framework. For example, Governor Gramlich reported that only about 30 percent of all subprime loans are made by depository institutions that have periodic exams. Even if the Fed were to do periodic compliance exams of the subsidiaries of financial holding companies, that would only increase the percentage to about 40 percent.

It is not surprising, then, that of the 21 completed Federal Trade Commission investigations into fair lending and consumer compliance violations, 19 involved independent mortgage companies and two involved subsidiaries of financial holding companies. None were Federally examined. If the Fed's recent proposal to expand reporting under the Home Mortgage Disclosure Act to more lenders is adopted, it will encompass only those whose mortgage lending exceeds $50 million per year. Many of the proposed changes to HMDA will only create a more uneven playing field by putting additional burden and costs on responsible lenders while the worst lenders go unexamined.

To stop the predators, we need to close the barn doors on examination and reporting. A level playing field in oversight and enforcement is key. Insured Depository Institutions (IDI) engaging in the best practices in the subprime lending market do extensive due diligence of their brokers to ensure fair lending practices. They maintain data on their loans and are rigorously examined by the bank regulatory agencies.

But the majority of lenders are not subject to the same regulatory oversight, do not have the same level of compliance management, and often do not even file HMDA reports. If they do file, there is very little oversight of their disclosure. In a town with no sheriff, the bandits are in charge. Unscrupulous brokers who are rejected by legitimate lenders, simply go to others who have no knowledge of the loan terms, or reputational or compliance concerns about funding predatory loans.

Some States like New York are conducting vigorous exams of their licensed mortgage companies, but unfortunately many States lack sufficient resources. Some States and municipalities believe that stricter laws and ordinances will solve the problem of predatory practices. Many NAAHL members believe that the plethora of local laws and ordinances may only drive out the responsible lenders who will choose not to offer what may become "high-cost loans" under a crazy quilt of new rate and fee restrictions.

Third, our symposium also confirmed that subprime lending is an important source of home finance. For many consumers, subprime loans may be the only way available to finance the American Dream—a home of their own. And many, many programs exist, in both the private and public sectors, to help subprime borrowers achieve prime borrower status—a worthy financial goal. Cutting off access to credit on appropriate terms would not be constructive. As OTS Director Ellen Seidman has warned, legislation must be very clear so as not to chill "the operation of the legitimate subprime market. The flow of responsibly delivered credit to underserved markets is critical to their survival and any legislative or enforcement solutions . . . must proceed with this caution in mind."

Fourth, we also heard that vigorous enforcement, at all levels of Government, works. We heard from people actively involved in combating predatory lending at the city and State levels. Increased Government investigations, criminal prosecutions to the fullest extent of the law, and revocations of mortgage brokers' licenses all help to eradicate predatory lending. State bank supervisors coordinating across State lines on a single company and its practices will also accelerate progress.

Fifth, consumer education is key. Our experts recommend that financial literacy education must begin early, down to and including the high school level. The NAAHL symposium also confirmed that both the public and private sectors, on all levels, are undertaking consumer education and outreach campaigns, to stop predatory lending before it even happens, with good results. For example, New York residents can easily use State government information to shop for competitive mortgage

[1] Held in Senate Banking Committee files.

rates. Chicago borrowers can call 1–866–SAVE–HOME to receive counseling and legal assistance, funded by banks and city government. Lenders across the country fund financial literacy programs to help borrowers with debt management, the implications of signing contracts, and tips on how to avoid stalkers who offer financing on predatory terms.

Increased Federal resources for targeted counseling in neighborhoods that are vulnerable to predators could greatly extend these efforts. Education may not solve the entire problem. As Martin Eakes points out, "the Department of Education says that 24 percent of adult Americans are illiterate." But counseling can go a long way. As Governor Gramlich proposed, "the best defense is if people really know what they are doing."

Overall, our symposium confirmed once again that predatory lending is a complex issue requiring a multifaceted solution. It takes a combination of responses from both the public and private sectors, including a broader Federal framework establishing a level playing field for legitimate lenders, more vigorous enforcement of existing laws, and more resources devoted to consumer education to deal with it.

But, as our closing speaker, the Honorable Mel Martinez, Secretary of the Department of Housing and Urban Development put it, "juntos podemos": together we can.

As the President of an organization whose members have spent years trying to increase the flow of private capital into underserved communities, I say, "together we must." Equity stripping, foreclosure triggering loans lead to family tragedies, foreclosures, and destabilized neighborhoods. They must be stopped. We at NAAHL commit to help you in any way we can.

PREPARED STATEMENT OF ESTHER "TESS" CANJA

PRESIDENT, AMERICAN ASSOCIATION OF RETIRED PERSONS

JULY 27, 2001

Good morning, Chairman Sarbanes, Ranking Member Gramm, and Members of the Senate Banking, Housing, and Urban Affairs Committee. My name is Esther "Tess" Canja. I live in Port Charlotte, Florida, and I serve as President of AARP.

AARP is actively engaged in efforts to protect consumer rights and interests. The Association has been directly involved since the early 1990's in researching issues, litigating cases, and working with Federal and State regulatory agencies and legislative bodies to expose, hold accountable, and seek redress from those who are responsible for a wide range of exploitive financial practices.

AARP appreciates this opportunity to bring into greater focus one of the most troubling forms of these exploitive financial practices—which is making unjustifiable high-cost home equity loans to older Americans. For most Americans, home equity accumulation is a factor of time (for many a "working lifetime"), and therefore is highly correlated with age. For older Americans, the most abusive loans are often the refinancing and equity-based home modification loans because they target the value of the home—frequently the owner's largest financial asset. These forms of abusive lending are particularly devastating when the older homeowner is living on a modest or fixed income.

It has been AARP's long-standing view that loans become predatory when they:

- take advantage of a borrower's inexperience, vulnerabilities and/or lack of information;
- are priced at an interest rate and contain fees that cannot be justified by credit risk;
- manipulate a borrower to obtain a loan that the borrower cannot afford to repay; and/or defraud the borrower.[1]

The investment in homeownership among older Americans is substantial. For example, based on American Housing Survey data for 1999, the median mortgage Loan to Value ratios (LTV's) steadily *decrease* from 74.8 for those under 35 years of age, to 31.7 for those age 65 and older.[2] That is to say, the median homeowner's equity increases by more than two-and-one-half times by age 65 and older. The U.S.

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[1] On January 31, 2001, the OCC, FRB, FDIC, and the OTS expanded the examination guidance for supervising subprime lending activities, limited to institutions under their respective jurisdictions, which recognizes ". . . that some forms of subprime lending may be abusive or predatory . . . designed to transfer wealth from the borrower to the lender/loan originator without commensurate exchange of value."

[2] See attachment 1, "Homeownership Rates and Loan to Value (LTV), 1999.

Census reports that American homeownership averaged an all-time high of 67.4 percent for the year 2000.

What is it about older American homeowners that makes them particularly attractive to predatory lenders?[3] Older homeowners are often targeted for mortgage refinancing and home equity loans because they are more likely to live in older homes in need of repair, less likely to perform repairs themselves, and are likely to have substantial equity in their homes to draw on. Many of them are nearing or are in retirement, and therefore are more likely to be living—or are preparing to live—on a reduced or fixed income. In this context, some of AARP's most recent research, litigation, and advocacy activities focus on abuses found in home repair and modification loans.

With some obvious qualifications, this means that the longer a homeowner lives in his/her home, building up equity as they pay down their mortgages, the greater the risk that they will be subject to lenders seeking excessive financial advantage through one of these loans. AARP has worked to educate its members as well as the public-at-large about how consumers can better protect themselves against such financial risks.[4] We believe consumer education to be a necessary part of a multi-level approach.

AARP also recognizes that the damage done by predatory practices is not limited to those who have lost, or are at risk of losing their home—as devastating as these losses clearly are. It also includes those older Americans who need and desire access to competitive, realistic risk-based home loans, but are reluctant or unwilling to pursue financial services and products due to their fear of potential exploitation. Ultimately, all forms of commerce—including financial services—are based on trust that each party to a transaction has been treated fairly, and disagreements resolved equitably. Whenever it occurs, predatory home lending undercuts the very essence of this basic tenet of commerce.

Consider these findings from an AARP-sponsored study, released in May 2000, entitled "Fixing to Stay".[5] For Americans age 45 and over:

- more than 4-in-5 say they would like to stay in their current residence for as long as possible; more than 9-in-10 age 65 or over feel this way; and
- almost 1-in-4 anticipates that they or someone else in their household will have difficulty getting around their home in the next 5 years.

When asked why they have not modified their home, or have not modified as much as they would have liked, respondents cited a number or reasons, including:

- not being able to do it themselves (37 percent);
- not being able to afford it (36 percent);
- not trusting home contractors (29 percent);
- not knowing how to find a good home contractor or company that modifies homes (22 percent).

In most areas, the results of this national survey, when compared to its sample of minority individuals (that is, African-Americans and Hispanics) were similar. However, there were a few important differences:

- among those who have refinanced their home or taken out a mortgage against their home, minorities are more likely to say they did so to obtain funds for home maintenance or repairs (50 percent minorities versus 35 percent national sample);
- however, minorities are also more likely than the national sample to be very or somewhat concerned about:

  being able to afford home modifications that would enable them to remain at home (44 percent versus 30 percent);

  finding reliable contractors or handymen (41 percent versus 28 percent);

  finding information about home modifications (34 percent versus 21 percent).[6]

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[3] Projections by the U.S. Census Bureau estimate that by the year 2020, the number of persons age 65 and older will grow to over 53 million—representing a 55 percent increase from the 34 million estimated for 1998. Changes in the age distribution of the Nation's older population are also occurring. Presently, the aging of the older population is driven by large increases in the number of persons age 75 and older.

[4] Attachment 2 provides an overview of AARP's decade-long campaign against predatory lending practices through December 2000.

[5] Attachment 3, which is an Executive Summary of the AARP-sponsored national survey of housing and home modification issues, entitled: "Fixing to Stay," May 2000.

[6] HUD's detailed study of almost 1 million—mostly refinancing—mortgages reported under HMDA in 1998, entitled: "Unequal Burden: Income and Racial Disparities in Subprime Lending

Continued

AARP's efforts to address these problems—whether through the sentinel effects of its litigation, its legislative, and regulatory advocacy, or its counseling and education programs—are directed at improving credit market performance, not limiting consumer access to credit for those with a less-than-perfect credit history. AARP believes that our—and other—consumer financial literacy campaigns are an important and necessary component of public and private sector efforts to make consumers their own first line of defense.[7] However, while consumer education and counseling programs are necessary, they are not sufficient.

AARP submitted comments on March 9, 2001, supporting the Federal Reserve Board's (the Board) proposal to strengthen the Home Ownership and Equity Protection Act (HOEPA) regulations in an effort to reduce abusive lending practices targeted at the most vulnerable borrowers. In its comments on the proposed regulatory amendments, AARP suggests that the Board use its current statutory authority to: lower the annual percentage rate (APR) trigger, expand the definition of points and fees, and prohibit certain unfair practices such as the use of "riders" to change the terms of a consumer agreement.

In addition, the Board solicited proposals for making legislative changes that address predatory lending practices. AARP recommended three statutory amendments to HOEPA that we believe are worthy of consideration by the Board for submission to the Congress. We recommended:

- inclusion of all fees and points in the loan's finance charges;
- inclusion of open-ended credit and purchase money loans within HOEPA's coverage; and
- the elimination of the "pattern or practice" requirement for HOEPA protection; that is, the borrower would only have to establish that a lender has made an unaffordable loan under HOEPA—not that the lender has engaged in a pattern or practice of such lending.

AARP agrees with the Board's assessment of the beneficial impact of its proposed amendment, that by expanding the coverage to an additional group of high-cost loans it will "ensure that the need for credit by subprime borrowers will be fulfilled more often by loans that are subject to HOEPA's protections against predatory practices." AARP believes that the Board should issue the final HOEPA amendment as soon as prudently possible.

Chairman Sarbanes, and Members of the Committee, the problems associated with abusive home equity-related lending practices are complex. To date, agreement on a comprehensive reform of the mortgage finance system to address these problems has proven elusive. Therefore, we are encouraged by the Committee's continued efforts to call attention to predatory mortgage lending and to establish effective deterrents. AARP is committed to working with this Committee, the Congress, and the Bush Administration to address the problems posed to the elderly by these devastating lending practices.

Thank you. I will try to answer any questions you may have.

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in America," found a disproportionate concentration of subprime loans in minority and low-income communities.

[7] In April 2001, AARP launched a State-based campaign effort that, over the course of this year, will focus on consumer education and advocacy efforts.

Homeownership Rates and Loan to Value (LTV) 1999

Percent

	Homeownership Rate (A)	Share of Owners w/ a Mortgage (B)	Median LTV (if have a mortgage) (C)
Under 35	39.7	79.7	74.8
35-44	67.2	77.5	63.1
45-54	76.0	69.1	51.5
55-64	81.0	47.9	41.8
65+	80.1	18.3	31.7
Total	66.8	56.5	58.1

Source: Column A - U.S. Census Bureau's Housing Vacancy Survey, Annual Statistics 1999.
Columns B & C - AARP Public Policy Institute analysis of HUD's American Housing Survey, 1999.

BACKGROUNDER

AARP FIGHTS PREDATORY MORTGAGE LENDING

AARP has taken the lead in the drive against predatory mortgage lending in recent years, launching a multi-pronged campaign that has moved at the national, state and local levels.

Through litigation, research and contacts with regulatory agencies and legislative bodies, the nation's leading organization for people 50 and older has sought to expose and restrict predatory practices that often target older Americans with low and moderate incomes.

AARP will continue to alert the public – particularly older Americans – to these exploitative practices. The impact of predatory lending practices can be devastating - - often causing the loss of home, life savings and independence.

AARP's efforts are directed at improving credit market performance, not at limiting consumer access to credit for those with less than a perfect credit history.

At the state level, AARP worked closely with the North Carolina Attorney General and other interested parties to pass North Carolina's consumer-oriented predatory mortgage lending legislation last year.

The principles of the North Carolina law now have been adopted by AARP's Board of Directors as Association policy. Among those principles are these:

- To require mortgage lenders to consider the borrower's ability to repay the loan and not just the amount of equity offered as collateral.
- To limit the amount of closing costs or other fees that lenders are permitted to include in the amount of the loan.
- To require complete and accurate disclosures to consumers that capture the entire cost of the loan, including all charges, such as interest rates, fees and mortgage insurance.
- To restrict unfair prepayment penalties that may be imposed upon the borrower.
- To establish minimum notice standards for foreclosure.

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Esther "Tess" Canja, President Horace B. Deets, Executive Director

This year, AARP has been active legislatively in at least five states, working with grassroots organizations to shape and support predatory lending bills. The states are New York, Illinois, California, Maryland and Missouri.

In New York, AARP pushed for a bill that would have provided significant consumer protections in foreclosure proceedings that might occur as a result of predatory loans. AARP also played an important role in a coalition of grassroots organizations that urged the state Banking Department to strengthen consumer protections in proposed new predatory lending regulations.

In Illinois, AARP has played an important role at the state and local level. The Association worked with other organizations in pushing for a bill based on the North Carolina law. The bill will be reintroduced in 2001.

In addition, AARP supported an ordinance proposed by Mayor Daley to prohibit the City of Chicago from doing business with a financial institution that owns or is affiliated with a predatory lender.

In California, in addition to advocating legislation to eliminate predatory lending practices, AARP is seeking changes in state law regarding home improvement contractors and the financing of home improvement contracts.

State home financing laws have been analyzed by AARP's Public Policy Institute, which is developing a model home financing statute that should be available this fall.

AARP has been aggressive at the national level as well, seeking legislation to halt consumer mortgage lending abuses.

In April, AARP announced its strong support of "Predatory Lending Consumer Protection Act of 2000," legislation introduced in the House by Congressman John LaFalce of New York and in the Senate by Senator Paul Sarbanes of Maryland. The companion bills would:

- Establish a more comprehensive definition of what constitutes high cost loans.
- Strengthen federal laws that govern those high cost mortgage loans.
- Prohibit a number of practices entirely if they are associated with high cost loans.

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AARP participated in the U.S. Senate Special Committee on Aging Consumer Education and Counseling Roundtable in February, 1999. The roundtable focused in part on ways to help prevent borrowers from being subjected to predatory lending practices.

AARP worked with the Department of Housing and Urban Development (HUD), other consumer groups and lending institution representatives on a new policy statement clarifying mortgage broker fees.

A representative of AARP's Federal Affairs Department served on the HUD-Department of Treasury Predatory Lending Task Force, and Board Member C. Keith Campbell of Alaska testified before a public forum on "The Elderly and Predatory Lending" that the two federal departments conducted last month in Los Angeles. The event was one of several that HUD and Treasury held around the country this spring.

Campbell cited a variety of "unsavory" lending practices that exploit "vulnerable older Americans," including repeated refinancing, known as "loan flipping", often following high pressure sales. "These practices are particularly devastating when the older homeowner is living on a modest or fixed income," Campbell told the forum.

AARP Foundation Litigation has represented borrowers in challenging predatory lending practices in the courts for the past 10 years. One goal is to gain compensation for victims of predatory lending. Another is to curb such practices by obtaining good court rulings and winning at the trial level.

In December, 1998, AARP Foundation Litigation joined in a lawsuit against First Alliance, a national mortgage lender based in Irvine, California. The case was filed to obtain restitution on behalf of all borrowers who had been allegedly victimized by First Alliance. AARP is continuing to represent these borrowers in First Alliance's recently-filed bankruptcy reorganization.

In recent months, AARP Foundation Litigation has been successful in predatory lending cases that its attorneys have pursued in the District of Columbia and West Virginia.

In the District of Columbia, Foundation Litigation filed a lawsuit on behalf of an elderly African-American widowed homeowner who had been enticed to take out a series of unaffordable and unreasonable mortgage loans (*Ferguson v. First Government*). In addition to representing Helen Ferguson in court, AARP also lodged a complaint with HUD about race-based targeting by First Government.

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As a result of the lawsuit and the complaint, First Government canceled Ms. Ferguson's remaining balance on her mortgage, provided additional monetary compensation, and agreed to take significant steps to train its employees, to open its books to government regulators and to create a relief fund for other First Government borrowers.

In the West Virginia case, Foundation Litigation attorneys were co-counsel with Mountain State Justice for a 67-year-old Charleston homeowner, Iris Bostic, who sought a $500 loan, but who was induced by a large national finance company into refinancing all of her debt into a $30,000 home mortgage. The suit against American General Finance Inc., based in Evansville, Indiana, alleged fraud, illegal business practices (including backdating agreements and charging excessive fees) and violations of the federal Truth in Lending Act. The case now has been settled, with a large compensation award for Ms. Bostic.

Foundation Litigation attorneys now have teamed up with Mountain State again in another West Virginia case (*Podelco v. Beneficial West Virginia, Inc.*). Mary Ann Podelco, a widow, was targeted for eight loans by predatory subprime lenders, her mortgage went from zero to $35,200 and she ultimately lost her home. The suit in a West Virginia state trial court is pursuing claims challenging the loan flipping practices of the lenders as unconscionable under West Virginia law. Mrs. Podelco also is seeking to pursue her claim that it was unconscionable for the lenders to make unaffordable loans – loans based on the value of the home and not on the borrower's ability to pay.

The impact of these and other cases has been to shine a spotlight on predatory lending practices and to set the groundwork for fixing these practices legislatively.

AARP also has issued consumer-oriented reports -- including its Public Policy Institute's publication "Predatory Financial Practices: How Can Consumers Be Protected" – and a variety of educational materials. Among these:

- A consumer fact sheet entitled "Do You Really Want a Home Loan?". The material includes information on avoiding home equity loan scams.

- In conjunction with the Federal Trade Commission, a Consumer Alert on questions to ask when using your home as collateral.

AARP's Website (www.aarp.org) provides information about how to avoid predatory lenders, and about home improvement fraud and other abusive activities.

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(For further information on these and other AARP initiatives against predatory lending, please call David Nathan at AARP Media Relations at 202-434-2560.)

FIXING TO STAY

A NATIONAL SURVEY OF HOUSING AND HOME MODIFICATION ISSUES

May 2000

Ada-Helen Bayer, Ph.D., AARP Research Group
Leon Harper, AARP Programs/Applied Gerontology Group

Fielded by Mathew Greenwald and Associates, Washington, D.C.

EXECUTIVE SUMMARY

The 2000 "Fixing to Stay" study is the fifth in a series of telephone surveys that AARP has sponsored since 1986. The studies examine the opinions and behavior of older Americans regarding their current and future housing situations. The 2000 study differs in several ways from earlier ones:

- The survey population now includes people age 45 and over to capture the opinions of the "baby boom" age group.
- The survey sample now includes oversamples of African Americans and Hispanics to allow more detailed analyses of the housing needs and preferences of these groups.
- The survey questionnaire now devotes more attention to home modifications that enable people to remain independent and increase the safety and convenience of their home.

CURRENT HOUSING

- The large majority of Americans age 45 and over live in single-family residences: 77 percent live in single-family detached homes, 8 percent live in mobile homes, and 5 percent occupy semidetached homes. Nine percent report living in multiunit buildings, such as apartment buildings.
- Forty-two percent of survey participants who live in dwellings other than multiunit buildings reside in homes with two or more levels. Eighty-eight percent of respondents now say they have a bathroom on the first floor of their home.
- Home ownership among Americans age 55 and over is at its highest level since these studies began in 1986. Eighty-six percent of these respondents own their home.
- People age 45 and over generally share their home with at least one other person. Forty-eight percent live with one other person, 12 percent live with two other people, and 11 percent with three or more other people. However, 28 percent of respondents live alone.
- Those respondents who share their home are most likely to live with a spouse (77%), but 29 percent live with children or stepchildren. Small percentages report that grandchildren (4%), parents or spouse's parents (3%), other relatives (3%), and nonrelatives (3%) live with them.
- Among those age 55 and over who share a home with at least one other person, the percentage living with a spouse has decreased from 89 percent in 1989 to 79 percent in 2000.

- Americans age 45 and over tend not to move frequently. Approximately three in five have lived in their current home for 11 or more years (23% for 11 to 20 years, 17% for 21 to 30 years, and 19% for more than 30 years). On the other hand, 20 percent have lived in their current residence for between one and five years, and 5 percent have lived there less than a year.
- Respondents who moved report doing so for many reasons. Of those who have moved within the past five years, 13 percent mention moving to a better location or neighborhood, and 10 percent cite a job change as the main reason for moving. Eight percent say they moved because they wanted a larger home, while 7 percent each cite retirement, wanting a smaller place, and wanting to be closer to family.

PLANS

- Most Americans age 45 and over say they would like to remain in their current residence for as long as possible. In fact, 71 percent of respondents *strongly agree,* and an additional 12 percent *somewhat agree* that they want to stay in their current residence as long as possible.
- The percentage of respondents age 55 and over who *strongly* or *somewhat agree* that they would like to remain in their current residence for as long as possible has increased significantly since the question was last asked in 1992 (84% in 1992; 89% in 2000).
- Sixty-three percent of survey participants believe that their current residence is where they will always live. Among those who do not, 29 percent say they have already made plans for where they will live in the future, while the remainder say they have not made such plans.
- If they need help caring for themselves, most respondents would prefer not to move from their current home (82%). Only a few express a preference for moving to a facility where care is provided (9%) or for moving to a relative's home (4%).

GETTING AROUND THE HOME

- Eight percent of survey participants report that they, or a member of their household, have difficulty getting around their home. Of this group, 62 percent indicate that they themselves have difficulty, 24 percent say their spouse has difficulty, and 7 percent report a parent has difficulty getting around their home. Sixty-three percent claim this person has difficulty *often*, while 25 percent indicate the person *sometimes* has difficulty.

- Of the homes in which someone has difficulty getting around:

- The functional problem most commonly reported is difficulty climbing up and down stairs (35%). Other frequently mentioned problems include difficulty walking or lack of mobility (15%) and specific problems with knees, hips, legs, or arthritis (15%).
- Respondents most frequently attribute difficulty to arthritis (25%); however, some cite back problems (13%) and knee problems or knee replacements (9%).

- Among all respondents age 45 and over, nearly one in four expect that they, or a member of their household, will experience problems getting around their home within the next five years (8% *very likely*; 15% *somewhat likely*).

HOME MODIFICATIONS

- Approximately three in ten Americans age 45 and over say they are *very* or *somewhat concerned* about:
  - Having a home in which friends or family who may have disabilities can get around (31%)
  - Being forced to move to a nursing home because they have trouble getting around their own home (31%)
  - Being able to afford home modifications that will enable them to remain at home (30%)
  - Having problems using features in their home as they get older (29%)
  - Finding reliable contractors or handymen, should they need to modify their home (28%)
  - Being able to provide care for a parent or relative (27%)

- Most respondents (86%) have made at least one *simple* change to their home to make it easier for them to live there. Respondents most frequently report having installed nightlights (63%), non-skid strips in the bathtub or shower (50%), and higher wattage light bulbs (32%). Somewhat fewer have lever faucet knobs (25%), a telephone with large numbers and letters (22%), carpets and rugs secured with double-sided tape (20%), an emergency response system (15%), lever doorknobs (14%), and non-slip strips on their stairs (12%).

- Of the 76 percent of respondents who are permitted to modify their homes, 70 percent say they have made at least one *major* modification to make it easier for them as they get older. These respondents most commonly indicate having installed light switches at the top and bottom of dark stairwells (40%). Just over one-third (34%) have made changes or modifications to their home that would allow them to live on the first floor. Twenty-five percent have handrails on both sides of their steps or stairs, and 23 percent have handrails or grab bars in their bathroom for better balance.

- Ninety percent of the respondents have made at least one simple change or major modification to their home. Of these respondents, most say they (65%) and/or their spouse (25%) made the decision to modify their home. Respondents most frequently indicate that the home modification(s) was their own idea (50%) and are most likely to have financed the change(s) as an out-of-pocket cost or household expense (62%). Respondents generally say they or their spouse did the work themselves (48%), although home repair companies or contractors (16%), friends or relatives (14%), and handymen (13%) are also cited.

- Sixty-seven percent of respondents who have made home modifications think that those changes will allow them, or others, to live in their home longer than they would have been able to otherwise. Of this group, three-fourths (75%) believe the modifications will enable them to live in their home for another ten years or more.

- Safety is most often cited as a reason for making home modifications. Seventy percent of respondents who have made changes say they made them so their home will have better safety features. A large percentage of respondents also say the reasons for making these changes were: to make the home easier to use by all members of the family (65%), to increase the ability to live independently (60%), to provide flexibility to adapt to the changing needs of family members (55%), and to upgrade or modernize the home (55%).

- When asked why they have not modified their home, or have not modified it as much as they would have liked, respondents most often cite not being able to do it themselves (37%) and not being able to afford it (36%). Other frequently selected reasons include: not trusting home contractors (29%), not knowing how to make the changes (25%), not having anyone to do it for them (23%), and not knowing how to find a good home contractor or company that modifies homes (22%).

- More than half of Americans age 45 and over (52%) express interest in receiving information about staying in their own home as they get older. Thirty-two percent are interested in receiving information about avoiding home repair or home modification fraud, and 28 percent indicate interest in information about types of home modification.

- Sixty-six percent of Americans age 45 and over say they would support their state passing legislation requiring that more homes be built with the home modification features discussed in the survey (37% *strongly support*; 29% *somewhat support*).

HOUSING-RELATED FINANCIAL ISSUES

- Twenty-seven percent of survey participants who own their home report having refinanced or taken out a mortgage on it in the past ten years. Of those who have refinanced their home, 35 percent used the loan for home maintenance or repairs, and 25 percent used the money for home modifications.
- Slightly over half of all respondents (51%) maintain they have heard of a reverse mortgage. Of those who have, only one percent of homeowners have a reverse mortgage, and six percent know someone who has one. About one in five respondents (19%) say that this is an idea they might consider in the future.

MINORITY DIFFERENCES

In most areas, the results of the national crossection survey[2] and the minority oversample (African Americans and Hispanics) are very similar. Among the more important differences, however, are the following:

- Minorities are more likely than the national sample to live in a multiunit building (18% versus 9%), yet fewer live in a mobile home (3% versus 8%).
- Home ownership is lower among minorities (70%) than among the national sample (85%). Perhaps because of this, minorities are less likely to say they are permitted to make changes or modifications to make it easier for them to live in their homes in as they grow older (67% versus 76%).
- Minority respondents are more likely to live with children or stepchildren (44% minorities versus 29% national sample) and are less apt to live with a spouse (58% versus 77%).
- Minority respondents are less likely to *strongly* or *somewhat agree* that they want to stay in their current residence for as long as possible (78% minorities versus 84% national sample).
- Among those who have refinanced their home or taken out a mortgage against their home, minorities are more likely to say they did so to obtain funds for home maintenance or repairs (50% minorities versus 35% national sample).

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[2] *The national crosssection sample includes African American and Hispanic respondents.*

- Minority respondents are less likely than the national sample to have heard of a reverse mortgage (31% versus 51%).
- Minorities are more likely than the national sample to be *very* or *somewhat concerned* about each of the following:
  - Being able to afford home modifications that would enable them to remain at home (44% versus 30%)
  - Having a home in which friends or family who may have disabilities can get around (42% versus 31%)
  - Being able to continue using features in their home as they grow older (42% versus 29%)
  - Finding reliable contractors or handymen, should respondents need to modify their home (41% versus 28%)
  - Being able to provide care for a parent or relative in their (the respondent's) home (40% versus 27%)
  - Finding information about home modification (34% versus 21%)
  - Being forced to move to another residence because they have trouble getting around their home (31% versus 25%)
- Minorities are more likely than the national sample to be *very* or *somewhat interested* in receiving information about:
  - Staying in their own home as they get older (63% versus 52%)
  - Avoiding home repair or home modification fraud (47% versus 32%)
  - Types of home modifications (44% versus 28%)
  - Finding reliable home improvement contractors (42% versus 21%)
  - Learning the facts about a reverse mortgage (40% versus 20%)
  - Financing home modifications (39% versus 17%)

PREPARED STATEMENT OF JOHN A. COURSON

VICE PRESIDENT, MORTGAGE BANKERS ASSOCIATION OF AMERICA
PRESIDENT & CEO, CENTRAL PACIFIC MORTGAGE COMPANY, FOLSOM, CALIFORNIA

JULY 27, 2001

Good morning Mr. Chairman and Members of the Committee. My name is John Courson, and I am President and CEO of Central Pacific Mortgage Company, headquartered in Folsom, California. I am also Vice President of the Mortgage Bankers Association of America (MBA),[1] and it is in that capacity that I appear before you today. This morning I have been asked to testify before your Committee to present MBA's views on the very serious issue of predatory mortgage lending.

First, I want to thank you for inviting the MBA into this very important discussion on a very urgent matter. I commend the Committee's leadership in calling for these hearings, as we believe that a full understanding of the issues is the only responsible way to finding solutions to the scourge of abusive mortgage lending.

As Vice President of the trade association that represents the real estate finance industry, and as President of a mortgage company, I am deeply troubled by the continuing reports of predatory and abusive lending practices that persist in our industry. It is imperative that you know, from the outset, where MBA stands on this issue. We condemn these practices in the strongest possible terms. The MBA recognizes that this is a problem that is real, and one that carries real repercussions for those communities that are affected. Although so-called predatory lending practices are difficult to measure and quantify, there is no hiding from the fact that certain rogue lenders and certain unscrupulous brokers continue to prey on our most vulnerable populations. Nor can we hide from our responsibility—as members of the finance industry—to act in the face of this continuing problem.

For over 80 years, the MBA has stood for integrity and fairness in mortgage lending. Our members have helped millions of Americans achieve the dream of homeownership. In so doing, we have established a tradition of encouraging the highest standards of responsible lending.

We, therefore, want to make clear that ending unfair lending practices is a major priority for our association. We have devoted substantial amounts of attention and time to this issue. We want to state in no uncertain terms that it is time to address the problems of predatory lending head-on, and in a way that does not constrict the flow of capital to credit-starved communities. Today, I will address the MBA's views on what needs to be accomplished to bring lasting and effective solutions to these abuses.

"Subprime" Lending

Before I do so, however, I think it is important to set forth some background on the nature and recent growth of the so-called "subprime" lending, since most of the reports of mortgage abuse appear to stem from this segment of the market. In general terms, that sector of the mortgage market that has become known as the "subprime market" serves customers that do not qualify for conventional, prime rate loans. The reasons why such consumers do not qualify are varied, but generally, these borrowers may have blemished credit records, or perhaps unproven credit or income histories.

A further element of this market, and of subprime loans generally, is that they tend to be more expensive in terms of fees and rates. This is so because they generally carry extensive due diligence costs and require hands-on servicing, and because they are inherently riskier than loans made in the prime market.

It is imperative to note that subprime lending has been extremely beneficial to thousands of families in the last couple of years. Subprime lending has opened up new markets and helped many consumers that would not have received needed funds but for the special products available in this sector of the market. The subprime market provides a legitimate and much needed source of credit for many families. As the Department of the Treasury and the Department of Housing and Urban Development acknowledged in a more recent report, "[b]y providing loans to

[1] MBA is the premier trade association representing the real estate finance industry. Headquartered in Washington, DC, the association works to ensure the continued strength of the Nation's residential and commercial real estate markets, to expand homeownership prospects through increased affordability, and to extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters excellence and technical know-how among real estate professionals through a wide range of educational programs and technical publications. Its membership of approximately 3,100 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, life insurance companies, and others in the mortgage lending field.

borrowers who do not meet the credit standards for borrowers in the prime market, subprime lending provides an important service, enabling such borrowers to buy new homes, improve their homes, or access the equity in their homes for other purposes."[2]

Defining the Problem

It is unfortunate, however, that as the subprime market has expanded, the reports of predatory and abusive lending have apparently increased as well. We note that the problem of abusive lending is not really new nor limited to the subprime market alone. State regulators report that they have been dealing with these types of issues for a long time, and that what was once called "mortgage fraud" is now being dubbed "predatory lending."[3] Regardless of the name, a major part of the challenge that we face in finding solutions to this problem is that it has proven quite difficult to answer the threshold question of how to define "predatory lending" or what constitutes "abuse" in the general context of mortgage lending. Surely we can identify examples of practices that everyone would agree are "abusive," but the problem we face is that these examples could be both underinclusive and overinclusive, depending upon the full circumstances of the loan transaction. Thus, often identified "predatory" practices could include the following: excessive fees and points that are often financed as part of the loan; loan "flipping" or "churning," in which a loan is repeatedly refinanced in a way that degrades the owner's equity in the property; intentionally making a loan that exceeds the borrower's ability to repay; and overly aggressive sales techniques that deliberately mislead the borrower.

It is important to note that in every example noted, the full context of the transaction must be analyzed to properly assess whether an abuse has occurred. It is impossible, for example, to identify "excessive" fees without knowing the nature and difficulty of the service provided in exchange for that fee. Nor can we recognize repeat refinances that are meant to strip equity without looking at the fee structure of the transaction and the equity of the consumer. In order to determine that a consumer has been "deliberately misled," we have to study the disclosures and the oral representations made in the context of the specific transaction at hand. Since every loan is unique and every transaction is tailored to specific needs and conditions, the answer of whether mortgage abuse has occurred in any given situation is dependent upon the totality of the circumstances of the borrower and the transaction. It is daunting, therefore, to isolate the specific "bad acts" that are employed by unscrupulous lenders in a way that allows for appropriate regulation.

We also note that even those regulatory agencies with jurisdiction over mortgage credit practices have not provided any clear guidance on the topic. Those agencies that have attempted to provide a definition have uniformly avoided the real issue, opting instead to provide either "categories" under which the abuses "tend to fall,"[4] or simply advancing descriptive examples and anecdotes of the more common abuses that they may have observed in the market.[5] Under either approach, the fundamental definitional issues are left unanswered. Sometimes the terms "predatory lending" and "subprime lending" are used interchangeably. This confusion and lack of adequate definitions at Federal and State levels, and the problem of lack of organized and coordinated data on predatory lending, is confirmed and described at length in a recent report issued by the Senate Banking Committee staff to Chairman Gramm, released in August 2000.

Source of Problem

MBA believes that predatory lending is a problem that has various sources. As we attempt to tackle this problem, it is necessary to isolate these sources, as they must be addressed individually before we can be successful in crafting lasting solutions. In short, the MBA believes that the three fundamental sources that need to be attacked jointly are the complexity of the laws, lack of education, and lack of enforcement.

Complexity of Mortgage Laws/Process

First and foremost, we believe that a fundamental root problem leading to abusive lending is the confusion created by the complexity of the mortgage process. Any consumer that has ever been through a settlement closing knows how confusing and cumbersome the process can be. Mortgage disclosures are voluminous and often

[2] U.S. Department of the Treasury and Department of Housing and Urban Development, *Curbing Predatory Home Mortgage lending: A Joint Report,* June 2000 (HUD/Treasury Report).

[3] See Statement of John L. Bley, Director of Financial Institutions, State of Washington before the Federal Reserve Hearing on Home Equity Lending (September 7, 2000).

[4] See, for example, HUD/Treasury Report, at p. 2.

[5] See Board Notice of Public Hearings and Request for Comments, at p. 3.

cryptic, and consumers simply do not understand what they read nor what they sign. In addition, the mandated forms lack reliable cost disclosures, making it difficult for prospective borrowers to ascertain true total closing costs and renders comparison shopping virtually impossible.

There are various confirmations of this core problem. In a recent report prepared by the Federal Reserve Board and the Department of Housing and Urban Development, these Federal agencies ascertained that most consumers do not understand the relation between the contract interest rate and the Annual Percentage Rate (APR) listed in the Truth in Lending disclosures. The agencies explain that "the [consumers'] belief was based on misconceptions about what the disclosures represent. For example, consumers believed the APR represents the interest rate . . . and the amount financed represents the note amount. . . ."[6] These are fundamental misunderstandings that can lead to very serious repercussions for unwary or unsophisticated shoppers. In fact, there are reports that these cryptic forms, and the public's misunderstanding of them, make the Federally required Truth in Lending disclosures a very useful tool for predators to confuse and defraud consumers.[7]

We can name a myriad of other examples, but simply put, the complexity of the current system is the camouflage that allows unscrupulous operators to hide altered terms and conceal crucial information without fear of the consumer discovering or even understanding the import of the masked or undisclosed items. In light of this complexity, confounded borrowers often have no choice but to turn to the loan officer for advice and explanation of the contents of the disclosures. In instances of abusive lenders, the consumer's reliance closes the loop of deception—the victims of these scams are completely blinded to the realities and repercussions of the transaction. These problems are exacerbated ten-fold in instances of uneducated or illiterate consumers.

Lack of Consumer Awareness/Education

The complexity of the mortgage process leads directly to, and is intertwined with, the second source of predatory lending—lack of consumer awareness and education. It is a reality today that even well-educated consumers tend to lack basic understanding of the mortgage shopping and home buying processes. For example, the borrower surveys conducted by the Federal Reserve Board revealed that over 20 percent of those surveyed contacted only one single source of credit. I already mentioned that consumers do not understand the meaning and importance of the APR figure. Nor do mortgage shoppers entirely comprehend that the early Good Faith Estimate disclosures are not final. Often, homebuyers believe that "listing" real estate agents carry fiduciary responsibilities vis-á-vis the purchaser. They generally do not. Again, all these misperceptions have real repercussions in the market, and they all stem from basic misunderstandings of the real estate and mortgage finance market.

Lack of Enforcement

The third problem creating a favorable environment for abusive lenders is the general absence of real enforcement in this area. It is important to understand that the mortgage lending industry is one of the most heavily regulated industries today. Mortgage lending is subject to pervasive State regulation and must comply with a wide array of Federal consumer protection laws including the Truth in Lending Act, Real Estate Settlement Procedures Act, Fair Housing Act, Fair Credit Reporting Act, Equal Credit Opportunity Act, Fair Credit Billing Act, Home Mortgage Disclosure Act, Federal Trade Commission Act, and Fair Debt Collection Practices Act. Many of the "predatory" abuses reported today either violate current law or result from lack of disclosures that violate current laws. We note that in practically all instances, these predatory loans also involve outright fraud and deception. We have to set a new priority to aggressively enforce the multitude of existing laws.

MBA believes that these root causes must be addressed in order to fully erase the pernicious lending practices that are occurring today. Any approach that does not address these three basic prongs—simplification, education, and enforcement—will

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[6] See Board of Governors of the Federal Reserve System and Department of Housing and Urban Development, Joint Report on the Real Estate Settlement Procedures Act and Truth in Lending Act, July 17, 1998 (Appendix A).

[7] There are various examples noted by regulators. One of them consists of a dishonest lender that may reveal to consumers that they are borrowing $50,000 when, in effect, the total amount borrowed is $60,000. This occurs because, under unique TILA rules, the "Amount Financed" number is derived by taking the amount of the note and subtracting "Prepaid Finance Charges." These subtracted charges include the lender's own loan origination fees and other fees. Under this scenario, the unscrupulous lender can rely on the "Amount Financed" disclosure to mislead the consumer into believing that they have a much smaller loan than they actually commit to at the closing table.

merely deal with the effects and not with the underlying causes of the problem. Anything short of this full approach will fail to resolve the crisis.

Looking Ahead

I reiterate that there is general agreement that there is a problem with abusive lending in many markets today. While there is some disagreement as to how to eliminate these practices, I believe that the mortgage industry, policy makers, and consumer representatives all share a sincere desire to end the abuses. I believe that we are all gathered here today to engage in a serious dialogue as to what needs to be done to advance real solutions to this problem.

Let me then address some steps we can all take to bring an end to this problem. As I mentioned before, we all share in the responsibility to ensure that predatory lending is eliminated.

Consumers

First, as outlined above, education of consumers is a most basic step in the struggle to push predators out of our neighborhoods. MBA believes that an educated consumer is the best prophylactic to predatory abuse.

Presently, MBA is assembling a workgroup to develop a series of resources aimed specifically at consumers that believe that they are being victimized by predatory lenders. The objectives of this initiative is to develop advice and materials that can be accessed directly and immediately by consumers seeking protection from unfair activities. To this end, the workgroup is developing a full list of legal rights and ethical norms that all consumers should expect from honest and reputable lenders. This list will be made available to the general public and disseminated to Government officials, consumer protection agencies, and consumer advocates to ensure that all prospective borrowers fully understand their rights in the transaction.

In connection with this document, the workgroup will also develop a system whereby affected consumers can obtain direct access to an enforcement agency or other source of immediate assistance on items pertaining to their loan situation. MBA believes that this direct access is crucial to protecting vulnerable borrowers. Again, the goal under this system is to provide immediate help to those consumers that feel they are being victimized by loan predators. This system would include a method for identifying "warning signs" of possible abuses that would alert consumers that they may be dealing with less than honest operators. Once a consumer identifies certain suspicious signs—that is, aggressive solicitations, unexplained changes at the closing table, requests to leave line items blank on material forms—then that consumer would be empowered to seek further immediate advice from a trusted third party before completing the transaction. We note that there is no system today that effectively delivers help and useful information that a victim requires at the very point where the abuse is occurring. We are trying hard to create a structure of support that works effectively and that can be implemented immediately. We hope to report back to you very soon with good news on our advancements.

Industry

The MBA has always been proactive in the fight against "predatory" lending abuses. As lenders and brokers, we share a strong responsibility to fight predatory abuses on various fronts. I will outline some of the examples of positive industry activities that are making a difference in this endeavor.

First, our association was the first, and remains the only national trade association to sign a "fair lending/best practices" agreement with HUD. This agreement was signed in 1994 and renewed in 1998. In this agreement, MBA committed to a number of steps that will promote fair lending and assist the industry in reaching underserved groups in our society.

Recently, MBA developed a set of "Best Practices" for our members. These Best Practices encourage members to conduct their business according to the standards contained therein and participate in periodic audits to test for compliance. These guidelines are designed to ensure that all customers are given fair and equitable treatment.

Further, MBA entered into a contractual relationship with the Mortgage Asset Research Institute (MARI) to create a national database of companies and individuals that have been identified by law enforcement or regulatory bodies as having engaged in illegal or improper behavior.

In 1998, MBA founded the Research Institute for Housing America (RIHA) and currently funds its projects, which support research and other activities to help determine how discrimination occurs in home buying process, and to eliminate discrimination. RIHA projects also endeavor to develop useful research on meeting con-

sumer demand for mortgage financing in underserved markets and to measure the societal benefits and costs of homeownership.

As mentioned above, we believe that consumer awareness and education are among the most effective tools available for combating predatory lending practices. In this area, we think that industry participants can do much to develop educational tools and programs that will enable consumers to make more informed choices. For example, MBA is a founding and active member of the Board of the American Homeowner Education and Counseling Institute (AHECI). The purpose of AHECI is to provide training and certification to the homeownership counseling industry. As a founding member of this organization, MBA provided $100,000 in startup funds.

MBA has worked with the National Council on Economic Education (NCEE) over the past several years to educate school children around the country in understanding the importance of good credit and the need for sound financial planning and management skills, as well as how to go about purchasing and financing a home. Recently, MBA partnered with NCEE with a donation of $130,000 to promote a program that will educate high school youth and adult consumers on the perils of abusive lending.

Last, MBA is currently engaged in discussions with lending organizations and other groups to determine how to best provide useful and complete information and education for homebuyers, with a special emphasis on subprime borrowers.

Government

MBA believes that there is much that Government can do to put an end to predatory lending abuses. First and foremost, MBA strongly believes that much more must be done to enforce the laws that are currently on the books. In the past quarter century, both Federal and State Governments have put in place a far-reaching body of laws designed to prevent abuse of consumers in credit transactions. Generally, there is a myriad of laws that exist in the different States that could effectively address the abuses that are occurring in the market today. These laws include prohibitions against unfair and deceptive trade practices; prohibitions against discrimination and redlining in finance transactions; limitations on specific terms of consumer and mortgage credit; limitations on insurance products; penalty provisions for noncompliance; prohibitions of deception misrepresentation, nondisclosure and concealment; and common law rules against fraud.

Before any additional laws are adopted, policymakers must realize that it does no good to legislate against practices that are already illegal in all jurisdictions. More laws will inevitably increase the complexity and costs of lending without a corresponding increase in consumer protection. Simply piling on more prohibitions will not resolve a crisis that today is caused by actors that operate at the outer fringes of the law. To be serious about solutions, we must pledge a full commitment to engage in serious enforcement of the laws.

MBA fully understands that enforcement actions are not an easy undertaking. They require much time, careful examinations, documentation of disclosures and documents, documentation of sales techniques, interviews with parties involved, among other things. In the end, however, this is the most effective way to stamp out these pernicious practices. To this end, MBA calls for increased funding of consumer protection agencies to accord them with all necessary resources so that we may begin to, once and for all, clamp down on unscrupulous actors in earnest.

Second, MBA believes that, in order to fight predatory lending, it is absolutely essential to enact comprehensive reform of the current mortgage lending laws. As mentioned above, predatory lending is in many ways a symptom of larger problems that have evolved from complicated and outdated mortgage laws. Without broad changes to existing laws and comprehensive reform of current cost disclosures, any efforts to address predatory lending will merely deal with the effects and not with the underlying causes of the problem. If the process remains confusing and perplexing, consumers will continue to be tricked and deceived. MBA has worked tirelessly to come up with a system that improves the consumer's opportunities to shop and allows for timely and effective disclosure of settlement costs and vital information to consumers.

Under MBA's comprehensive reform package, lenders would be allowed to provide mortgage applicants with an early price guarantee that permits consumers to effectively shop for mortgage products in the market. Under this plan, the closing cost guarantee to be provided to consumers would include all the costs required by the lender to close the loan, This guaranteed disclosure system would let consumers know, early in the mortgage application process, the maximum settlement costs a lender could charge. Under MBA's plan, the cost guarantee would be binding and enforceable.

MBA's reform proposal also seeks to streamline all current Federal loan disclosures so that they provide home shoppers with clearer and more concise information without the confusion inherent in the current forms. We envision a system where disclosures and educational materials, including advising consumers of the availability of counseling, would be provided to the consumer very early in the mortgage application process, in effect. We believe that these educational materials must be rewritten and restructured to make them more understandable and much friendlier to consumers. For example, MBA believes that interactive resources or the use of media other than booklets would go a long way in augmenting the accessibility and the use of these materials. And, unlike the current RESPA materials, these materials would contain full and comprehensive advice regarding mortgage abuse, including possible sources of counseling.

We note also that by streamlining the current legal and regulatory landscape, we also make it easier to identify abuses and prosecute unscrupulous players. If we remove all the gray areas from the current process, and provide for clear penalties and remedies that punish violators, we will make it easier to regulate, examine, and enforce.

Last, and in connection with previous statements, MBA believes that Governmental agencies everywhere must do more to promote consumer awareness and education. To this end, we support expanded funding for the development of counseling programs and counseling certification systems that assure that consumers receive all information they need to protect themselves in this very complex transaction.

Conclusion

In summary, the MBA believes that the continuing search for solutions to this problem must expand to comprehensively include all the underlying factors that allow predatory lending to flourish. We can no longer afford to focus on Band-Aids that merely cover up the harms. We must address predatory lending through direct attacks on three fronts—a commitment to full enforcement, robust education, and a simplification of existing laws. Nothing short of that will suffice.

Thank you for the opportunity to appear before the Committee. I look forward to answering your questions.

PREPARED STATEMENT OF IRV ACKELSBERG

MANAGING ATTORNEY, COMMUNITY LEGAL SERVICES, INC.
TESTIFY ON BEHALF OF
THE NATIONAL CONSUMER LAW CENTER
THE CONSUMER FEDERATION OF AMERICA
THE CONSUMER UNION
THE NATIONAL ASSOCIATION OF CONSUMER ADVOCATES
U.S. PUBLIC INTEREST RESEARCH GROUP

Chairman Sarbanes and members of the Committee, on behalf of our low-income clients, we thank you for inviting us to testify today regarding the increase in predatory mortgage lending and appropriate remedial actions to address this problem. I testify here today on behalf of my organization, **Community Legal Services of Philadelphia** and the **National Consumer Law Center**[1] with which I work closely, as well as the **Consumer Federation of America, Consumers Union,** the **National Association of Consumer Advocates** and the **U.S. Public Interest Research Group**.[2] The clients and constituencies of these legal services programs and consumer groups collectively encompass a broad range of families and households who have been affected by predatory lending.

We want to commend you, Chairman Sarbanes, for your persistent efforts to address the blight of predatory lending. The bill he introduced in the 106th Congress, S.2415, is a sophisticated and comprehensive proposal which – if passed – will stop most predatory mortgages.

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[1]**Community Legal Services, Inc.** is a non-profit legal aid organization that represents low-income consumers in Philadelphia at no charge. CLS represents thousands of individuals who receive Truth in Lending disclosures in the course of consumer credit transactions. CLS also represents the Association of Community Organizations for Reform Now ("ACORN"), a membership advocacy group of low-income citizens concerned, among other things, about the predatory lending epidemic.

The **National Consumer Law Center** is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of eleven practice treatises and annual supplements on consumer credit laws, including *Truth In Lending,* (4th ed. 1999) and *Cost of Credit: Regulation and Legal Challenges* (2nd ed.(2000), and *Repossessions and Foreclosures* (4th ed. 1999) as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers.

NCLC has advised legal services and private attorneys on litigation strategies to deal with such loans, and provided extensive testimony to Congress regarding necessary protections to be included in federal law, including the Home Ownership and Equity Protection Act. Since the passage of HOEPA, NCLC has continued to work with a broad coalition of consumer and community groups and with various federal agencies to create a comprehensive solution to abusive lending practices.

NCLC launched a Sustainable Homeownership Initiative several years ago. As a part of that initiative, NCLC works closely with Freddie Mac, Fannie Mae, the Neighborhood Reinvestment Corporation, banks, and housing counselors to sustain homeownership through training, coalition building, as well as specific intervention projects in some cities, such as Boston and Chicago.

[2]**Consumers Union** is the publisher of Consumer Reports.

The **Consumer Federation of America** is a non-profit association of over 280 pro-consumer groups, with a combined membership of 50 million people. CFA was founded in 1968 to advance consumers' interests through advocacy and education.

The **National Association of Consumer Advocates** (NACA) is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers.

The **U.S. Public Interest Research Group** is the national lobbying office for state PIRGs, which are non-profit, non-partisan consumer advocacy groups with half a million citizen members around the country.

Abusive home equity lending is a longstanding problem that exploded in the early 1990's. Vulnerable homeowners who cannot access mainstream forms of credit have generally been the target of these abusive practices.[3] Many homeowners have been beguiled into obtaining home equity loans with high rates of interest to finance home repairs or for credit consolidation. The refinancing of low rate purchase money mortgages with high rate first mortgage loans has become a serious problem in low and middle income communities leading to the increasing loss of homeownership. The terms of these high cost loans are not necessary to protect the lenders against loss; indeed the terms are generally so onerous that they precipitate default and foreclosure. With these equity based loans, even foreclosure does not pose actual risk of loss to the lender. The Home Ownership Equity Protection Act passed by Congress in 1994 to address these abuses, while helpful, has not significantly reduced the abuses faced by many low-income, minority and elderly homeowners.

There has been considerable discussion over the supposed difficulty in defining a predatory mortgage loan. But, most predatory mortgage loans include one or more of the following basic ingredients:

- The loan is equity based, rather than income based – such that the lender's assurance of repayment is based on the equity in the home, not the homeowner's income.
- High points and fees are financed in the loan.
- The loan is refinanced and new points and fees are imposed.
- Brokers, home improvement contractors and other third parties are used as expensive bird dogs to originate loans.

The balance of this testimony addresses the following issues:

I. Proof of the Problem – Escalating Foreclosures

II. Causes of the Mortgage Crisis for American Households

III. Signs of a Predatory Loan

IV. Lower Credit Scores Do *Not* Justify Higher Costs of Predatory Mortgages

V. The Shape of Reform – Address Predatory Mortgage Lending By Expanding HOEPA

VI. Increased Regulation Will *Not* Reduce Access to Legitimate Credit

VII. Other Federal Laws Should Be Changed to Address the Predatory Mortgage Problem

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[3] Dozens of examples were raised in the variety of Congressional hearings held on these issues. *Problems in Community Development Banking, Mortgage Lending Discrimination, Reverse Redlining, and Home Equity Lending: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs,* 103d Cong., 1st Sess. 258, 260 (Feb. 17, 1993); *Hearing on S.924 Home Ownership and Equity Protection Act, Before the Senate Banking Committee,* 103d Cong., 1st Sess. (May 19, 1993); *The Home Equity Protection Act of 1993, Hearings on H.R. 3153 Before the Subcommittee on Consumer Credit and Insurance of the House Committee on Banking, Finance and Urban Affairs,* 103d Cong., 2d Sess. (March 22, 1994); *Hearing on Community Development Institutions, 103-2, before the House Subcommittee on Financial Institutions Supervision, Regulation and Deposit Insurance,* 103d Cong., 1st Sess. (Feb 2-4, 1993).

I. Proof of the Problem – Escalating Foreclosures

There should be no doubt that there is a mortgage lending crisis in America.

- Between 1980 and 1999 both the number and the rate of home foreclosures in the United States have skyrocketed. The absolute number of foreclosures rose 277%. This means that although this was a period of economic prosperity, almost four times the number of homes were foreclosed upon in 1999 as in 1980.[4]

- This increase in foreclosures cannot be traced either to a rise in homeownership, or to the increase in mortgage loans being made. During the same time period, homeownership increased by only 2%, while the rate of foreclosures *per mortgage* increased by 120%.[5]

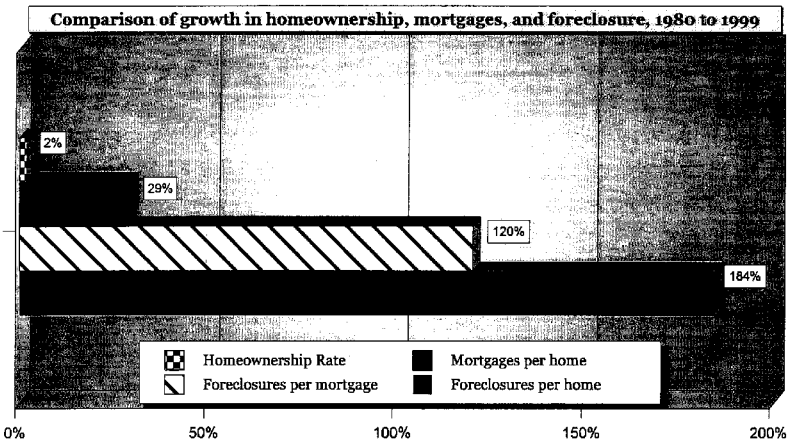

Figure 1 Sources: Mortgage Bankers Assoc. of America, Delinquency Survey; Statistical Abstract of the U.S.: 2000. "Home" means homeowner-occupied unit.

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[4]Mortgage Bankers Association of America. *National Delinquency Survey, 2000.* Data of mortgages in foreclosure at the end of each period studied comes from 130 different lenders and is representative of approximately ½ of the mortgages in existence. These numbers are actually grossly undercounted because the foreclosures of mortgages made by finance companies are not included in the statistics compiled by the Mortgage Bankers Association of America (which provides the raw data for the Census statistics). Also, foreclosure statistics do not include homeowners who simply turn their home over to the lender to avoid foreclosure.

[5]*Id.*

The two conditions which unite to cause this alarming increase in foreclosures are the increase in the *number* of mortgage loans outstanding and the *quality* of those loans:

- The increase in home secured lending during this period was almost twofold, from 30 million loans outstanding in 1980 to 52.5 million loans in 1998.[6]

- The problem is that too many home loans are being made for purposes that have nothing to do with the home, and too often these loans are being made with terms that are inherently unconscionable – that increase the costs of homeownership and the risk of loss of homeownership to the borrower.

II. Causes of the Mortgage Crisis for American Households

Predatory mortgage lending has been facilitated by several important developments:

- the deregulation of home lending laws;
- the limitation of tax deductibility of consumer debt to home secured loans;
- the increases in real estate values which has expanded availability of home equity for many households; and
- the proliferation of mortgage brokers.

Each is examined separately below.

Deregulation of home lending. The single most expensive, complicated, and important investment most Americans make in their lifetime is thinly regulated in this nation. There are minimal federal or state laws that govern the rates, fees, or terms that lenders can charge for loans used to purchase or refinance a home. In the past two decades, Congress has done little to ensure that the needs of homeowners are balanced against the interests of the lending industry. Indeed, in furtherance of increasing homeownership, Congress has even restricted the states' abilities to set limits on the rates and terms lenders can impose on home loans.[7] While there have been slight increases in homeownership, the lending industry has had its liquidity greatly increased by the development of a significant secondary market. Other than prohibitions against discrimination in the granting of credit, the Truth in Lending Act and the Real Estate Settlement Procedures Act basically provide the only state or federal regulation of home loans. With slight exceptions, these two laws are mostly limited to disclosure requirements.

Many homeowners go through the home purchase, financing and refinancing process without any problem. Many others, however, find themselves confused, feel deceived, or worse: they lose their home

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[6] *See* Table No. 823, Mortgage Delinquency and Foreclosure Rates: 1980 to 1998, U.S. Census Bureau, Statistical Abstract of the United States, Banking, Finance and Insurance, 1999.

[7] In 1980, Congress preempted the ability of states to set interest rate caps on most first mortgage loans. **Depository Institutions Deregulation and Monetary Control Act of 1980**, § 501 (DIDA), codified at 12 U.S.C. § 1735f-7a. In 1982, Congress prohibited states from limiting the types of terms (such as balloon payments and negative amortization) that could be allowed on many first mortgage loans. The **Alternative Mortgage Transaction Parity Act** of 1982 (AMTPA). 12 U.S.C. § 3800, *et seq.*

as a result of abusive or unjustified loan terms. This latter group is much larger than it should be. These abusive loans are an indication of a failure in the marketplace; competition and self regulation do not stop bad loans from being made.

Wrong Message Sent by Tax Code. In 1986, Congress changed the tax code to allow taxpayers to deduct the interest for consumer loans only if the loan is secured by the home. This sent a pervasive message to homeowners that borrowing against home equity was sensible economic planning. Unfortunately, this is quite often incorrect, even for middle income families. For low-income households, this tax deduction is generally of no benefit because the working poor has little or no tax liability, due to the earned income tax credit. Others are paying at the tax system's lowest tax rates.

One consequence of limiting deduction of consumer debts to home equity loans is that many Americans are now paying much *more* interest on consumer debt, albeit generally at a lower rate per year. This is largely due to a lack of understanding and appreciation for the costs of financing debt over an extended period of time.

Generally, families are persuaded to pay off car loans, credit cards, and other non-housing related expenses with loans secured by their homes because of the perceived tax savings generated by the deductibility of interest related to home secured debt. This perception of savings is generally misplaced: although the actual rate of interest is lower, the money is lent for a much greater length of time. Even after tax benefits are considered the result is a costlier loan. For example, consider this .car loan refinanced into a home loan:

- *Car loan paid in installments.* A five-year loan with an interest rate of 15% for $20,000, will have a total interest expense on the loan of $8,548.

- *Car loan refinanced into home equity loan.* A 30-year home loan for the same amount at an 11% interest rate effectively *costs* the homeowner more than four times as much in extra interest expense – even after counting the tax benefits. Just the interest charges on $20,000 over 30 years will be $48,567. Even if 30% of the interest expenses results in a tax savings for the consumer, the net cost of financing the car over the life of a home mortgage is still 70% of $48,567 or $33,997 – almost one and one-half times the cost of the car loan. (Note – even if this home loan is refinanced early, the amount of this debt for the car is always included in the amount owed, or when the home is sold, the net cash to the borrower is reduced by this amount.)[8]

A more serious consequence is the increase in *the loss of equity for American households.* Even as the ratio of debt to savings for American families has risen over the past twenty years, the ratio of home equity debt to other debts has increased at a much greater pace.[9] This has several consequences:

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[8]Even if the interest rates are lowered in this example, to those generally available to the prime borrower, the end result is still the same. The cost of financing a car loan in a 30 year home loan is far more expensive, even with the tax benefits.

[9]Federal Reserve Board of the United States. Federal Reserve Bulletins, January, 2000. *"Survey of Consumer Finances"* tables, 1989-1998.

- U.S. families are *switching* much of their debt from installment or credit card loans, to home secured loans.

- This has the effect of significantly reducing the home equity savings for these households – and home equity savings has long been the traditional method of building assets for American families.

Consider the following chart, which shows the dramatic *increase* in home secured debt in the past decade, as well as the *decrease* in home equity. This bleeding of home equity causes a general diminution of the wealth and security of millions of American families.

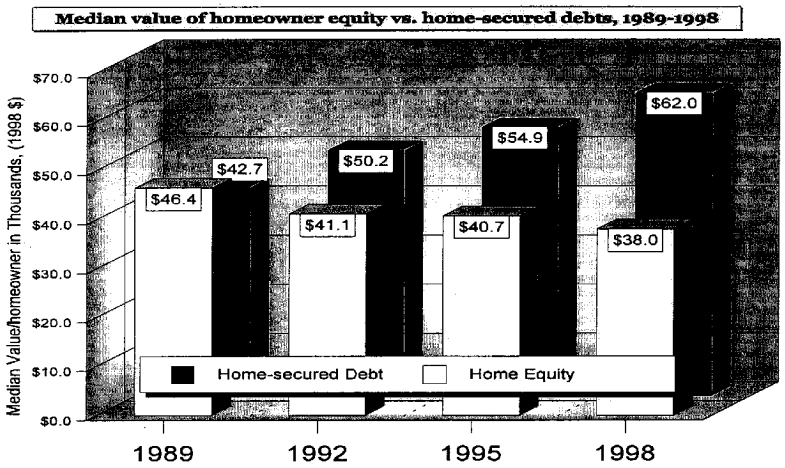

Figure 2 Source: Federal Reserve Bulletins, January, 2000.

Increases in Available Home Equity. Many finance companies[10] target homeowners who have substantial equity in their homes in order to protect their investments when the borrowers cannot pay. Elders are a common target for this equity based lending, because many have built significant equity in

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[10]Mainstream banks nearly abandoned low-income neighborhoods across the country, especially minority low-income neighborhoods. This created a vacuum for finance companies charging high rates of interest. Indeed, some mainstream banks helped fill the vacuum by setting up high rate finance companies or, alternatively, by funneling cash to unscrupulous lenders. The term "reverse redlining" has been coined to describe a practice wherein banks make loans at one rate in white communities through their banking arm and at another higher rate in communities of color through separate finance company subsidiaries. Evidence in a case brought in Atlanta, for example, established that black borrowers were charged 11.06% in up front fees by Fleet Finance Co. (a subsidiary of Fleet Bank). In comparison, white borrowers were charged fees of 8.26% of the loan amount (still too high a figure).

their properties over time. Based on this equity, a lender is in an advantageous situation: either the borrower pays the loan back with high interest or foreclosure on the home permits a recovery from the property directly. In fact, when foreclosure occurs and the borrower's property is sold to the lender for less than fair market value (as it generally is), the lender can resell the property after foreclosure and realize the homeowner's equity. These anticipated windfalls encourage some lenders to make loans designed to result in foreclosure. Given appreciating real estate values throughout much of the country, finance companies are able to make loans at high costs with very little risk.

Incentives for brokers and "bird dogs." HUD estimates that mortgage brokers handle about half of all home mortgage loans, or about 3 million mortgages per year totaling $333 billion.[11] Lenders often pay brokers to bring them loans. These lender payments are usually paid in one of two ways: by a "yield spread premium" or "volume-based compensation." A yield spread premium is a fee from a mortgage lender to a mortgage broker paid when the broker arranges a consumer mortgage loan where the interest rate on the loan is inflated to an amount higher than the "par" rate to cover the cost of the fee.[12] The par interest rate is the base rate at which the lender will make a loan to a borrower on a given day. Some lenders also compensate brokers based upon the volume of loans which brokers steer their way.

These payments to brokers drive up the cost of mortgage loans and create reverse competition where brokers have incentives to steer borrowers to lenders that pay brokers the most rather than to lenders who give borrowers the most favorable terms. This problem is exacerbated for low-income borrowers because unscrupulous elements of the mortgage industry perceive them as vulnerable targets.

Home improvement contractors often act as mortgage brokers as well, having agreements to funnel customers in need of financing to a lender. Sometimes, the contractor receives a payment from the lender. Other times, the contractor is simply content to have a funding source at the ready when a homeowner mentions that he or she cannot afford the suggested work.

III. Signs of a Predatory Loan

The most meaningful mark of a predatory loan is in the high amount of points and fees[13] financed by the borrower.[14] The more the borrower is charged up-front, the more the immediate financial gain

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[11]*See* News Release of Sept. 17, 1997 last located at www.hud.gov/fha/res/respa/html, accompanying HUD's announcement of proposed changes to regulations under the Real Estate Settlement Procedures Act.

[12]For an example, *see* the National Consumer Law Center, Cost of Credit: Regulation and Legal Challenges § 11.2.1.4.3 (2d ed. & Supp.).

[13]We include in our definition of fees the high costs of single premium credit insurance.

[14]There are numerous other predatory mortgage loan *indicators*, as set out below. Each must be addressed. But the single most important aspect of predatory lending is the financing of points and fees. Until this part of the problem is directly addressed, predatory lending will continue, without significant reduction of the problem:

- **Credit insurance packing** with high priced pre-paid term credit insurance which add thousand of

(continued...)

achieved by the lender. This is why many of these loans are not affordable to the homeowner – the lender has an incentive to make them non-performing loans. If that loan does not perform such that the homeowner is forced to refinance, it just means more profit for the lender at each refinancing. For the homeowner, it means more equity is stripped from the home each time.

Consider the following high cost loan:

Borrower receives:	$70,000	
Borrower pays:[15]		
5 Points	3,850	($3,850 all profit to lender)
Closing Costs	1,400	($1,000 profit to lender)
Credit Insurance	2,200	($1,000 commission to lender)
Total Loan Amount	$77,450	$5,850 - immediate profit to lender upon sale of loan to investor
Interest Rate of 12%	30 year term	Monthly payment - $796.66

After 36 payments, the loan balance is $76,495.40
(yet this homeowner has received $70,000, and paid $28,680 over 3 years)

So long as there is sufficient equity in the home (and there generally is plenty), this lender *benefits* every time the borrower defaults. A default provides the lender with reason to make a new loan, and charge more points and fees. This creates another immediate opportunity to turn a quick profit. Even if the borrower does not default, predatory lenders convince borrowers to refinance their loans and receive a small amount of additional cash to the homeowner, thus taking advantage of the large prepayment penalty typically included in these loans.

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[14](...continued)

dollars in unnecessary costs to loans for borrowers who could obtain more reasonably priced credit insurance if paid on monthly basis;

- High and unfair **prepayment penalties;**
- **Mandatory arbitration clauses,** which require the homeowner to arbitrate at considerable expense before arbitrators who have no incentive to follow consumer protection laws, and whose decisions are not reviewable by any court;
- **Spurious open end loans** whereby the lender is allowed to avoid making the more comprehensive disclosures required by closed end credit, and thereby avoid any chance of the homeowner asserting the right of rescission, as well as completely avoiding the restrictions under the Home Ownership and Equity Protection Act, regardless of the cost of the loan;
- **Paying off low interest mortgages** such as purchase money loans with FHA with much higher interest rate loans;
- **Refinancing unsecured debt** for which the borrower could not lose the home, with high interest rate debt which must be paid to avoid foreclosure;
- **Yield spread premiums** paid to the broker even when the homeowner has already paid all closing costs, increases the cost of the loan.
- **125% loan to value loans** are predatory for a different reason than the typical predatory loan we most often see in the low-income community. These loans effectively prohibit homeowners from selling their homes or filing bankruptcy to escape unaffordable debt, without losing their home.

[15]*See,* Testimony of the New York State Attorney General's Office before the Banking Committee of the U.S. House of Representatives, May 24, 2000. Mortgage brokers "routinely charge up to 10% of the total loan value in fees." Conversely, the Federal Housing Finance Board's *"Monthly Interest Rate Survey"* shows initial fees and charges averaging less that one point from 1993 through 2000 on conventional residential mortgages.

Assume in three years, this borrower falls behind and refinances. The refinanced loan will effectively cost the borrower another 10% of the loan amount in points, fees and closing costs. Thus, even though the borrower has paid almost $30,000 in home secured debt in three years, once he refinances again, his home equity plunges by another $7,650.

The result of these practices for homeowners is a dramatic loss of equity. In the course of ten years, assuming a refinancing each 3 years, the financial consequences will be devastating:

Value to homeowner	$70,000	$0	$0
Pay off of prior loan		$76,495	$83,107
Loan with 10% points and fees financed	$77,450	$84,145	$91,300
Home Equity lost at loan closing[16]	($7,450)	($14,145)	($21,300)[17]
Total amount paid by homeowner to "achieve" this lost equity		($28,680)	($59,839)

The current state of the law encourages, even rewards, the type of loan described above. Yet, these high points and fees financed in these loans are not necessary to compensate the lender in this market. These costs are charged because there is a complete failure of competition in this marketplace, necessitating increased regulation.

IV. Lower Credit Scores Do *Not* Justify Higher Costs of Predatory Mortgages

Subprime lenders justify the financing of high fees and interest rates as necessary based on the risk of loss from loans to homeowners with blemished credit. However, the typical structure of subprime loans creates minimal risk of loss due to either a default or a foreclosure. When credit is secured by a home, and the loan-to-value ratio is more than sufficient to protect against foreclosure losses (70% or less), there is no basis for significantly increased rates and fees. Actually, the higher pricing itself creates more risk, and the excessive fees charged up front cause the most damage to the homeowner by stripping equity from the home.

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[16]This amount assumes the market value of the home remains the same.

[17]It should be noted that if the same $70,000 loan had only 3 points in fees financed instead of 10, and there were no subsequent refinancings, this homeowner would not have lost any equity by year six.

An examination of the risks in mortgage lending supports this point. Losses to a mortgage lender can result from four events:

1) late payment and default;
2) foreclosure;
3) prepayment of the loan before the lender has recouped the expenses incurred in making the loan; or
4) litigation expenses.

Risk of Loss from Defaults. As defaults do not necessarily result in foreclosure (and, in fact, the industry agrees that most defaults are self-corrected by borrowers, particularly within the first three months from default), lenders recoup default expenses from late fees and additional interest charges. Late fees are structured to compensate creditors for expenses incurred when payments are made late, such as dunning notices. Additional interest is generally charged for the loss of use of the principal while the payment was late. Late fees in the mortgage context are usually 5% of the payment then due. If the monthly payment is $1,000, the late fee is $50. Given the collection of late fees and additional interest, the risk of loss due to a mere default is negligible.

Risk of Foreclosure. A more serious loss could arise if a default continues and results in a foreclosure sale. In this instance, the lender stands to lose only if the sale brings less than the combination of the balance due on the mortgage plus the costs and fees incurred in the foreclosure. As foreclosure sales generally recoup less than fair market value of the property, mortgage lenders traditionally protect against this risk by requiring a loan-to-value ratio no greater than 80%. When the loan-to-value ratio is greater than 80%, private mortgage insurance of some sort is generally required.

Subprime lenders, however, usually insist that the loan-to-value ratio be no greater 60-75%. This ratio insures little or no loss in case of a foreclosure sale. When the loan-to-value ratios are so low, the risk of loss due to foreclosure also does not justify the increased pricing in the subprime market.

Risk of Prepayment. When a lender extends considerable expenses in the making of a loan, the lender does risk loss if the loan is prepaid before the regular payments on the loan allow the recoupment of these expenses. In the prime mortgage market, the effect of competition protects lenders: the low interest rate the borrower currently has discourages the borrower from prepaying the loan. Typical prime mortgage loans stay on the books for an average of five years. Thus only 2% of prime loans have a prepayment penalty.

The subprime market is a different story. Fully 70% subprime loans have prepayment penalties because of lack of perceived options on the part of the borrowers.[18] In the subprime mortgage market the brokers are generally the gatekeepers for the loans, and they operate on the reverse competition method of yield spread premiums. The higher the premium paid to a broker, the more likely the broker will match a lender up with an unwitting borrower. The hefty price paid to the broker in the yield spread premium is

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[18]*See* Gail McDermott, Leslie Albergo, Natalie Abrams, Esq., NIMS Analysis: Valuing Prepayment Penalty Fee Income Standard & Poor's, News Release, Jan. 4, 2001. *Also see,* North Carolina Coalition for Responsible Lending, Prevalence of Prepayment Penalties, available at http://www.responsiblelending.org/PL%20-%20Coalition%20Studies.htm citing data obtained in an interview with the Mortgage Information Corporation and the industry newsletter, *Inside Mortgage Finance,* and the following articles on conforming mortgages: "*Freddie offers a new A-, prepay-penalty program,*" Mortgage Marketplace, May 24, 1999; Joshua Brockman, "*Fannie revamps prepayment-penalty bonds,*" American Banker, July 20, 1999.

an expense that the lender must recoup in order to avoid a loss, especially considering that the same broker has an incentive to market aggressively another loan to the same borrower. Thus, the lender must charge prepayment penalties to protect itself from the costs incurred by yield spread premiums.

If prepayment penalties were disallowed, unreasonable yield spread premiums would not be paid by lenders, because they could not afford the risk. This would not mean that loans would not be made – they are made every day in the prime market without hefty premiums and prepayment penalties.

Real Risk of Loss. Although lending to homeowners with blemished credit does not by itself create the potential for losses sufficient to justify the increased prices and many of the practices in the subprime mortgage industry, there is still considerable risk of loss to investors. The risk of loss comes from lawsuits challenging the predatory activities, not from borrowers' failure to comply with the contract terms.[19] However, this risk of litigation resulting from the lender's own bad acts certainly does not justify higher charges, and should not be considered a valid reason to avoid regulation which might effectively stymie this type of credit.

What Risks Justify High Costs? According to studies by Freddie Mac,[20] and extensive analyses of the prospectuses of a variety of subprime lenders, annual losses rarely exceed 3% even in the lowest rated subprime mortgage loans.[21] Therefore, there is little justification for interest rates or fees which are 50% or more higher than those charged on prime mortgages.[22] Certainly there is no justification for the huge differential in rates and points, fees and costs currently charged by many subprime lenders. Regulation which has the effect of preventing loans with unjustified costs will not prevent extensions of credit with justifiable rates.

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[19] For example, United Companies and First Alliance Mortgage Company filed bankruptcy in recent years largely to protect themselves from litigation precipitated by predatory practices.

[20] *See* Howard Lax, Michael Manti, Paul Raca, and Peter Zorn, *Subprime Lending: An Investigation of Economic Efficiency,* (Feb. 25, 2000) (Freddie Mac study which compared the interest rates on subprime loans rated A-minus by the lenders originating these loans with the rates on prime loans purchased by Freddie Mac which Freddie Mac then rated A-minus using its underwriting model; Freddie Mac found that, on average, the subprime loans bore interest rates that were 2.15% [215 basis points] higher; the study could find no justification for such a large discrepancy).

[21] Typical subprime lenders experience annual loss rates below 1% of the their loan portfolios. For example, Banc One reported in a March, 1999 prospectus supplement that its net losses as a percentage of the average amount outstanding on all serviced mortgage loans was .78% on 3/31/99. *See* Banc One Financial Services Home Equity Loan Trust 1999-2, Prospectus Supplement at S-20. All prospectuses and supplements hereafter cited may be obtained through the SEC's EDGAR database, at www.sec.gov/edgarhp.htm. Subprime mortgage lenders concentrating on the most risky borrowers still report modest losses. For example, Aames Financial Corp. reported in February 1999 that its actual annual losses as of 12/31/98 were 1.08% of the serviced portfolio, and it estimated cumulative (i.e. not annual, but over the life of the loan pool) losses of 2.7% of the balance of loans securitized. A more conservative lender, New Century Financial, reported in March 2000 that its current loan production was a mix of about 25% "C" category loans, 20% "B" category, and 55% "A-" or "A" categories. *See* New Century Home Equity Loan Trust Series 2000-NC1, Prospectus Supplement, form 424(b)(5) dated March 22, 2000 and filed with the S.E.C. March 24, 2000, at page S-25.

[22] An interest rate of 12% is 50% higher than an interest rate of 8%.

One particularly outrageous practice of many predatory lenders is the charging of high fees and rates even the homeowner's credit status qualifies for a lower cost loan. According to Fannie Mae, approximately half of all subprime borrowers could qualify for lower cost conventional financing.[23] This practice is abetted by the industry habit of not reporting mortgage payment data to credit reporting agencies. The failure to report *positive* mortgage payment habits by homeowners actually helps these lenders hold homeowners captive in high cost lending relationships.

V. The Shape of Reform – Address Predatory Mortgage Lending By Expanding HOEPA

The government, as well as the housing and lending industries, has done an excellent job in recent years of expanding programs to establish new homeownership opportunities for low-income families. The next challenge is to enhance the long term sustainability of the homeownership experience for these families. The ultimate success of homeownership as an asset building strategy will be measured by the degree to which new homeowners are able to afford proper maintenance, avoid foreclosures, build equity in their homes, and use their equity effectively as wealth. As illustrated in Part I above, the market does not work to protect homeowners from abusive mortgage loans.

In 1994, Congress passed the Home Ownership and Equity Protection Act (HOEPA) to prevent some predatory lending practices after reviewing compelling testimony and evidence presented during a number of hearings that occurred in 1993 and 1994. This law created a special class of regulated closed-end loans made at high rates or with excessive costs and fees. Rather than cap interest rates, points, or other costs for those loans, the protections essentially prohibit or limit certain abusive loan terms and require additional disclosures. HOEPA's provisions are triggered if a loan has an APR of 10 points over the Treasury security for the same term as the loan, or points equal to more 8% of the amount borrowed.[24]

It was hoped that HOEPA would reverse the trend of the past decade which had made predatory home equity lending a growth industry and contributed to the loss of equity and homes for so many Americans. However, experience over the last six years has shown that while HOEPA has made a start at addressing the problems, there are still huge numbers of unprotected borrowers subject to the abuses of high cost home equity lenders.

The three most significant problems with HOEPA:

1) HOEPA does not in any way limit what the lender can charge as up-front costs to the borrower. It is the combined fees – closing costs, credit insurance premiums, and points – which deplete the equity in abusive loans. These excessive fees are charged over and over, each time the loan is refinanced. And with each refinancing, the homeowner's equity is depleted by these charges because they are all financed in the loan. The effect of this situation is to encourage lenders to refinance high cost loans because they reap so much immediate reward at each closing. If the law limited the amount of points and closing costs that a lender could finance in high cost loans, this incentive to steal equity would be stopped cold.

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[23] *See*, Fannie Mae, March, 2000 Press Release at p4, www.FannieMae.com/news/pressreleases/0667.html.

[24] 15 U.S.C. § 1602(AA)(1)(B).

2) The interest rate trigger and the points and fees trigger in HOEPA are both too high, allowing many abusive lenders to avoid HOEPA strictures by making high cost loans just under the trigger.

3) HOEPA does not apply to open end loans. When HOEPA was passed in 1993, there were few predatory open end mortgage loans being made. In the past seven years, that picture has changed. It has become apparent that open end credit provides another vehicle for mortgage abuses. There is no longer any reason to exclude open end mortgage loans from HOEPA's coverage. More importantly, unless open end loans are brought within the scope of HOEPA, the failure to regulate them will simply push the bad actors into that market.

But, otherwise, HOEPA has some good ideas. It is based on the economic rationale that the higher the charges for the loan, the more regulation is necessary and appropriate. By passing HOEPA, Congress has already recognized two essential truths: that there are some loans for which the marketplace does not effectively apply restrictions; and government must step in to provide balance to the bargaining position between borrowers who either lack the sophistication to avoid bad loans or do not believe they have a choice if they want the credit.

Senator Sarbanes' bill from the 106th Congress (S.2415) leaves the basic structure of HOEPA in place while expanding its coverage and prohibiting abusive terms not currently addressed in the law.

Covering More High Cost Loans.

S.2415 covers more high cost loans in several ways:

1. By lowering the annual percentage rate trigger to 6 points over the equivalent Treasury securities for first mortgage loans.
2. By establishing an annual percentage rate trigger to 8 points over the equivalent Treasury security for junior mortgage loans; this has the effect of encouraging lenders to make second mortgage loans – they are permitted a higher interest before their loan is regulated. This will address the problem of high rate lenders refinancing low interest rate first mortgages with a higher rate loan just to extend slightly more credit to the homeowner.
3. By extending the application to open end lines of credit secured by the home. This will address the spurious open end credit that is quite prevalent in the predatory mortgage market.
4. By including all points and fees (explicitly including yield spread premiums paid to mortgage brokers) and credit insurance charges in the points and fees trigger, and limiting it to 5% of the total amount of the loan.

Providing More Substantive Protections for Covered Loans.

Limitation on Financing of Points and Fees. A key regulation is the limitation on the financing of points and closing costs. Loans covered would be prohibited from financing all but 3% of the loan in points or closing costs. To the homeowner, the worst abuse in the predatory mortgage market is the

financing of high points and fees.[25] *The essential core of S.2415 is in the expansion of HOEPA protections to prohibit the financing of points, fees and credit insurance premiums, and the charging of prepayment penalties.*

S.2415 does not put a cap on the points or fees that can be charged for high rate loans; it only prohibits lenders from financing more than 3% of them. Clearly, for most borrowers, prohibiting the financing of these charges will be the same as prohibiting the charges altogether, but this will not necessarily mean that these loans cannot be made. It will only mean that these fees will be rolled into the interest rate charged the borrower – the lender will pay the fees and recoup them through the interest payments on the loan. The rate of interest charged borrowers will increase, but the borrower's equity ownership in the home will be preserved. There are indisputable advantages flowing from the limitation on financing of more than 3% in points and fees:

- *Less equity will be stripped from the home.* The amount of money that the borrower owes interest on will be much closer to the amount which benefits the borrower. Every payment the borrower makes will reduce the loan amount. If there are repeated refinancings, the loan amount will not rise. The equity in the home is no longer the source of financing the loan – the loan can only be financed through the borrower's income.

- *The lender will have the incentive to make these loans affordable.* Currently, a typical predatory mortgage transaction creates thousands of dollars of immediate profit to the lender upon sale of the loan to an investor. When the borrower refinances the loan, the lender sees a substantial profit, providing an incentive to the lender to encourage refinancings, regardless of whether the borrower can actually afford to repay the refinanced loan. Yet, if the lender only reaps a benefit from the loan through the *payments* the lender has a clear incentive to make sure that the borrower can afford the payments.

- *The market will work to keep the interest rate on these loans competitive.* So long as the borrower has not invested a significant amount of money in each loan – as is done when thousands of dollars in points and fees are financed – there is little to stop the borrower from shopping for a lower rate loan when his credit improves, or interest rates fall - just as is done in the prime market. As a result, when the loan is first made the wise subprime lender will make the rate only high enough to cover the costs, the real risk, and a reasonable profit. If more is charged, the borrower will be able to refinance at a lower rate with a competitor.

Financing Credit Insurance Premiums. S.2415 prohibits the financing of single interest credit insurance premiums, as well as the related product of debt cancellation agreements. Mortgage borrowers rarely make a separate, considered decision to purchase these products. Credit insurance sometimes

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[25]In S. 2415, the points and fees trigger includes *all* points, fees, and insurance charges. Under current HOEPA law, there are confusing rules to determine which fees and insurance charges are included in the trigger for up-front costs. For example, under current law, the HOEPA trigger excludes "reasonable" charges if they are not retained by the creditor and are not paid to a third party affiliated with the creditor.15 U.S.C. § 1602(aa)(4)(C). Fees for appraisals performed by unaffiliated third parties would not be counted if only the direct cost is passed on to the borrower. On the other hand, such a fee is counted if the cost is padded. Determining what is a "reasonable" for purposes of triggering coverage, however, is a difficult burden for homeowners to meet. The closing costs trigger should include all points and all fees for closing costs.

provides lenders with a substantial portion of their profits.[26] We have found that the premiums are included in loan documents with little or no prior discussion with the homeowner, who is faced with the daunting prospect of canceling a loan at a closing as the only way to avoid this expensive add-on purchase.

The dual market for credit insurance products has a marked disparate impact on minority homeowners. As recent studies by HUD amply demonstrate, subprime mortgage lending is disproportionately concentrated in minority neighborhoods of major cities.[27] The same minority homeowners are paying the high cost of single advance premium credit insurance, while predominantly white homeowners with conventional mortgages are offered the less expensive monthly premium credit insurance products, which are also offered separately from the mortgage transaction. There are significant financial incentives, creating "reverse competition" in the sale of credit insurance.[28] It is the creditor which selects the insurance which will be sold to its customers, which leads the creditor to select the products most profitable for it, the full cost of which is passed on to the homeowner. Some major lenders have their own insurance affiliates.

A recent study calculates that over $2 billion in excess premiums were paid by borrowers in 1997.[29] Some estimates are that half of subprime mortgages have credit insurance, compared to 6% in the prime mortgage market.[30] Compensation ratios on credit insurance products range from approximately 33% (for credit life) to over 50% (for credit unemployment).[31] Additionally, creditors often also benefit

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[26] *Equity Predators: Stripping, Flipping and Packing Their Way to Profits: Hearing before the Special Committee on Aging* United States Senate, 105th Cong. 2d Sess. 33-34, Serial No. 105-18 (Mar. 16, 1998)(statement of Jim Dough, former employee of predatory lender).

[27] *See e.g.* HUD, *Unequal Burden: Income and Racial Disparities in Subprime Lending in America* (April 2000) in which HUD discusses the results of studies conducted in Atlanta, New York, Baltimore, Los Angeles, and Chicago. Key findings of the Department of Housing and Urban Development analysis show that: 1) From 1993 to 1998, the number of subprime refinancing loans increased ten-fold. 2) Subprime loans are three times more likely in low-income neighborhoods than in high-income neighborhoods. 3) Subprime loans are five times more likely in black neighborhoods than in white neighborhoods. 4) Homeowners in high-income black areas are twice as likely as homeowners in low-income white areas to have subprime loans.

[28] *See generally* NCLC, *Cost of Credit: Regulation and Legal Challenges* (2nd ed. 2000) § 8.2.3.2

[29] *See also,* NCLC, Cost of *Credit: Regulation and Legal Challenges* (2nd ed. 2000) § 8.1.

[30] The Coalition for Responsible Lending reports that estimate from a person knowledgeable about the industry in its comments to the Board on the proposed HOEPA revisions. *See* Comments of Self-Help and the Coalition for Responsible Lending on Docket #R-1090 (Feb. 20, 2001).

[31] *See* Mary Griffin and Birny Birnbaum, *Credit Insurance: The $2 Billion A Year Rip-Off,"* p. 3 (1997 figures) (March, 1999 Consumers Union and the Center for Economic Justice)[hereafter Griffin and Birnbaum]. The report notes that in Texas, commissions for auto dealers averaged around 50%, compared to an overall average of 35% for credit life and disability. *Id.* p 15. A 1999 SEC 10-K filed by American Bankers Insurance Group (now part of Fortis, Inc.) listed the following data for 1998: Operating expenses: 13.9%; Commissions 43.7%; benefits, claims, losses & settlement expenses, 35.5%. For the 5 year period between 1994 and 1998, commissions ranged

(continued...)

from claims experience. This back-end stake gives creditors a financial disincentive to help homeowners through a claims process, which can be especially burdensome for credit disability insurance.

The remedy for this reverse competition is to only allow credit insurance to be sold when the premiums can be paid monthly, along with the loan payments, and the credit insurance can be canceled at any time.[32] The Federal Reserve Board and HUD specifically endorsed this proposal in their Report to Congress in July, 1998.[33] Several state and local laws and ordinances designed to stop predatory lending only permit this.[34] Further, in just the last few weeks, several of the largest subprime lenders have announced – after significant pressure has been publically applied – that they will forego the sale of single premium credit insurance on the mortgage loan products in the future.[35]

Prohibiting Prepayment Penalties. The prohibition against financing points, fees and credit insurance premiums only works if it is accompanied by a protection on the backend of the loan: a prohibition against prepayment penalties. Without such a prohibition, predatory mortgage lenders will still be able to strip equity and will not be forced to make their loans actually competitive.

Subprime lenders claim that borrowers voluntarily choose prepayment penalties to reduce their interest rates. Borrower choice cannot explain, however, why some 70% of subprime loans currently charge prepayment penalties and only 2% of conventional loans do (almost all in California). The real reason is that conventional mortgage markets are competitive and sophisticated borrowers have the bargaining power to avoid these fees; borrowers in subprime markets often lack sophistication or are desperate for funds and simply accept the penalty that lenders insist that they take. S.2415 addresses this issue by only allowing prepayment penalties to be charged if the loan is refinanced in the first 24 months and limiting the penalty to that amount of 3% of the loan amount that was not financed in the original loan. The rationale for this is that 3% is sufficient to cover the lender's costs for making the loan; any more than that is unnecessary equity stripping. In this scheme the lender has the option of whether to charge all or part of the 3% up front or if there is an early prepayment of the loan. *This aspect of the bill is crucial to clamping down on the frequent loan flipping which is the cause of the loss of equity.*

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[31](...continued)
from 40% to 43.7%.

[32]Allegations of coercion in the sale of what is suppose to be a "voluntary" product have been the subject of federal enforcement cases and private litigation. *In re US LIFE Credit Corp. & US LIFE Corp.*, 91 FTC 984 (1978), *modified on other grounds* 92 FTC 353 (1978), rev'd 599 F.2d 1387 (5th Cir. 1979); *Lemelledo v. Beneficial Management*, 674 A.2d 582 (N.J. Super. Ct. App. Div. 1996).

[33]Board of Governors of the Federal Reserve System, Department of Housing and Urban Development, *Joint Report to the Congress Concerning Reform to the Truth in Lending Act and the Real Estate Settlement Procedures Act,* July, 1998, at 74.

[34]North Carolina's anti-predatory lending statute (N.C. Gen. Stat. §§ 24-1.1) prohibits prepayment fees on most home loans under $150,000. Regulations for the states of New York (*NYCRR §§ 41.1 — 41.9*) and Massachusetts (*209 CMR 32.32; 209 CMR 40.00; 209 CMR 42.00*) prohibit prepayment fees for borrowers with debt payments exceeding 50% of income or if fees, including insurance, exceed 5% of the loan. Illinois regulations (*38 Ill. Adm. Code 160, 190, 345, 1000, 1050, and 1075*) prohibit these fees for "high cost loans."

[35]*See e.g.*, Patrick McGeehan, *Third Insurer to Stop Selling Single-Premium Credit Life Policies,* New York Times, Business Section.

Protections for Homeowners in Home Improvement Loans. Recognizing the high number of abuses which flow from home improvement loans, S.2415 establishes new protections applicable to all *home improvement loans* secured by the home. This home improvement law would ensure that a) homeowners have an effective method of enforcing their warranty rights, and b) lenders are held responsible for the actions of home improvement contractors.

One of the primary problems which arise from home improvement loans is the application of the "holder in due course" rule. This rule generally applies to purchasers of negotiable instruments, such as mortgage loans.[36] The holder in due course doctrine protects assignees of negotiable instruments from liability for the wrongdoing performed by the original lender though the borrower might be harmed.

Thus, generally regardless of a home improvement contractor's wrongdoing, the homeowner's obligation to pay the lender/assignee continues as long as the assignee purchased the loan without notice of the fraud or other misconduct. In the mortgage context, the homeowner is left to pay the mortgage despite having perfectly valid claims and defenses arising out of the home improvement transaction. Problems often arise because some home improvement contractors are insolvent, or they disappear (and reincorporate under a new name or file bankruptcy) at the first hint of litigation.

In 1976, the Federal Trade Commission passed a rule limiting the holder in due course doctrine for the purchase of consumer goods or services.[37] The purpose of the FTC Holder Rule is to give consumers the right to assert claims and defenses against creditors in situations where a seller provides or arranges financing and then fails to perform its obligations. The FTC Holder Rule rightly shifts the risk of seller misconduct to creditors who could absorb the costs of misconduct.[38] While the FTC Rule created some protection for consumers in this context, it is limited in several ways. First, the consumer rights provided by the FTC Rule depend upon seller compliance in placing a required notice in the loan document. Second, recovery by the consumer for seller wrongdoing is limited to the amount paid under the consumer credit contract. Third, there is no private right of action to enforce the FTC Rule.

If the holder in due course doctrine were eliminated for assignees and purchasers of home equity loans (and these mortgage lenders were potentially liable for all of the claims and defenses which the borrower had against the originator), the industry would be forced to engage in self-policing. If mortgage lenders were to be clearly liable for the claims borrowers have against the originating home improvement contractors, the mortgage lenders would more carefully screen those with whom they do business. That, in turn, should help dry up the financial lifeline that has enabled the predatory home improvement contractors to operate.

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[36]Morton J. Horwitz, The Transformation of American Law, 1780-1860, at 213-215. A promissory note is an unconditional promise to pay a fixed amount of money, with or without interest, that is payable to order or to bearer, is payable upon demand or at a definite time, and does not state any other undertaking. U.C.C. § 3-104(a), (e) (1990). The actual note or loan document signed by a borrower secured by a mortgage is ordinarily considered a negotiable instrument and bought and sold on the secondary mortgage market. For a more in depth discussion of this doctrine, *see* Julia Patterson Forrester, *Constructing a New Theoretical Framework for Home Improvement Financing,* 75 Or. L. Rev. 1095, 1103-09 (1996).

[37]16 C.F.R. § 433.

[38]Forrester, *supra*, at 1108.

Prohibit Mandatory Arbitration Clauses. Over the last few years, including mandatory arbitration clauses in consumer credit contracts has become standard operating procedure. Creditors use arbitration clauses as a shield to prevent homeowners from litigating their claims in a judicial forum, where a consumer friendly jury might be deciding the case. Arbitrators, who typically handle disputes between two businesses, are unfamiliar with consumer protection laws, and may be unsympathetic to consumers. Creditors also prefer arbitration because their exposure to punitive damage awards is dramatically reduced, and the threat of class actions is generally nullified.

Arbitration also limits discovery in most cases, which benefits the creditor, not the homeowner, and the arbitration may cost the homeowner far more than bringing an action in court.[39] By comparison, low-income consumers generally can file actions in court and waive all fees. And homeowners lose their rights to appeal the arbitrator's erroneous interpretation of the law. This allows arbitrators to ignore state or federal consumer protection statutes and judicial precedent.

Consequently, any comprehensive law addressing predatory mortgage lending must include a prohibition against mandatory pre-dispute arbitration clauses. S.2415 appropriately includes such a provision.

Best Practices' Promises by the Industry Will *Not* Stop Predatory Lending.

Recently, intense public pressure on lenders have yielded some partial, but significant changes in the way some lending companies say they will conduct their business. However, for a number of reasons, these concessions alone will be unable to protect consumers from the threats of predatory lending.

Permanence. Industry concessions can be withdrawn without any public input or recourse. In contrast, sound protections offered by legislation require public action by legislators who are accountable to their constituents.

Enforceability. Statutory prohibitions of predatory lending can provide a variety of enforcement options that are available to consumers, as well as local, state and federal authorities. On the other hand, the enforcement of corporate pledges is left to leadership of these institutions. Should a lender violate a pledge, they would likely face nothing more punitive than fleeting public disdain.

Scope. Of the few lenders who have made statements, none has promised to eliminate all of the abuses that exist in the marketplace. Thorough consumer protection can not be provided piecemeal, with some lenders offering to stop some practices, while other lenders fail to offer consumers even such small

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[39] While arbitration proceedings can theoretically be inexpensive, lenders intentionally make their arbitration proceedings costly as an added deterrent to consumers pursuing their rights. This financial cost is exemplified by one of the few cases in which a predatory lending victim actually pursued "justice" in a lender required arbitration proceeding. Candace Truckenbrodt, a victim of the notorious lender, First Alliance Mortgage Co. (Famco), filed her claims in arbitration. Ms. Truckenbrodt was required to pay $1,350 merely to initiate the arbitration, a cost ten times greater than filing a case in federal court (unlike court proceedings, arbitration does not provide for the waiver of fees for consumers who are poor). Her total expenses were $2,377.14 to obtain, one year later, an arbitration ruling that denied her claims against FAMCO without any explanation and without any right to appeal. This is the same FAMCO that has been pursued by several Attorneys General (including Massachusetts, Illinois and Minnesota) for its predatory lending practices and has been found by the Federal Trade Commission to have engaged in deceptive lending practices.

guarantees. True consumer protection can only be provided through federal legislation that applies to all actors and addresses all abuses.

VI. Increased Regulation Will *Not* Reduce Access to Legitimate Credit

The premise of HOEPA is that when rates or fees are charged which are considerably higher than the norm, additional regulation is appropriate. The higher the rates and fees, the more likely the loan is predatory, and the more necessary closer regulation becomes.[40] When Congress first passed HOEPA, there was little concrete information available about the number of loans that would be affected by the triggers, or the extent to which credit availability would be limited by HOEPA. We now have the data supplied by the staff of the Federal Reserve Board and other federal agencies, and an analysis by Professor Cathy Mansfield.[41] Current information shows that while some subprime lenders charged as much as 13 points above comparable treasury rates, the *median* subprime mortgage rates are typically 4 to 5 percentage points above comparable treasury securities. Thus, the bulk of subprime lending is well below the proposed – 8 or 6 point – HOEPA triggers in S.2415.

Reducing the trigger to Treasury to 6 points will not substantially affect legitimate subprime mortgage credit. However, loans above the trigger are highly likely to have predatory features, or involve borrowers at very high risk of default and foreclosure, for whom HOEPA protections are especially important. Professor Mansfield's data suggest that even a reduced cutoff of 6 points would affect fewer than 25% of loans made in the 1995 to 1999 period.[42] Yet, these are the loans most in need of the protective provisions of HOEPA.

To the industry's cry of "reduced credit availability," the advocacy community responds: "Only bad credit will be reduced, not good credit." Because they fall so far outside the median, no amount of

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[40]*See generally, Problems in Community Development Banking, Mortgage Lending Discrimination, Reverse Redlining, and Home Equity Lending, Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs,* 103d Cong., 1st Sess. (Feb. 3, 17, 24, 1993); *Hearing on S. 924 Home Ownership and Equity Protection Act, before the Senate Banking Committee,* 103d Cong., 1st Sess. (May 19, 1993), *The Home Equity Protection Act of 1993, Hearings on H.R. 3153 Before the Subcommittee on Consumer Credit and Insurance of the House Committee on Banking, Finance and Urban Affairs,* 103d Cong., 2d Sess. (March 22, 1994); *Hearing on Community Development Institutions, 103-2, before the House Subcommittee on Financial Institutions Supervision, Regulation and Deposit Insurance,* 103d Cong. 1st Sess. (Feb. 2-4, 1993).

[41]Cathy Lesser Mansfield, *The Road to Subprime "HEL" Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market,* 51 S.C.L. Rev. 473, 536-37 (Spring 2000).

[42]*Id.* at Table 1. It should be noted that the HOEPA trigger is based on APR, which is generally higher than the interest rate. On the other hand, a significant difference between the APR and the interest rate on a long-term mortgage loan results from very high prepaid finance charges (points), which is another strong indicator of potential predatory practices.

additional credit risk can justify these rates, without the added protections of HOEPA. The Federal Reserve Board commented on this point:

> A borrower does not benefit from . . . expanded access to credit if the credit is offered on unfair terms or involves predatory practices. Because consumers who obtain subprime mortgage loans have fewer credit options than other borrowers, or because they perceive that they have fewer options, they may be more vulnerable to unscrupulous lenders or brokers.[43]

We agree with the Federal Reserve Board that access to predatory lending is not a benefit to homeowners. Destructive credit is worse than no credit at all. This is evident in light of the increase in foreclosures, the disintegration of many low-income and minority neighborhoods,[44] and the erosion of the tax base of cities due to foreclosures. *Further, we maintain that access to credit will not be reduced if predatory mortgage lending is severely curtailed.* Predatory mortgage loans have simply replaced other forms of credit that were not as devastating. For example, prior to the explosion in home mortgage lending, homeowners without access to mainstream banks typically obtained credit from finance companies. Small loans – typically with interest rates around 36% – and relatively high second mortgage loans – typically with interest rates of 18% or more – provided needed credit to these households. While there were problems with these types of credit (as equated to what was available from banks, this credit was comparatively expensive) their use did not have the devastating impact on homeownership and communities that predatory mortgage lending has had in the past few years.

If the result of extended regulation is actually to reduce the numbers of mortgage loans available to homeowners with impaired credit, other avenues of credit will simply quickly open up. It does not make sense to encourage the use of home secured credit if that credit creates an increased risk of losing the home.

VII. Other Federal Laws Should Be Changed to Address the Predatory Mortgage Problem.

Just as there are a number of causes for predatory mortgages, a panoply of changes to federal law and policies are necessary to terminate the worst abuses. In addition to amending the HOEPA – as proposed by S.2415 – other changes in federal law are also necessary. Set out below is an overview of the other changes we believe are necessary:

A. Tax Reform to Encourage Preserving Home Equity

The changes in the 1986 Tax Reform Act that only permit personal interest deductions for loans secured by residences should be amended to limit home secured debt to debt which is not only secured by the home, but is also obtained for reasons relating to the home. Also, all individual taxpayers should be permitted some measure of deductions for unsecured personal credit. We propose that changes to the tax

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[43] 65 Fed. Reg. 81438, 81441 (Dec. 26, 2000).

[44] *See* Debbie Gruenstein and Christopher E. Herbert, *Analyzing Trends in Subprime Originations and Foreclosures: A Case Study of the Boston Metro Area, Abt Associates Inc.* (Sept. 2000); Daniel Immergluck and Marti Wiles, *Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development,* Woodstock Institute (November 1999), available at www.woodstockinst.org.

code be essentially revenue neutral, to both the U.S. Treasury, and to most individual taxpayers, along the following basic guidelines:

- Loans for home secured debt should be tax deductible only for that portion of the loan which is related to the purchase, repair or improvement of the home or related property.

- In exchange, all individual taxpayers should be provided with a percentage of their income which can be deducted for expenditures spent for consumer debt.

Existing home mortgage loans could be grandfathered, such that the interest expenses for these loans would remain deductible, in recognition of the decisions that millions of taxpayers to date have made.

The effect of this small, but significant, change in the tax laws would be to remove the unhealthy incentives that too many American households are faced with to spend their home equity to pay off consumer debt. This change would encourage the decades-old national policy of encouraging and sustaining home ownership, and reverse many of the terrible consequences of the 1986 tax code.

B. Federal Protections Should Be Established in Foreclosure Proceedings

Given the alarming increase in foreclosures over the past two decades, federal law must provide some additional protections to borrowers losing their homes to foreclosure.

- Increased funding for housing counselors and mandatory notice regarding their availability. Good housing counselors can facilitate loan workouts on purchase money mortgages that preserve home ownership, prevent foreclosure, and reduce costs for lenders. Fannie Mae, Freddie Mac, and the FHA have implemented loss mitigation tools to avoid foreclosure and housing counselors are an essential part of that process. All mortgage lenders should be required to provide some support for housing counselors and notice of the availability of housing counselors should be required before any foreclosure can proceed.

- Lenders should provide homeowners with the opportunity to pay off the arrearage and avoid foreclosure. Although this seems obvious and in the best interest of both parties, this is not always done. Lenders should be required to give notice to defaulting homeowners of the amount past due and the amount needed to avoid foreclosure prior to the addition of fees. The notice should list the various workout options available. These options have been accepted by Fannie Mae, Freddie Mac, and the FHA as appropriate loss management tools in the industry. Lenders should also be required to attempt to avoid foreclosure through various loan workout mechanisms. Further, a lender should not be permitted to unreasonably reject a workout proposal and simply proceed to foreclosure.

C. Expansion and Extension of the Community Reinvestment Act

The CRA should be expanded so that all mortgages made by a bank, as well as its subsidiaries and affiliates, are considered when a CRA rating is determined. All mortgages which are considered predatory should be counted against a bank's CRA rating. Similarly, HMDA should provide better

information about all mortgage loans made by financial institutions, including information about rates, points and fees charged, refinancings and foreclosures.

We propose that for each loan that a bank or its subsidiaries or affiliates makes which fits *any one* of the following criteria, there should be explicit negative consequences – the loan should be counted *against* the bank's CRA rating:

1. Loans with excessive costs. Loans in which more than 3% of the total loan amount (or 4% if the loan is FHA-insured) consists of up-front points and fees.[45]

2. Loans with higher annual percentage rates. Loans in which the annual percentage rate equals or exceeds four percentage points (4%) over the yield on United States Treasury securities having comparable maturities at the time the loan is made.[46]

3. Loans with prepayments penalties and other abusive terms. Loans which (a) have a prepayment penalty provision; (b) have a clause allowing for the interest rate to increase upon default; or (c) negatively amortize at any point during the term.

4. Loans in which credit insurance is financed. Loans in which the lender financed, directly or indirectly, any credit life, credit disability, credit unemployment or credit property insurance, or any other life or health insurance, or any payments financed by the lender directly or indirectly for any debt cancellation or suspension agreement or contract, except insurance premiums or debt cancellation or suspension fees calculated and paid on a monthly basis shall not be considered financed by the lender.

5. Loans which contain mandatory arbitration clauses. Loans which contain a mandatory arbitration clause that limits in any way the right of the borrower to seek relief through the judicial process for any and all claims and defenses the borrower may have against the lender, broker, or other party involved in the loan transaction.

D. Increased Data Collection is Critical – the Home Mortgage Disclosure Act should cover all Mortgage Loans

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[45]Points and fees must be defined as: (a) all items listed in 15 U.S.C. § 1605(a)(1) through (4), except interest or the time-price differential; (b) all charges listed in 15 U.S.C. § 1605(e); (c) all compensation paid directly or indirectly to a mortgage broker, including a broker that originates a loan in its own name in a table-funded transaction; (d) the cost of all premiums financed by the lender, directly or indirectly for any credit life, credit disability, credit unemployment or credit property insurance, or any other life or health insurance, or any payments financed by the lender directly or indirectly for any debt cancellation or suspension agreement or contract, except insurance premiums calculated and paid on a monthly basis shall not be considered financed by the lender. Total loan amount means the principal of the loan minus the points and fees.

[46]The equivalent yield for the Treasury securities should be determined by the following rules: (a) adjusted to a constant maturity of a comparable term (as made available by the Federal Reserve Board) as of the week immediately preceding the week in which the interest rate for the loan is established. Further, b) if the terms of the home loan offers any initial or introductory period, and the annual percentage rate of interest is less than that which will apply after the end of such initial or introductory period then the annual percentage rate of interest that shall be taken into account for purposes this subsection shall be the rate which applies after the initial or introductory period; (c) in the case of an annual percentage rate which varies in accordance with an index, the rate shall be the maximum rate permitted at any time by the loan documents.

Effective enforcement of these rules requires sunshine – HMDA should be changed to require the full disclosure of all information for all subprime lending by all mortgage lenders, regardless of whether the loans are made by the lender, its subsidiary or an affiliate. Specifically, HMDA should require the following information about each loan:

- the annual percentage rate and interest rate of the loan;
- the principal amount of the loan and the amount financed (as defined by TILA);
- the total closing costs, points and fees, and financed credit insurance premiums (and related products);
- the delinquency and foreclosure rates on an annual basis (for all subprime loans, as compared to other types of loans in the total portfolio);
- the length of time between purchase and refinance, if any, on an aggregate basis.

PREPARED STATEMENT OF NEILL A. FENDLY, CMC

IMMEDIATE PAST PRESIDENT, NATIONAL ASSOCIATION OF MORTGAGE BROKERS

JULY 27, 2001

Mr. Chairman and Members of the Committee, I am the Immediate Past President of the National Association of Mortgage Brokers (NAMB), the Nation's largest organization exclusively representing the interests of the mortgage brokerage industry. We appreciate the opportunity to address you today on the subject of abusive mortgage lending practices.

NAMB currently has over 12,000 members and 41 affiliated State associations nationwide. NAMB provides education, certification, industry representation, and publications for the mortgage broker industry. NAMB members subscribe to a strict code of ethics and a set of best business practices that promote integrity, confidentiality, and above all, the highest levels of professional service to the consumer.

In these hearings, the Committee will hear a number of individual stories as well as comments from advocates about some egregious, and in our view inexcusable, mortgage lending practices. You will also hear from others in the mortgage industry about possible solutions, which NAMB supports and is actively involved in developing. My testimony today will briefly outline some of these. But I would like to focus this testimony on helping the Committee understand the important and unique role of mortgage brokers in the mortgage marketplace, and offer the unique perspective of mortgage brokers in examining the problem of predatory lending.

Today, our Nation enjoys an all-time record rate of homeownership. While many factors have contributed to this record of success, one of the principal factors has been the rise of wholesale lending through mortgage brokers. Mortgage brokers have brought consumers more choices and diversity in loan programs and products than they can obtain from a branch office of even the largest national retail lender. Brokers also offer consumers superior expertise and assistance in getting through the tedious and complicated loan process, often finding loans for borrowers that may have been turned down by other lenders. Meanwhile, mortgage brokers offer lenders a far less expensive alternative for nationwide product distribution without huge investments in "brick and mortar." In light of these realities, it is no surprise that consumers have increasingly turned to mortgage brokers. Today, mortgage brokers originate more than 60 percent of all residential mortgages in America. The rise of the mortgage broker has been accompanied by a decline in mortgage interest rates and closing costs, an increase in the homeownership rate, and an explosion in the number of mortgage products available to consumers. These positive developments are not mere coincidences. They would not have been possible without the advent of wholesale lending through mortgage brokers.

Mortgage brokers now have an extremely important role in our economy. With the collapse of the savings and loan industry in the 1980's, followed by the rapid consolidation of mortgage banking firms in the 1990's, today we find that in many communities, particularly in central cities and small towns, people might have a hard time finding a retail bank branch or retail mortgage lending branch. But they can usually find a mortgage broker right in their community that gives them access to hundreds of loan programs. Mortgage brokers are generally small business people who know their neighbors, build their businesses through referrals from satisfied customers, and succeed by becoming active members of their communities.

The recent expansion in subprime lending, which has been noted by the Committee in these hearings and others, has also relied heavily on mortgage brokers. Mortgage brokers originate about half of all subprime loans. Many mortgage brokers are specialists in finding loans for people who have been turned down by other lenders. These are hard-working people who, for one reason or many reasons, do not fit the profile that major lenders prefer for their customers. Each of them is unique. Some lenders just do not want to be bothered with such customers that take a little more time and effort to qualify. Some do not want to accept the risk of lending to someone who may have had a bankruptcy, an uneven employment history, or a problem with a previous creditor.

Mortgage brokers can usually find a loan for someone who has been turned down by others. Most mortgage brokers who originate subprime loans do so primarily because they enjoy helping people. Certainly these loans can be profitable, and borrowers do pay higher rates and fees because of the increased risk, but subprime loans are also time-consuming and often very difficult to arrange.

Mortgage brokers often do an amazing amount of work on these loans. They work with borrowers, sometimes for weeks, to help them understand their credit problems, work out problems with other creditors, clean up their credit reports when possible, and review many possible options for either purchasing a home or utilizing

their existing home equity as a tool to improve their financial situation. The brokers are rewarded with the knowledge that they have enabled a hard-working family to buy its first home, avoid foreclosure, get out from under a crushing load of high-rate credit card debt, finance their children's education, pay delinquent taxes, repair their homes, and help their parents pay off their mortgages and health care bills.

People of all income levels may end up in situations that leave them unable to qualify for the lowest mortgage rates and fees. But they still need, and deserve to have, access to mortgage credit. It is a lifeline for those who are drowning in debt, facing a huge medical bill, trying to survive a layoff. It is the least expensive source of credit for those who may have made some mistakes or had some misfortune in the past and now need money to improve their home, finance their children's education, or even start a business. They need to have the widest possible range of choices when they are buying a home or need a second mortgage. And today they do. It is important for them, and for others like them in the future, that Congress be very careful to avoid measures that will rob them of choices they deserve and the tools they need to manage and improve their financial situation.

One of the most important choices available to consumers with low-incomes, little or no cash, and/or impaired credit is the "no- or low-cost" loan. Mortgage brokers have originated thousands of loans for people who were able to buy a home, refinance, or obtain a home equity loan with little or no upfront closing costs or broker fees. These costs are financed through an adjustment to the interest rate. Retail lenders offer "no- or low-cost" loans at adjusted rates as well. When a mortgage broker arranges a loan like this, the broker is compensated by the lender from the proceeds of the loan. This kind of payment goes by many names, but is often called a "yield spread premium." These payments are perfectly legitimate and legal under Federal law, the Real Estate Settlement Procedures Act, so long as they are reasonable fees and the broker is providing goods, services, and facilities to the lender. These payments to mortgage brokers are also fully disclosed to borrowers on the Good Faith Estimate and the HUD–1 Settlement Statement, and are included in the interest rate. Retail lenders, however, are not required to disclose their profit on a loan that is subsequently sold in the secondary market, as most mortgages are today. This method of enabling consumers to obtain loans through mortgage brokers with little or no upfront costs is now under assault in the courts. Despite Statement of Policy 1999–1, issued at the direction of Congress by the Department of Housing and Urban Development in 1999, which clearly set forth the Department's view that the legality of mortgage broker compensation must be judged on a case-by-case basis, trial lawyers across America have continued to file and pursue class action lawsuits claiming that all such payments are illegal and abusive.

Recently, the 11th Circuit agreed with the plaintiff in one of these suits and allowed a class action to be certified. Although at first glance this appears to be only a procedural decision, it has resulted in a flood of new litigation against mortgage brokers and wholesale lenders, and caused a great deal of uncertainty and anxiety in the mortgage industry. The cost of defending these class actions is staggering. The potential liability could run to over a billion dollars. The prospect of a court deciding that the prevalent method of compensation for over half the mortgage loans in America is illegal is chilling, to say the least.

If these lawsuits succeed, some lawyers will benefit at the expense of the mortgage industry. Their clients might get small refunds, or a few dollars off the cost of their next loan. But the real losers will be tomorrow's first time home buyers, tomorrow's working families, tomorrow's entrepreneurs who will not be able to get a mortgage without paying hundreds of dollars upfront. And, further down this road, many small businessmen and women may not be able to stay in business as mortgage brokers without being able to offer these "no-cost" loans. As competition decreases, all potential mortgage borrowers will suffer higher costs and fewer choices. This illustrates the unintended consequences that can come from litigation, regulation, or legislation that singles out one part of the mortgage industry, places blanket restrictions or prohibitions of certain types of loan terms or products, or places unreasonable restrictions on interest rates and fees. We have ample reason to believe that such measures will increase the cost of homeownership, restrict consumer choice, and reduce the availability of credit, primarily to low- and moderate-income consumers.

To further illustrate the problem with blanket restrictions on loan terms, consider the balloon loan. A balloon term in a given loan could be abusive if the borrower has not been advised that the loan contains such a feature and is not prepared for the practical ramifications. Further, it may be that the borrower's situation does not make such a feature appropriate. Yet, very often, a balloon is a valuable tool to help a borrower obtain a lower interest rate and lower monthly payments that are affordable. If the borrower's circumstances are such that a refinance loan should be rea-

sonably feasible at some time in the future, and possibly even at a lower interest rate because the borrower has improved his or her credit standing in the meanwhile, then a balloon term can be a desirable feature. Many reputable, mainstream lenders offer balloon loans to customers in all credit grades, and many borrowers freely choose such loans, because they are good options in many cases.

The same is true for other loan terms or conditions frequently cited as abusive, including negative amortization, prepayment penalties, financing of closing costs, and even arbitration clauses. In certain circumstances, each of these may be abusive, but in the majority of cases they provide the consumer with a feature that fits his or her unique circumstances, such as a reduced interest rate or lower monthly payment. Virtually no loan terms are always abusive, and almost any loan term that is offered in the market today can be beneficial to some consumers. Whether a loan is abusive is a question that turns on context and circumstances, from case to case. This is the primary reason why NAMB and the mortgage industry have opposed legislation or regulation that would impose new, blanket restrictions or prohibitions on loan terms. We believe such measures will increase the cost of homeownership, restrict consumer choice, and reduce the availability of credit, primarily to low- and moderate-income consumers.

NAMB believes that the problem of predatory lending is a threefold problem of abusive practices by a small number of bad actors; lack of consumer awareness about loan terms; and the complexity of the mortgage process itself. We believe all three of these areas must be addressed, together and with equal force, if the problem is to be solved without the unintended consequences mentioned earlier. The mortgage industry is working vigorously in all three areas, and NAMB wants to continue working with Congress to address all these areas—in particular, reform and simplification of the mortgage process.

Addressing Abusive Practices

Those of us who are hard-working, reputable mortgage originators want nothing more than to get the bad actors out of our industry. We do not like competing against people who fraudulently promise deceptively low rates or costs and do not disclose their fees, thereby making those of us who obey the law appear more expensive. We do not like the bad publicity our industry receives from media stories about lenders or brokers who take advantage of senior citizens and poor people. We know the long-term survival of our industry depends on having satisfied customers and maintaining the trust people have in us as professionals, so we cannot afford to have anyone making loans that hurt consumers and violate that trust.

All types of institutions have bad actors among their ranks. This is not an issue that is confined to lenders, mortgage brokers, depository institutions, or independent companies. Bad actors are found among all of these types of entities. We wish to emphasize in particular that mortgage brokers are not the only ones involved; we have observed that many have blurred the distinction between mortgage brokers and various other types of companies.

A popular misconception is the belief that abusive lenders operate within existing regulatory guidelines. Rather, most of them choose to ignore laws and regulations that properly apply to them. There is a small minority of institutions that do not obtain State licensure as required. Some ignore State consumer protection laws. They do not observe the existing restrictions in the Federal HOEPA. They may even violate basic disclosure rules under RESPA and TILA. In many cases they are committing outright fraud, which violates yet other State and Federal statutes. And, in general, they do not join industry groups such as NAMB or the comparable organizations for their respective industries.

There are many tools at our disposal now to deal with these people and companies. Laws already exist at the Federal and State level that give regulators and prosecutors the authority to revoke licenses, impose fines, and even pursue criminal prosecution of lenders or brokers that commit fraud, charge unreasonable fees, and otherwise violate HOEPA, RESPA, TILA, and other Federal statutes. The Federal Trade Commission has brought enforcement actions under HOEPA. These enforcement actions do have a deterrent effect on others. The Department of Housing and Urban Development is improving its own lender approval and enforcement policies for FHA lending. Many States have toughened their licensing laws, usually with the full support of our affiliated State mortgage broker associations.

The industry is also taking steps to address practices and behaviors in the market that can be eliminated and thereby maintain trust in our industry. We note that one of these, the sale of single-premium credit life insurance, has been dramatically curtailed in recent weeks by the major companies involved with that product. In another example, a major subprime lender recently stopped using several hundred mortgage originators that did not meet its standards of professional practice. NAMB

supported this effort and continues to encourage wholesale lenders to use their broker agreements to ensure sound origination practices. NAMB and other major mortgage lending organizations have adopted Codes of Ethics and Best Business Practices guidelines, and we all encourage consumers to make sure that their lender or broker is a member of one of these national organizations.

Another unacceptable practice is loan flipping. NAMB supports reasonable measures that would stop this kind of abusive practice, but still allow people to refinance their loans when they need to. For example, we support the proposal by the Federal Reserve to limit the amount of fees that can be charged in a refinance of a HOEPA loan by the existing lender to the new money financed. Some subprime lenders are addressing this practice by discouraging frequent refinancing of their existing customers. One major subprime lender just this week announced new measures to ensure that refinances truly benefit the borrower. We think this is a great step that other lenders should and will soon follow. Many of the consumer groups here today are working with major lenders on these industry initiatives.

Consumer Education

The second part of addressing predatory lending is improving consumer awareness. An informed consumer is almost never a victim of a predatory loan. Every organization coming before the Committee today is involved in some way with consumer education. NAMB encourages its members to never originate a loan to an uninformed consumer. NAMB's website includes extensive consumer information and links to sites that provide consumers a wealth of information they can use to make informed mortgage choices. The NAMB Mortgage 101 Center provides consumers with information from one of the mortgage industry's most popular and reliable online resources. The website provides consumers with information, in an unbiased manner, about completing applications, the purpose of an appraisal, bankruptcy and its alternatives, mortgage calculators, down payments, FHA loans, loan programs, refinancing, relocation, second mortgages, VA loans and many other topics. This website provides consumers with unbiased answers to many basic questions and many more specific issues.

Fannie Mae, with its "Consumer Bill of Rights" campaign and Freddie Mac with its "Don't Borrow Trouble" campaign are putting millions of dollars into educating people about how to choose a good mortgage loan and avoid being victims of predatory lending. AARP has launched a great education campaign aimed at seniors, who are often the target of predatory lenders. NAMB supports these efforts.

It is also important for consumers to understand how to use credit, and the impact of their credit on their ability to obtain a mortgage at the lowest cost. There are also industry efforts underway in this area, and we understand Senator Corzine and others on this Committee are looking at ways to use Federal education programs and dollars to promote financial education in the public schools. NAMB supports the education of consumers in broader financial issues, such as managing money, managing credit card debt, and other important issues. Ideally, these areas should be taught routinely as part of the standard junior high school or high school curricula in schools. NAMB has also dramatically increased educational programs offered to its members, and revamped its certification program, to encourage all mortgage brokers to be well informed about current laws, regulations, and ethical business practices.

Comprehensive Mortgage Reform

The third part of the solution is one into which NAMB has put a tremendous amount of effort. That is a comprehensive overhaul of the statutory framework governing mortgage lending. We cannot emphasize enough to this Committee how badly this framework needs to be changed, and how important this is to curtailing abusive lending.

The two major statutes governing mortgage lending were enacted in 1968 and 1974. The disclosures required under these laws are confusing and overlapping. The laws actually prevent consumers from being as well informed as they could be, and put consumers at a decided disadvantage in the mortgage process. For example, in most cases the borrower does not know the exact amount of the closing costs until he/she arrives at the closing, because the law requires only that costs be estimated early in the process. The way the interest rate, terms, and monthly payments on a mortgage are calculated and disclosed is confusing and makes it impossible for consumers to effectively compare different types of mortgage products. Mortgage brokers are required to itemize their profit on each loan, but retail lenders are not.

This is all terribly confusing to consumers. The entire process is much too complicated in a modern world of instant communications and one-click transactions. Mortgage brokers are confronted every day with the frustrations of our customers

about the many confusing, and largely useless, disclosures and paperwork. And we know better than anyone that unscrupulous lenders take advantage of this complexity and confusion to deceive and mislead borrowers, hide onerous loan terms in pages of fine print, and load up unnecessary fees at closing when the borrower feels pressured and unable to walk away. Confused consumers, oftentimes desperate for cash or credit, are more likely to simply rely on the word of an unscrupulous loan officer and not question their loan terms, rates, or fees.

If the mortgage process were simplified, as we have proposed, consumers could more effectively shop for loans. They could easily compare fixed-rate, adjustable-rate, balloon loans, etc. They would have simple disclosures without a lot of fine print that can hide deceptive fees or onerous loan terms. They would easily be able to question and change terms and fees with which they do not agree, well before closing. In addition, a simplified process would reduce costs for originators, and the savings would be passed on to consumers. These changes would put the consumer in a stronger position with more information, thereby drastically decreasing the opportunities for abusive lending.

NAMB has been engaged from the beginning in efforts to reform the laws regulating mortgage originations. We participated in the Negotiated Rulemaking convened by HUD in 1995, which sought to resolve the issues surrounding mortgage broker compensation under RESPA. Following that effort, it became apparent to NAMB that the entire statutory framework governing mortgage lending needed an overhaul. In 1996, NAMB was the first major industry group to form an internal task force on mortgage reform and begin developing a proposal for comprehensive reform of RESPA and TILA. We participated in the Mortgage Reform Working Group in 1997 and 1998, which sought to reach a consensus among industry and consumer advocates on how to reform RESPA and TELA. And we participated in the HUD-Treasury Department joint task force on predatory lending convened by the previous Secretaries of HUD and Treasury, in which we continued to press the case for comprehensive reform.

NAMB remains committed to the goal of comprehensive mortgage reform and simplification. We urge this Committee in the strongest terms to work with our industry on reform legislation. We ask the consumer advocates here to reengage with us in developing a reform proposal. Without comprehensive statutory reform and simplification of the entire process, consumers will still be too confused and too vulnerable to deceptive disclosures and unnecessary fees at closing. Legislation that seeks only to restrict or prohibit certain loan terms or pricing will only add to the complexity of the process and reduce the availability of credit.

Conclusion

In conclusion, I want to reiterate that NAMB supports measures by the industry and regulators to curb abusive practices, punish those who do abuse consumers, and promote good lending practices. We support legislation that would reform and simplify the mortgage process, and believe this is the legislation that is most needed to empower consumers. We believe the problem of predatory lending can only be solved through a three-pronged approach of enforcing existing laws and targeting bad actors; educating consumers; and reforming and simplifying the mortgage process. In considering any new legislation, we urge Congress to apply this fundamental principle: Expanding consumer awareness and consumer power, rather than restricting consumer choice and product diversity, should be the goal of any new legislation affecting the mortgage process.

Thank you for this opportunity to express our views. We look forward to working with the Committee in the future.

PREPARED STATEMENT OF DAVID BERENBAUM

SENIOR VICE PRESIDENT, PROGRAM AND DIRECTOR OF CIVIL RIGHTS
NATIONAL COMMUNITY REINVESTMENT COALITION

JULY 27, 2001

Good morning Chairman Sarbanes, Senator Gramm, and Members of the Committee. My name is David Berenbaum, and I am Senior Vice President—Program and Director of Civil Rights of the National Community Reinvestment Coalition (NCRC). NCRC is a national trade association representing more than 800 community based organizations and local public agencies who work daily to promote economic justice in America and to increase fair and equal access to credit, capital, and

banking services to traditionally underserved populations in both urban and rural areas.

NCRC thanks you for the opportunity to testify today on the subject of predatory lending. In particular, I will focus our testimony on:

- Defining predatory lending;
- Identifying why existing statutory and regulatory consumer protections are inadequate; and
- Strongly endorsing new public policy legislation and private sector initiatives to eliminate the practices that perpetuate the dual lending market in our Nation.

With all due respect to the representatives from the subprime lending industry who are testifying in these series of hearings, it is important to "cut to the chase" and to challenge the myths associated with subprime lending. First, subprime lending is *not* responsible for the all time high levels of homeownership in the United States. Second, subprime lending is *not* responsible for ending redlining in our communities. Third, responsible subprime lenders will *not* stop underwriting mortgage loans in our neighborhoods simply because new legislation prompts industry "best practices" to replace "predatory practices" in our cities and counties. And fourth, unfortunately existing law—and certainly industry suggestions of consumer education alone—are not adequate to foster greater compliance on a voluntary, statutory or regulatory level.

The Community Reinvestment Act and fair lending laws have been responsible for leveraging tremendous increases in loans and investments for underserved communities. For example, vigorous enforcement of existing CRA and fair lending laws encourage depository institutions to compete for business in minority and lower-income communities—precise areas predatory lenders target. Unfortunately, financial modernization legislation has opened the doors for too many nondepository lending institutions and affiliates of depository institutions to escape the scrutiny of regular CRA and fair lending reviews. One of the unintended consequences of financial modernization has been to allow some lenders to operate in an unregulated environment, fearless of oversight and in a predatory manner. By itself, regulatory enforcement cannot ensure that the millions of annual lending transactions are free of abusive and predatory terms and conditions.

Mr. Chairman, Senator Gramm, there are lenders and brokers in the marketplace engaged today, not only in deception and fraud, but also discrimination. They need to be held accountable. While they masquerade as good neighbors, bankers, brokers, and legitimate business people, these "predators" systematically defraud innocent individuals out of their money and property. They accomplish their illicit purposes by means of fraudulent loans and high-pressure, unscrupulous methods. Using these loans, predatory lenders extract unconscionable and unjust fees from their victims until there is no money left to extract; then they expropriate their victims' homes through foreclosures which, in many cases, the loans were specifically designed to facilitate. Predatory subprime lenders intentionally misuse and exploit the weaknesses in existing laws and regulations to their benefit and injure our communities every day. This was powerfully addressed by the victims of predatory lending who testified at yesterday's hearing.

The collective efforts of the advocates at this table and others around the Nation are responsible for 2001 heralding the death of single-premium credit life—Citigroup, Household, American General and several other companies and their respective trade associations have abandoned the product.

It is our hope that 2001 will also be the year that Congress and the President, in cooperation with the GSE's, the industry and community organizations, will enact protections to ensure equal professional service, fair lending and equal access to credit based upon risk, not race and community demographics, in the subprime lending market. New law is needed to cover both loan origination and purchases made in the secondary market. In partnership with the GSE's and responsible lenders we can create funds to refinance predatory loans and realize sensible and profitable market corrections. Freddie Mac's and Fannie Mae's recent entry into the subprime market is prompting subprime loan originators to review problematic products and policies, that is, credit life, through monitoring of portfolios and clear subprime underwriting guidelines. Through new legislation, reinvigorated use of existing laws, enlightened regulatory oversight, and consumer empowerment and sunshine concerning the issues of credit scoring in loan origination and automated underwriting, we can make 2001 truly a remarkable year.

Definitions

A subprime loan is defined as a loan to a borrower with less than perfect credit. In order to compensate for the added risk associated with subprime loans, lending institutions charge higher interest rates. In contrast, a prime loan is a loan made

to a creditworthy borrower at prevailing interest rates. Loans are classified as "A," "A-minus," "B," "C," and "D" loans. "A" loans are prime loans that are made at the going rate while "A-minus" loans are loans made at slightly higher interest rates to borrowers with only a few blemishes on their credit report. The so-called "B," "C," and "D" loans are made to borrowers with significant imperfections in their credit history. "D" loans carry the highest interest rate because they are made to borrowers with the worst credit histories that include bankruptcies.

In contrast, a predatory loan is defined as an unsuitable loan designed to exploit vulnerable and unsophisticated borrowers. Predatory loans are a subset of subprime loans. They charge more in interest and fees than is required to cover the added risk of lending to borrowers with credit imperfections. They contain abusive terms and conditions that trap borrowers and lead to increased indebtedness. They pack fees and products onto loan transactions that consumers cannot afford. They do not take into account the borrower's ability to repay the loan. They prey upon unsophisticated borrowers who rely in good faith on the expertise of the loan originator or their agent. Ultimately, predatory loans strip equity and wealth from communities.

Recent Trends In Subprime Lending

Since predatory lending is a subset of subprime lending, it is important to take a closer look at the subprime market and its growth to better understand the growth of the predatory lending problem facing underserved communities today. Increasingly, subprime lending is becoming the only option of all too many low-income and minority borrowers. This reality sadly documents the continued existence of the race line in America and the continued existence of the dual lending market in the United States. Whereas before, African-Americans were openly denied access to credit, today the "race tax" is more sophisticated, more costly—and equally exploitative. Where once redlining undermined communities, today "reverse redlining" has become the norm and threatens to undermine our communities' economies, social services, and tax base. On an individual level, the emotional and financial cost of predatory lending cannot even be calculated, and endangers every family's investment in their home and future. If, for example, an African-American female head of household who lives in Baltimore, Maryland, with good credit refinances a $150,000 loan at 6.75 percent for 30 years, the cost to the consumer in interest is $200,240. If, however, this same African-American female is pressured or coerced into refinancing with a subprime loan at 14.75 percent for 30 years, the total interest paid over the life of the loan will be $522,015—a difference of $321,775. These are funds that the mortgage holder could have used for home improvements, a college education, to start a small business or for financial security. This is how the dual lending market imposes a "race tax" upon our communities. In fact, predators have made the "race tax" situation worse for our victim by charging her closing costs in excess of four points, tying in a high interest credit card, and including an exorbitant prepayment penalty fee—all standard predatory practices.

Sadly, an analogy to racial profiling is appropriate here. We have all become familiar with the term "Driving While Black." Subprime predatory lending has become the equivalent of "Borrowing While Black."

The attached exhibits, which map subprime and conventional lending patterns using census data, vividly reveal lending disparities in predominantly white and predominantly minority census tracts. For example, the map of Trenton, New Jersey shows that minority neighborhoods in 1999 were 4 times more likely to receive subprime refinance loans. Subprime lenders made more than 43 percent of loans in Trenton minority census tracts but only 11 percent in predominantly white tracts. The disparity in subprime market share by minority level of neighborhood in Austin, Texas and Baltimore, Maryland was also very large. In Austin, subprime lenders' market share in minority neighborhoods was about 3.5 times greater than their market share in predominantly white neighborhoods. And in Baltimore, subprime lenders issued approximately 50 percent of all the conventional refinance loans issued in minority neighborhoods in 1999. When subprime lenders dominate the refinance market in minority and low-income neighborhoods, they are apt to take advantage of their dominance and make abusive loans. Stronger antipredatory laws combined with stepped up CRA enforcement of prime lenders is necessary to eliminate abuses and increase competition and choices of loan products in these neighborhoods. The appendix to the NCRC testimony provides data tables and maps showing lending disparities across States including New Jersey, New York, Texas, and Maryland. These maps easily could represent disparities in any urban community in the United States today. The practices which gave rise to these lending patterns undermine our Nation's commitment to fair lending, CRA and corporate responsibility and best practices.

A national poll conducted for NCRC in 2000 by the bi-partisan team of Jennifer Laszlo and Frank Luntz; found that Americans overwhelmingly support fairness in lending. Of those surveyed, 92 percent said they believed that every creditworthy person should, by law, be given information about the best loan rate for which they qualify. With abusive subprime and predatory lending, this is not the practice.

NCRC, and our members, have documented over 30 widespread lending practices that despite existing legal protections have contributed to the problem of predatory lending. These predatory practices, which I will now identify, include issues relevant to the marketing, sale, underwriting, and maintenance of subprime loans.

Marketing:

- Aggressive solicitations to targeted neighborhoods
- Home improvement scams
- Kickbacks to mortgage brokers (Yield Spread Premiums)
- Racial steering to high rate lenders

Sales:

- Purposely structuring loans with payments the borrower can not afford
- Falsifying loan applications (particularly income level)
- Adding insincere cosigners
- Making loans to mentally incapacitated homeowners
- Forging signatures on loan documents (that is, required disclosure)
- Paying off lower cost mortgages
- Shifting unsecured debt into mortgages
- Loans in excess of 100 percent LTV
- Changing the loan terms at closing

The loan itself:

- High annual interest rates
- Product packing
- High points or padded closing costs
- Balloon payments
- Negative amortization
- Inflated appraisal costs
- Padded recording fees
- Bogus broker fees
- Unbundling (itemizing duplicate services and charging separately for them)
- Required credit insurance
- Falsely identifying loans as lines of credit or open end mortgages
- Forced placed homeowners insurance
- Mandatory arbitration clauses

After closing:

- Flipping (repeated refinancing, often after high-pressure sales)
- Daily interest when loan payments are late
- Abusive collection practices
- Excessive prepayment penalties
- Foreclosure abuses
- Failure to report good payment on borrower's credit reports
- Failure to provide accurate loan balance and payoff amount

Congress, therefore, on a bipartisan basis, should pass the strongest legislation possible to end these practices and establish law that the industry, regulators, State attorneys general, advocates, and consumers can use to safeguard the public interest. In 2001 to date, 31 States have introduced over 60 legislative measures attempting to combat predatory lending practices. Additionally, nine major metropolitan cities and counties have introduced local ordinances to deal with predatory lending. Surely, a meaningful national standard is preferable.

Keeping in mind our definition of a predatory loan—an unsuitable loan designed to exploit vulnerable and unsophisticated borrowers—enacting relevant consumer protections becomes a straightforward legislative policy exercise which clarifies and complements existing civil rights, consumer protection, and disclosure laws.

The Truth Behind the Statistics

Over the past several years, there has been a tremendous explosion in subprime lending. According to the Department of Housing and Urban Development (HUD), subprime refinance lending increased almost 1,000 percent from 1993–1998. The backing of Wall Street investment firms has helped fuel much of the explosion in subprime lending in recent years. As a relevant *New York Times/ABC News* investigation revealed, from 1995 to 1999 the amount of money raised on Wall Street for subprime lenders rose from $10 billion to nearly $80 billion annually.

NCRC has serious concerns about this exponential rise, especially given its disproportionate growth among low-income and minority neighborhoods. Again, HUD documents that individuals in low-income neighborhoods are three times more likely to receive subprime refinance loans than those living in high-income neighborhoods. In African-American neighborhoods, HUD's analysis shows that borrowers living there are five times more likely to receive subprime refinancing than those living in white neighborhoods.

National data analysis done by NCRC shows that 67 percent of all subprime refinance loans made in 1998 were sold to private investment firms and other financiers, compared to just 20 percent of all prime home refinance loans. The most recent manifestation of this widespread practice is financial service corporations that only purchase subprime loans on the secondary market in order to avoid complying with the Community Reinvestment Act, minimize HOEPA and related consumer protections—such as the Truth In Lending Act (TILA) and the Real Estate Settlement Procedures Act (RESPA)—and to avoid compliance with our Nation's civil rights protections.

Thus, while some maintain that subprime lending has been responsible for the surge in homeownership among minorities and low- and moderate-income borrowers, NCRC believes that increased prime lending by CRA-covered banks has played the major role in the increase in homeownership. Proponents of subprime lending caution against aggressive antipredatory lending regulation and legislation, saying that such efforts will choke off credit in underserved communities. NCRC, in contrast, asserts that antipredatory legislation and regulation will not constrain home mortgage lending to traditionally underserved communities and is needed to protect communities from unscrupulous actors.

These very extreme disparities in subprime lending by race and income cannot be solely related to the credit history or risk of the borrower. In fact, as Freddie Mac and Fannie Mae have estimated, anywhere between 30 and 50 percent of subprime borrowers could qualify for prime loans. This is product steering or "reverse redlining" at its worst. Mr. Chairman, there are lenders and brokers out there engaged not only in deception and fraud, but also discrimination, who need to be held accountable. However, with the exception of a handful of actions brought by the Federal Trade Commission, the recommendations of recent HUD/Treasury Report go unfulfilled. Over the past 5 years thousands of seniors, African-Americans, Latinos, and women have been victimized by predatory lending practices. As a result, public opinion has developed into consensus. Predatory lending, payday lending, predatory insurance, and credit cards are all receiving "strict scrutiny" from public and private sector "attorneys general."

A recent study by the Research Institute for Housing America (RIHA) concludes that minority borrowers are more likely to receive subprime loans after controlling for credit risk factors. RIHA cautions against a conclusion that price discrimination alone explains this since minority borrowers may have different techniques of searching for lenders—or access to credit limited only to subprime lenders. However, when one considers the totality of the research by NCRC, HUD, Fannie Mae, Freddie Mac, RIHA, and others, it seems fair to say that the burden of proof lies with those who assert that discrimination and predatory lending is the exception to the rule and not the norm in the subprime market.[1]

In late October 2000, the incoming Chairman of America's Community Bankers told an *American Banker* reporter that "We need to be very careful that subprime lending, which has a useful place, does not get confused with predatory lending . . . because lending to borrowers with imperfect credit history . . . is one of the reasons we have increased homeownership to record levels in the United States."[2]

The home mortgage lending data do not support the contention that subprime lending has driven the surge in homeownership for traditionally underserved populations. In 1990, low- and moderate-income borrowers (LMI borrowers have up to 80 percent of area median income) received 18.5 percent of all home mortgage loans made in the country (loans to borrowers with unknown incomes were excluded from the calculations). By 1995, LMI borrowers received 26.9 percent of all home mortgage loans, or 8.4 percentage points more than they had in 1990. By 1999, LMI loan share had increased to 30.7 percent or only 3.8 more percentage points than in 1995. The surge in subprime lending occurred from 1995 to 1999, yet LMI borrowers experienced the largest gains in home mortgage lending from 1990 to 1995. The first part of the decade witnessed a tremendous increase in conventional and affordable

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[1] Anthony Pennington-Cross, Anthony Yezer, and Joseph Nichols, *Credit Risk and Mortgage Lending: Who Uses Subprime and Why?* Working Paper No. 00–03, published by the Research Institute for Housing America.

[2] New Leader After Year of Upheaval at ACB, *American Banker,* October 30, 2000.

prime loans as depository institutions worked in partnership with community organizations to make CRA-related home mortgage loans.

The story is similar for home mortgage lending trends to African-Americans and Latinos. African-Americans and Latinos received 10.1 percent of the home mortgage loans in 1990 made to African-Americans, Latinos, and Whites. The African-American and Latino loan share climbed to 14.4 percent in 1995 and to 16.1 percent in 1999. The share of home mortgage loans made to African-Americans and Latinos increased by 4.3 percentage points from 1990 to 1995, but only 1.7 percentage points from 1995 to 1999. Pundits and proponents of subprime lending talk about how it has made homeownership accessible, but the statistics show the biggest gains for minorities occurred in the first part of the decade when CRA-related lending surged—as opposed to the second part of the decade when subprime lending soared.

The RIHA study cited earlier concludes, "Yet there is little evidence to support the idea that subprime lending (primarily) serves lower-income households or households with little wealth to use as a down payment." And RIHA should know what it is talking about, since it is a research institute founded by mortgage banks and their trade association, the Mortgage Bankers Association of America.

NCRC acknowledges that responsible subprime lenders play a role in the marketplace. However, most predatory lenders are primarily consumer lenders and should not be confused with CRA-covered lenders that have done the most work in making the American Dream of homeownership possible. Despite this, even a portion of CRA-covered loans has become predatory since the onset of financial modernization. In particular, price discrimination, or charging higher interest rates than is necessary to cover risk, by subprime mortgage divisions of banks has become all too common.

Next, opponents of tighter control of subprime lending suggest that improved disclosure of terms and conditions of loans will provide the needed protections against predatory lending. Loan transactions, particularly mortgages, can be the most complex transaction in a typical consumers lifetime, making it difficult for the average American to understand loan terms, choice of products, and that counseling or consumer protections may be available. I offer that consumers not only need the disclosures, but also need assistance safety net of new legislative protections.

Legislative Remedies

NCRC believes that current law and regulation are weak and err on the side of allowing exploitative practices that are not economically justified in terms of being necessary to make loans profitable. Steep prepayment penalties on high interest loans, high balloon payments, repeated flipping, credit insurance, and fee and product packing were not necessary for profitable home mortgage loans made to first time homebuyers during the tremendous homeownership expansion in the 1990's, especially in the first half of the decade. These products and practices remain inappropriate today in the current economy of supercharged loan origination, refinance and home improvement. Instead, these abusive terms and conditions trap and exploit unsophisticated borrowers. Their unsuitability to the borrower and lender is demonstrated by higher foreclosures associated with predatory lending.[3] Indeed, the FDIC has found that although subprime lenders constitute about 1 percent of all insured financial institutions, they account for 20 percent of depository institutions that have safety and soundness problems.[4]

In order to protect consumers and the lending industry from unsafe and predatory practices, NCRC favors Federal antipredatory legislation that builds and expands the Homeownership and Equity Protection Act of 1994 (HOEPA). HOEPA defines loans that exceed a certain interest rate and fee threshold as high interest loans. It then outlaws various terms and conditions on high interest loans. The shortcoming with HOEPA is not its structure but its high interest rate and fee thresholds. The current interest rate threshold, for example, is 10 percentage points above Treasury bill rates which currently translates into interest rates of 16 percent and higher. The HUD/Treasury Task Force on Predatory Lending estimates that the current HOEPA interest rate threshold covers only about 1 percent of subprime loans.[5]

NCRC strongly supports the Predatory Lending Consumer Protection Act of 2001 (H.R. 1051) introduced by Representative LaFalce and soon to be introduced by Senator Sarbanes. Many of the provisions and protections included in the legislation are

[3] *Analyzing Trends in Subprime Originations and Foreclosures: A Case Study of the Atlanta Metro Area,* Abt Associates Inc., February 2000.

[4] Department of the Treasury, Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, Proposed Agency Information Collection Activities (Collecting subprime lending information on call reports), *Federal Register,* May 31, 2000, pages 34801–34819.

[5] HUD-Treasury Curbing Predatory Lending report, p. 85.

what NCRC has been advocating for tighten up HOEPA. NCRC believes that HOEPA should be amended in the following manner:

- Coverage—HOEPA should be expanded to cover home mortgage lending, reverse mortgage lending, and open-ended transactions secured by real estate. Currently, HOEPA applies only to closed-ended consumer transactions secured by a borrower's home. In order for HOEPA's protections to be comprehensive, it is time to extend it to all lending secured by a borrower's principal dwelling.
- Interest Rate Threshold—The interest rate threshold should be lowered from 10 percentage points above Treasury bill rates to 4 percentage points above Treasury rates. Using the figures in the HUD/Treasury report, NCRC estimates that this would cover about 70 percent of all subprime lending, or the percentage of subprime lending which is estimated to contain prepayment penalties.
- Fees—NCRC believes that the fee threshold should be lowered from 8 percent of the loan amount to 3 percent of the loan amount. Fannie Mae has indicated that it will not purchase loans with fees exceeding 5 percent of the loan amount. This is a significant policy statement from a major secondary market player indicating that Fannie Mae does not believe that fees above 5 percent are economically justified from a profitability point of view.[6] In addition, NCRC maintains that "yield-spread" premiums should be included in the calculation of the fee threshold. NCRC also agrees with the HUD/Treasury recommendation that for high interest rate loans, a ceiling should be established on the percentage of fees that are financed and added to the loan amount instead of being paid up-front. The HUD/Treasury recommendation is that fees exceeding more than 3 percent of the loan amount must not be financed.
- Flipping—NCRC agrees with the HUD/Treasury recommendation that refinances of high interest rate loans that occur within 18 months of the original loan should be prohibited unless a tangible net benefit accrues to the borrower. Such a benefit should include a reduction in the loan interest rate of 1.5 percentage points.
- Prepayment penalties—HOEPA currently allows prepayment penalties in the first 5 years. HOEPA must be changed to either eliminate prepayment penalties altogether on loans that exceed the interest rate and fee threshold or at least prohibit prepayment penalties beyond the first year after the origination of a high interest loan.
- Balloon payments—HOEPA prohibits balloon payments on high interest loans within the first 5 years of origination. NCRC agrees with the HUD/Treasury recommendation that balloon loans must be prohibited until 15 years after the issuance of high interest rate loans. A shorter time frame invites flipping as predatory lenders convince borrowers facing steep balloon payments to refinance, usually at higher interest rates and added fees.
- Single-premium credit insurance—This is an abuse that must be ended on all loans. Fannie Mae and Freddie Mac have indicated that they will not purchase loans with single-premium credit insurance.[7] Congress should follow their lead and prohibit single-premium insurance. If financial institutions wish to sell credit insurance, it should be on a monthly basis and must allow the borrower to cancel it at any time.

Additional HOEPA reforms should outlaw mandatory arbitration clauses and prohibit high interest rate loans with negative amortization and/or which exceed 50 percent of the borrower's income. With such changes, public policy will respond to the pervasive abuses occurring in the marketplace that cannot be addressed solely through improved disclosures or more extensive financial literacy and prepurchase counseling.

Further, NCRC recommends that this Committee strongly consider amending the Home Mortgage Disclosure Act (HMDA) to include loan terms and conditions, and the CRA and fair lending exams should be improved to help stamp out predatory lending. Disclosures of annual percentage rates (APR's) will be vital for fair lending enforcement to ensure that minorities and/or women of similar income levels and buying homes of similar values (or refinancing similar dollar amounts) are not charged significantly higher amounts than whites and/or males.

The Senate Banking Committee should also strongly consider the Community Reinvestment Modernization Act of 2001 (H.R. 865), introduced by Representatives Barrett and Gutierrez with 34 cosponsors. This legislation will allow the Community Reinvestment Act to keep pace with the tremendous changes taking place in the fi-

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[6] *Fannie Mae Chairman Announces New Loan Guidelines to Combat Predatory Lending Practices,* Fannie Mae News Release of April 11, 2000.

[7] Fannie Mae April 11 press release and letter to the editor of the *American Banker* by David Andrukonis of Freddie Mac on April 6, 2000.

nancial industry by extending CRA to all lending affiliates of financial holding companies. Mortgage companies, insurance agents, and other nontraditional lending affiliates of holding companies would be required to comply with CRA. Lenders would be penalized on CRA exams for making predatory loans. In addition, the bill would extend CRA-like requirements to insurance companies and securities firms. Insurance companies would be required to publicly disclose data on the race, income, and gender of their customers. Mergers between depository and nondepository institutions would be subject to public comment periods with regulatory agency decisions based on CRA, fair lending, safety and soundness, and antitrust factors.

Regulatory Responses and Remedies

There are regulatory steps that can be taken today by the Federal banking agencies, particularly the Federal Reserve Board, to combat predatory activities. The Board has direct jurisdiction over the practices of those subprime lenders that are bank holding company subsidiaries. In addition, the Board also has jurisdiction over many companies that underwrite, purchase, and service mortgage-backed securities based on subprime loans by nonbank lenders.

The Federal Reserve Board can conduct examinations, including fair lending examinations, of any bank holding company subsidiary, including subprime lenders—and it should start doing so. It should be noted that the Federal Reserve, in its July 2, 2001 approval order concerning the Citigroup-European American Bank merger, did commit to conduct a thorough examination of CitiFinancial. However, the Board still refuses to routinely conduct such examinations. The General Accounting Office (GAO) and the HUD/Treasury Report have both recommended that the Federal Reserve Board conduct such examinations. Another important way the Board has jurisdiction over the portion of the subprime market that is predatory is through its supervision of companies which underwrite, purchase, and service mortgage-backed securities based on subprime loans by nonbank lenders and companies that make warehouse loans to, or do underwriting, servicing or trustee/custodian work for, other subprime lenders.

It is quite clear, Mr. Chairman, that while all of the regulatory action recommended by NCRC is necessary to combat predatory lending, it is not sufficient. To truly end this scourge, Congress must pass strong antipredatory lending legislation that significantly strengthens and expands current consumer protection provisions under HOEPA. Even if the Federal Reserve adopted its Regulation Z proposal to lower the HOEPA interest rate threshold to 8 percentage points above Treasury securities, only 5 percent of subprime loans would be covered under the Federal Reserve's own admission. Congress alone can change the HOEPA statute to make the interest rate threshold lower. The Predatory Lending Consumer Protection Act of 2001 would lower it to 6 percentage points above Treasury securities, and cover about 25 percent of subprime loans as estimated by HUD. In addition, the Federal Reserve does not believe that it has the power to eliminate credit insurance on subprime loans. The current predatory lending bill includes such provisions, which are needed to prohibit these practices.

Federal banking regulators must also increase their scrutiny of subprime lending during CRA exams and accompanying fair lending reviews. CRA has been instrumental in leveraging a tremendous increase in safe and sound lending to traditionally underserved communities. It is one of the most important means by which to stimulate conventional lending institutions to compete against predatory lenders in lower-income and minority communities. But for CRA to succeed in this endeavor, it must be enforced rigorously.

Recently, disturbing evidence indicates that some CRA examiners are giving depository institutions CRA "credit" or points for payday lending and other suspect activities without scrutinizing the terms and conditions of this lending. The Federal Deposit Insurance Corporation has just publicly indicated that it will not count predatory loans for CRA credit. The Office of Thrift Supervision recently failed a thrift that was making abusive payday loans. NCRC is also pleased that the Federal banking agencies just updated their interagency CRA Question and Answer document to indicate that bank CRA ratings will be downgraded if they make predatory loans in violation of the Truth in Lending Act, the Real Estate Settlement Procedures Act, and HOEPA. We urge the Federal banking agencies to codify this during the CRA regulation review that is just starting. Too many other questionable subprime and payday lenders have passed their CRA exams—and NCRC can provide examples upon request. There are signs that this will be changing; increased scrutiny from Capitol Hill will help make sure that unscrupulous lenders will fail their CRA and fair lending exams.

NCRC and its members, working with fair lending experts and its nationwide membership, have crafted a model antipredatory lending bill as part of our efforts

to eliminate the problem. It is attached as an exhibit to this testimony. NCRC is pleased that many of the provisions included in its model bill are also included in the various antipredatory lending bills currently circulating in Congress.

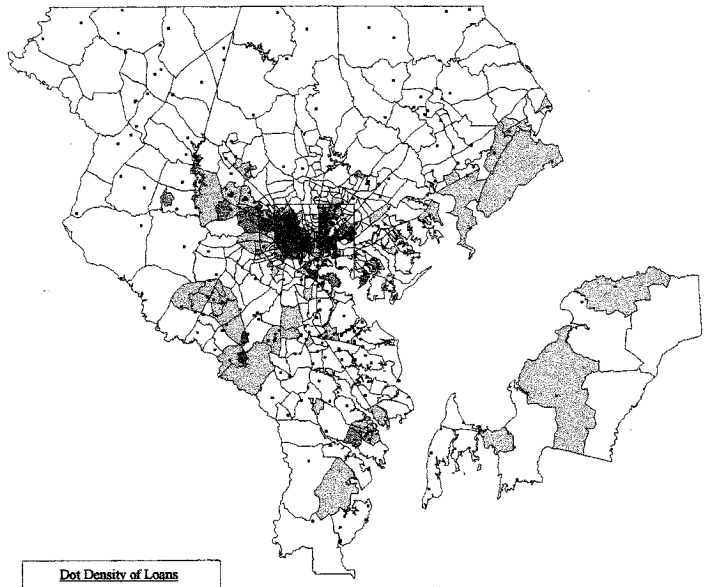
Conclusion

NCRC acknowledges the fact that subprime lending does play a role in expanding access to credit for those with blemished credit records. However, a growing portion of this industry is responsible for the "balkanization of credit," whereby vulnerable low- and moderate-income, minority, and elderly individuals are being targeted by predatory lenders whose only intent is to deceive and dispossess them of their property and wealth. Senators Sarbanes, Schumer, and Representatives LaFalce and Schakowsky have consistently and forcefully echoed this concern, and are to be commended for their leadership in proposing strong legislation to combat predatory practices. Representatives Barrett and Gutierrez should also be applauded for their sponsorship of the Community Reinvestment Modernization Act of 2001 in the House.

Stronger legislation and regulation are needed to end the scourge of predatory lending. Noble attempts have been made at the State and local level to implement legislative and regulatory protections against predatory lending. NCRC applauds these initiatives and supports them. However, a comprehensive HOEPA statute, accompanied by stronger regulations, is needed to establish uniformity and prevent predators from preying upon borrowers in States with weak laws. A uniform national framework will promote competition from prime lenders and responsible subprime lenders. It will benefit communities and lenders alike by prohibiting unsafe and unsound lending that is designed to exploit borrowers and neighborhoods and strip them of their wealth. It will empower Federal and State regulators and enforcement agencies to use the law effectively to stem the tide of predatory lending.

Mr. Chairman, under the law, if a person holds someone up at gunpoint and robs them of their possessions, that person goes to jail. However, if a lender uses deception, high-pressure sales tactics, and other abusive means to steal another person's home—their most prized possession—the lender profits. Predatory lending is no different than robbery at gunpoint, and both our laws and regulations must adequately reflect that fact.

NCRC
Refinance Loans to Owner-Occupants in 1999
By Minority Level of Census Tract
Baltimore MSA Subprime Lenders



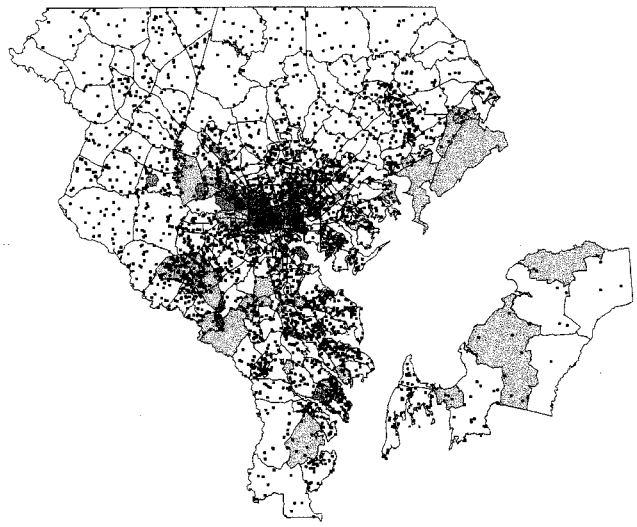
Dot Density of Loans

1 Dot = 10 Loans

Minority Population
as a % of Tract Population

- <10% minority (270)
- 10%<20% minority (91)
- 20%<50% minority (90)
- 50%<80% minority (44)
- 80%-100% minority (93)

NCRC
Refinance Loans to Owner-Occupants in 1999
By Minority Level of Census Tract
Baltimore MSA Prime Lenders



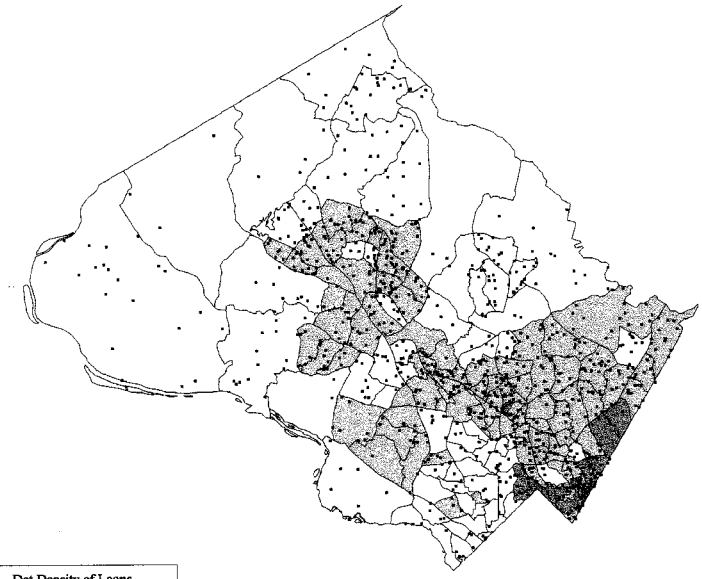
Dot Density of Loans

1 Dot = 10 Loans

Minority Population
as a % of Tract Population

- <10% minority (270)
- 10%<20% minority (91)
- 20%<50% minority (90)
- 50%<80% minority (44)
- 80%-100% minority (93)

NCRC
Refinance Loans to Owner-Occupants in 1999
By Minority Level of Census Tract
Montgomery County MSA Subprime Lenders



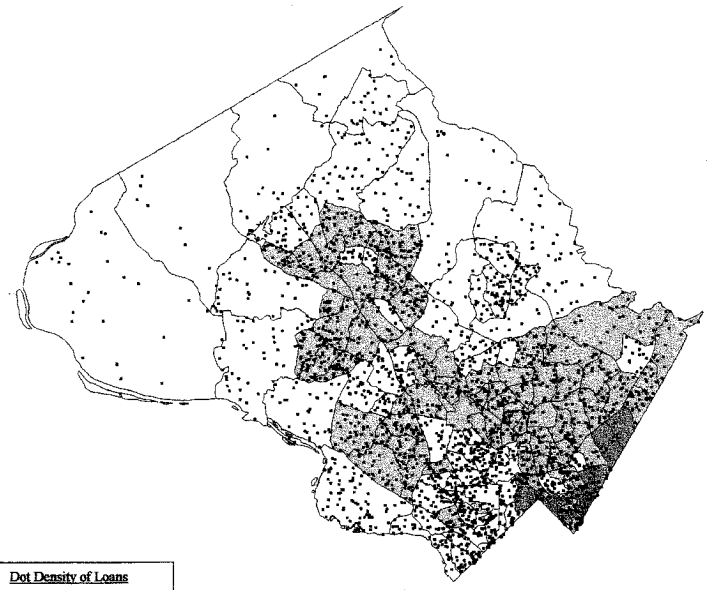
Dot Density of Loans

1 Dot = 1 Loan

Minority Population
as a % of Tract Population

- <10% minority (20)
- 10%<20% minority (44)
- 20%<50% minority (81)
- 50%<80% minority (14)
- 80%-100% minority (1)

NCRC
Refinance Loans to Owner-Occupants in 1999
By Minority Level of Census Tract
Montgomery County MSA Prime Lenders



Dot Density of Loans

1 Dot = 5 Loans

Minority Population
as a % of Tract Population

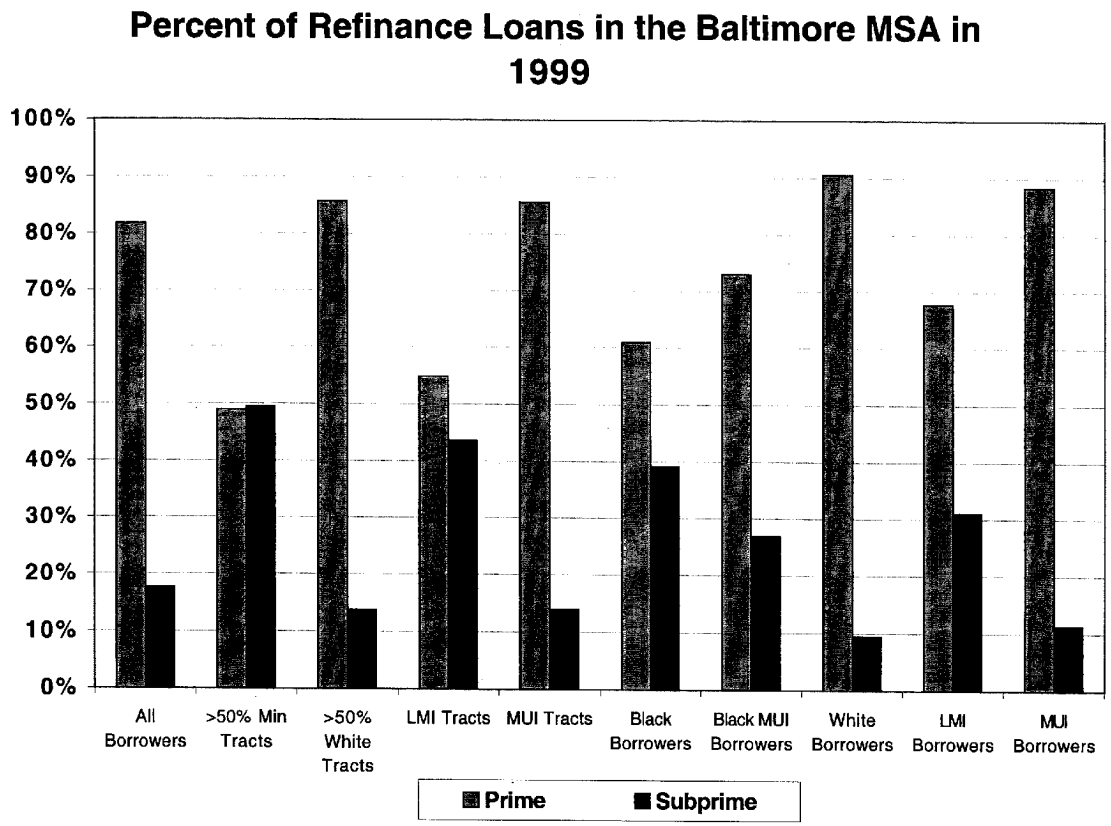
- <10% minority (20)
- 10%<20% minority (44)
- 20%<50% minority (81)
- 50%<80% minority (14)
- 80%-100% minority (1)

Baltimore MSA Market Share 1999
Conventional Refinance Lending to Owner-Occupants

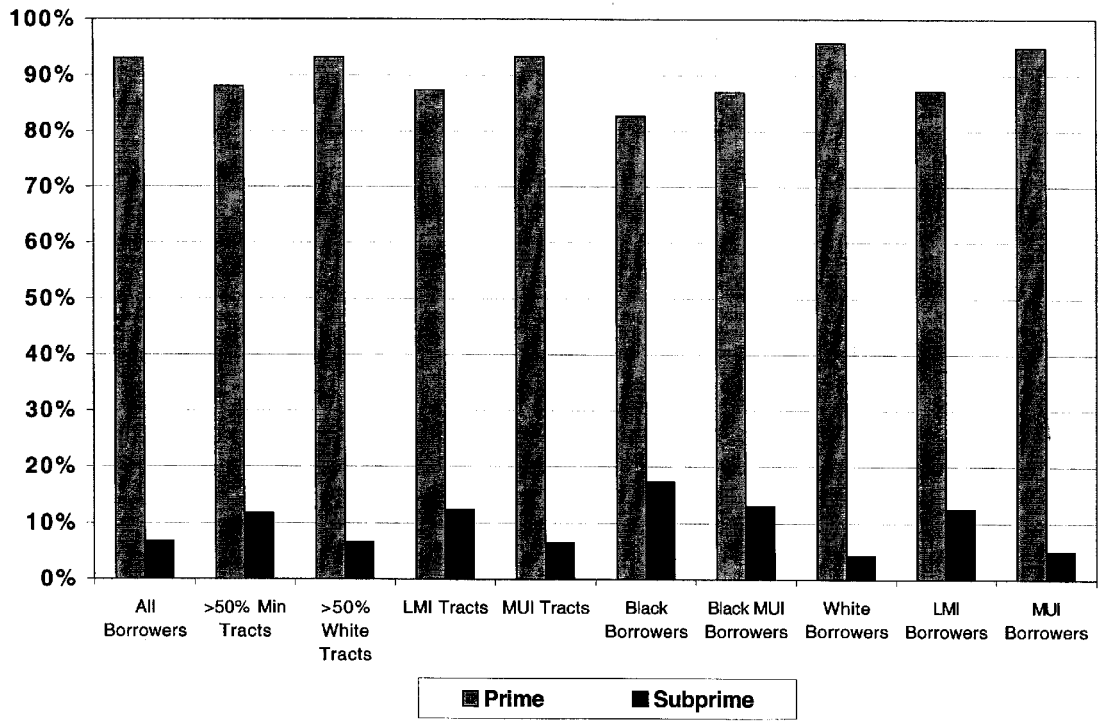
	Subprime Loans	Prime Loans	Total Loans	Subprime Share	Prime Share	Market Share Disparity
All Borrowers	6,627	30,875	37,774	17.5%	81.7%	
>50% Min Tracts	1,972	1,951	3,994	49.4%	48.8%	3.6
>50% White Tracts	4,641	28,892	33,734	13.8%	85.6%	
LMI Tracts	2,024	2,545	4646	43.6%	54.8%	3.1
MUI Tracts	4,583	28,288	33066	13.9%	85.6%	
Black Borrowers	1,680	2,617	4,297	39.1%	60.9%	4.1
Black MUI Borrowers	478	1,297	1,775	26.9%	73.1%	2.4
White Borrowers	2,355	22,533	24,893	9.5%	90.5%	
LMI Borrowers	3,796	8,300	12,257	31.0%	67.7%	2.8
MUI Borrowers	2,698	21,263	24,072	11.2%	88.3%	

Montgomery County MSA Market Share 1999
Conventional Refinance Lending to Owner-Occupants

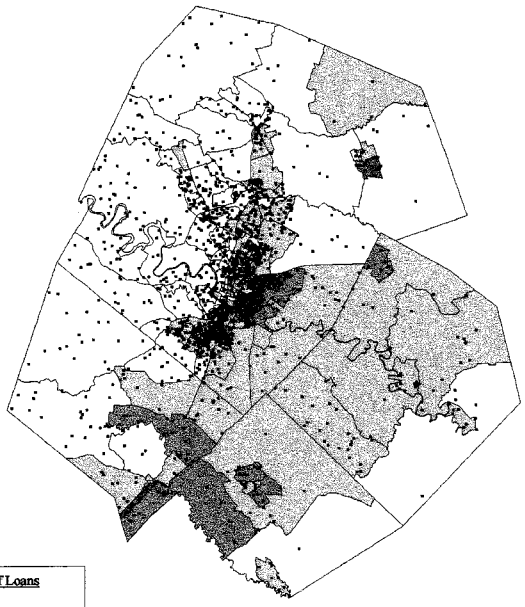
	Subprime Loans	Prime Loans	Total Loans	Subprime Share	Prime Share	Market Share Disparity
All Borrowers	959	13,221	14,208	6.7%	93.1%	
>50% Min Tracts	55	414	470	11.7%	88.1%	1.8
>50% White Tracts	902	12,804	13,733	6.6%	93.2%	
LMI Tracts	86	608	696	12.4%	87.4%	1.9
MUI Tracts	871	12,610	13507	6.4%	93.4%	
Black Borrowers	145	695	840	17.3%	82.7%	4.1
Black MUI Borrowers	63	423	486	13.0%	87.0%	2.6
White Borrowers	374	8,551	8,926	4.2%	95.8%	
LMI Borrowers	448	3,118	3,577	12.5%	87.2%	2.5
MUI Borrowers	494	9,476	9,987	4.9%	94.9%	


Percent of Refinance Loans in the Baltimore MSA in 1999
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
All Borrowers
>50% Min Tracts
>50% White Tracts
LMI Tracts
MUI Tracts
Black Borrowers
Black MUI Borrowers
White Borrowers
LMI Borrowers
MUI Borrowers
Prime
Subprime

Percent of Refinance Loans in Montgomery County, MD in 1999



NCRC
Refinance Loans to Owner-Occupants in 1999
By Minority Level of Census Tract
Austin-San Marcos MSA Subprime Lenders



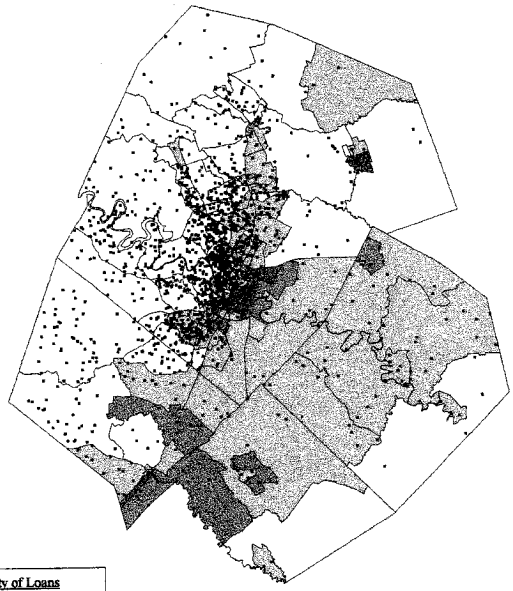
Dot Density of Loans

1 Dot = 1 Loan

Minority Population
as a % of Tract Population

- <10% minority (51)
- 10%<20% minority (50)
- 20%<50% minority (94)
- 50%<80% minority (27)
- 80%-100% minority (17)

NCRC
Refinance Loans to Owner-Occupants in 1999
By Minority Level of Census Tract
Austin-San Marco MSA Prime Lenders



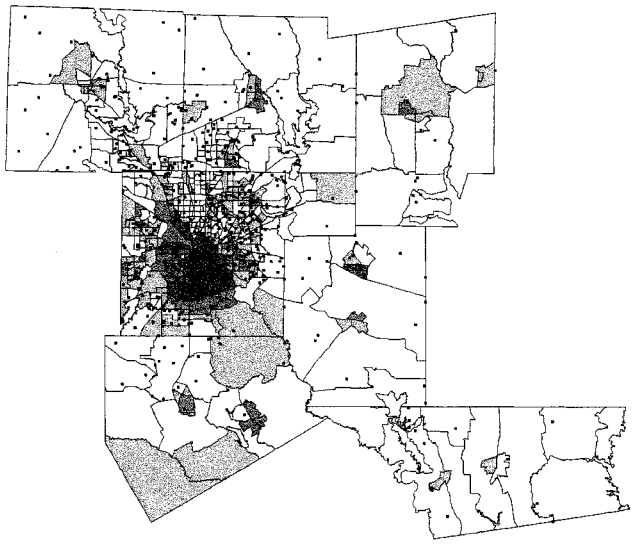
Dot Density of Loans

1 Dot = 5 Loans

Minority Population
as a % of Tract Population

- <10% minority (51)
- 10%<20% minority (50)
- 20%<50% minority (94)
- 50%<80% minority (27)
- 80%-100% minority (17)

NCRC
Refinance Loans to Owner-Occupants in 1999
By Minority Level of Census Tract
Dallas MSA Subprime Lenders



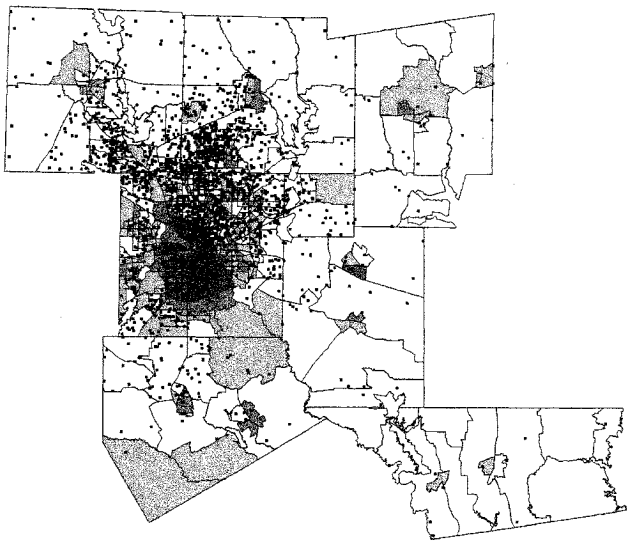
Dot Density of Loans

1 Dot = 5 Loans

Minority Population
as a % of Tract Population

- <10% minority (118)
- 10%<20% minority (151)
- 20%<50% minority (163)
- 50%<80% minority (76)
- 80%-100% minority (72)

NCRC
Refinance Loans to Owner-Occupants in 1999
By Minority Level of Census Tract
Dallas MSA Prime Lenders



Dot Density of Loans

1 Dot = 10 Loans

Minority Population
as a % of Tract Population

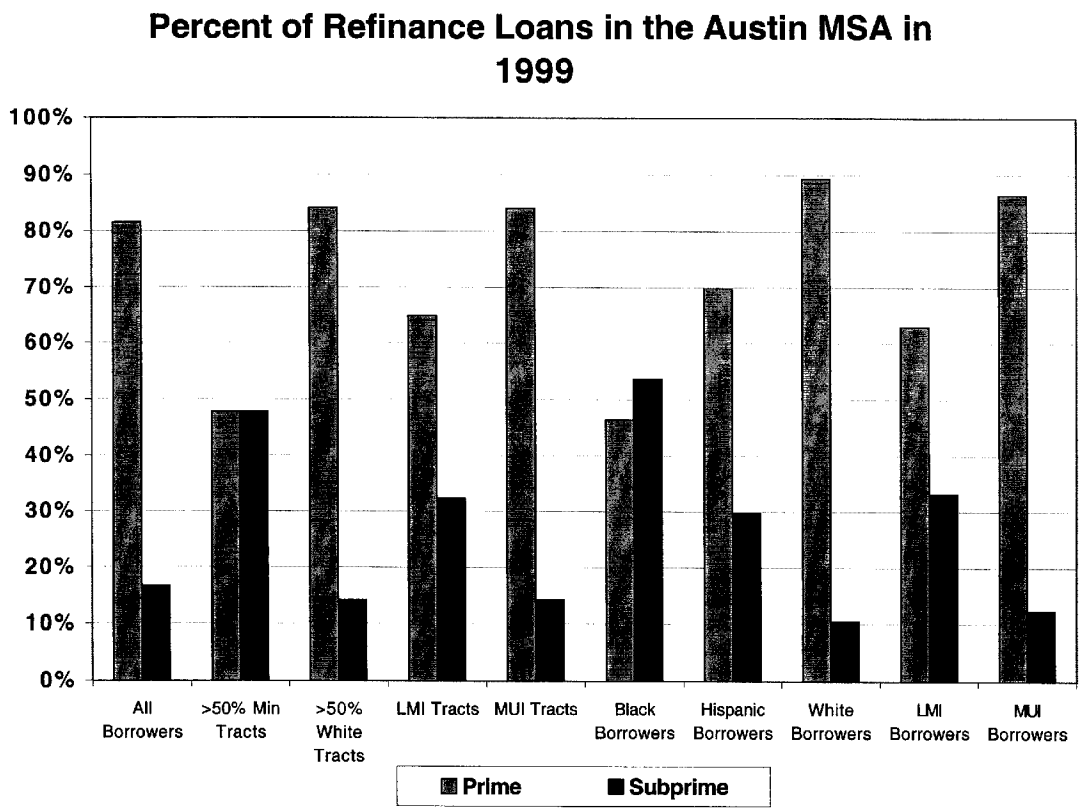
- <10% minority (118)
- 10%<20% minority (151)
- 20%<50% minority (163)
- 50%<80% minority (76)
- 80%-100% minority (72)

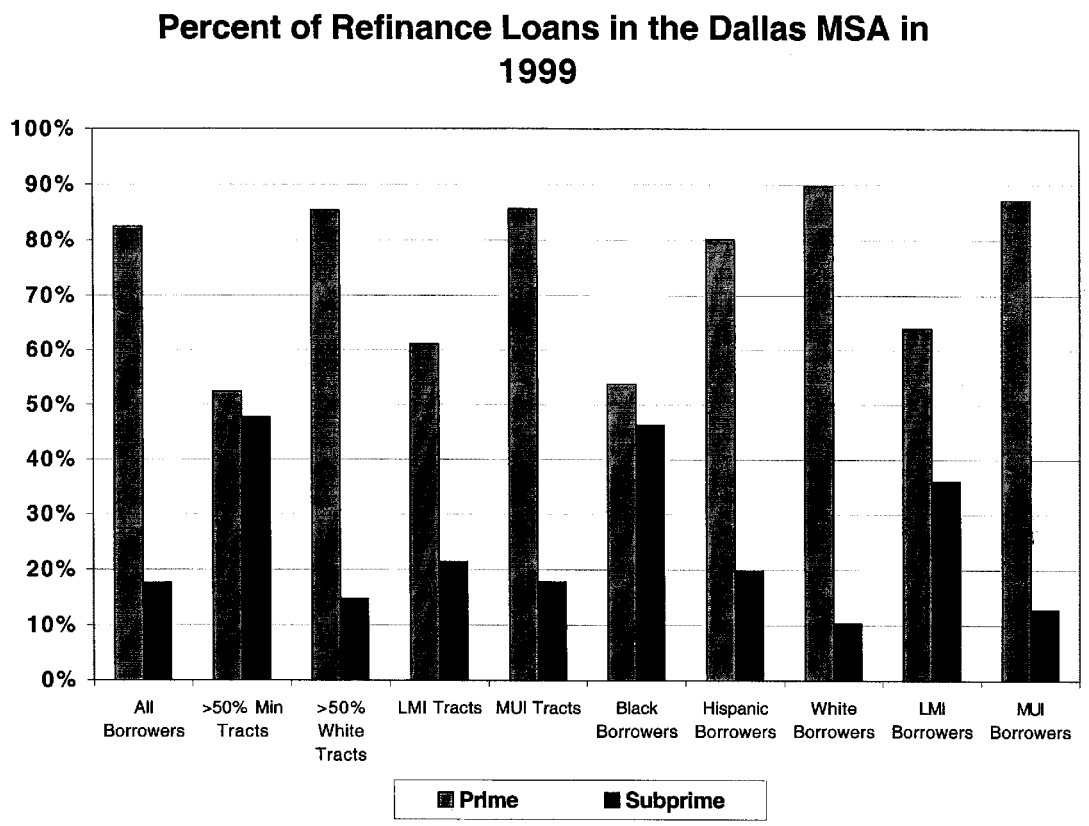
Austin-San Marcos MSA Market Share 1999
Conventional Refinance Lending to Owner-Occupants

	Subprime Loans	Prime Loans	Total Loans	Subprime Share	Prime Share	Market Share Disparity
All Borrowers	1,583	7,753	9,513	16.6%	81.5%	
>50% Min Tracts	327	326	683	47.9%	47.7%	3.4
>50% White Tracts	1,252	7,412	8,811	14.2%	84.1%	
LMI Tracts	401	805	1,241	32.3%	64.9%	2.3
MUI Tracts	1,178	6,926	8,246	14.3%	84.0%	
Black Borrowers	171	148	319	53.6%	46.4%	5.1
Hispanic Borrowers	260	610	874	29.7%	69.8%	2.8
White Borrowers	682	5,807	6,502	10.5%	89.3%	
LMI Borrowers	756	1,433	2,280	33.2%	62.9%	2.7
MUI Borrowers	824	5,789	6,699	12.3%	86.4%	

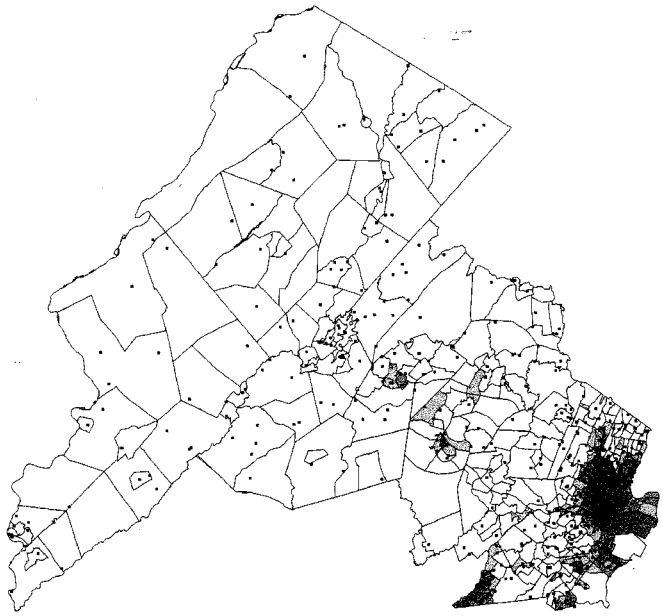
Dallas MSA Market Share 1999
Conventional Refinance Lending to Owner-Occupants

	Subprime Loans	Prime Loans	Total Loans	Subprime Share	Prime Share	Market Share Disparity
All Borrowers	4,441	20,776	25,217	17.6%	82.4%	
>50% Min Tracts	1,067	1,175	2,242	47.6%	52.4%	3.2
>50% White Tracts	3,359	19,566	22,925	14.7%	85.3%	
LMI Tracts	1,272	1,994	3266	21.3%	61.1%	1.2
MUI Tracts	3,153	18,740	21893	17.8%	85.6%	
Black Borrowers	653	758	1,411	46.3%	53.7%	4.5
Hispanic Borrowers	322	1,300	1,622	19.9%	80.1%	1.9
White Borrowers	1,708	14,939	16,647	10.3%	89.7%	
LMI Borrowers	2,144	3,818	5,962	36.0%	64.0%	2.8
MUI Borrowers	2,269	15,486	17,755	12.8%	87.2%	


Percent of Refinance Loans in the Austin MSA in 1999
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
All Borrowers
>50% Min Tracts
>50% White Tracts
LMI Tracts
MUI Tracts
Black Borrowers
Hispanic Borrowers
White Borrowers
LMI Borrowers
MUI Borrowers
Prime
Subprime


Percent of Refinance Loans in the Dallas MSA in 1999
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
All Borrowers
>50% Min Tracts
>50% White Tracts
LMI Tracts
MUI Tracts
Black Borrowers
Hispanic Borrowers
White Borrowers
LMI Borrowers
MUI Borrowers
Prime
Subprime

NCRC
Refinance Loans to Owner-Occupants in 1999
By Minority Level of Census Tract
Newark MSA Subprime Lenders



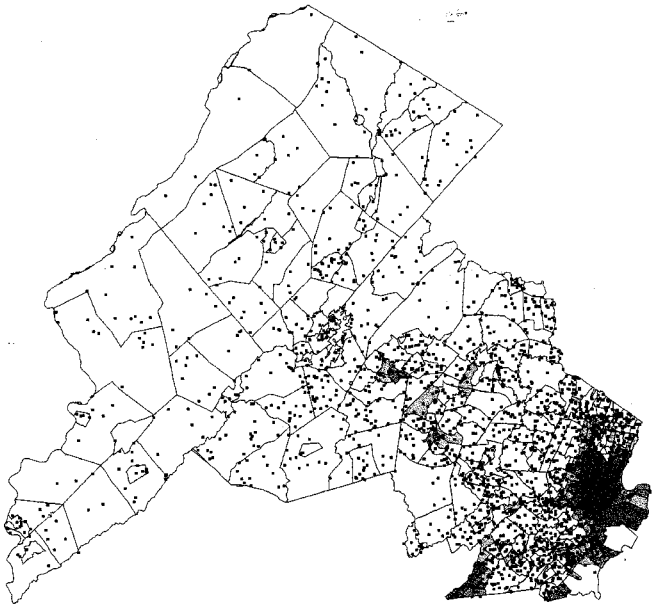
Dot Density of Loans

1 Dot = 5 Loans

Minority Population
as a % of Tract Population

- <10% minority (187)
- 10%<20% minority (71)
- 20%<50% minority (54)
- 50%<80% minority (43)
- 80%-100% minority (128)

NCRC
Refinance Loans to Owner-Occupants in 1999
By Minority Level of Census Tract
Newark MSA Prime Lenders



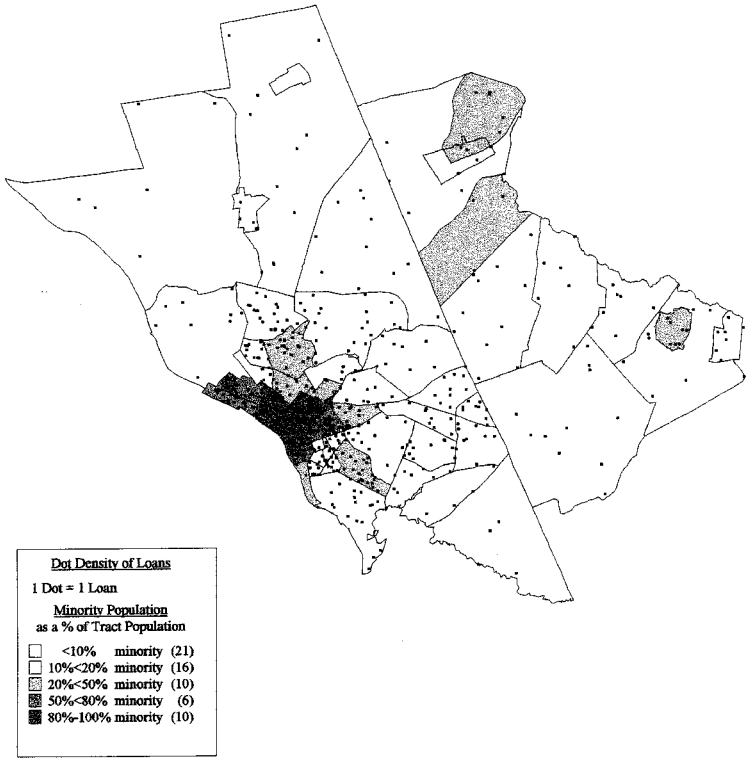
Dot Density of Loans

1 Dot = 10 Loans

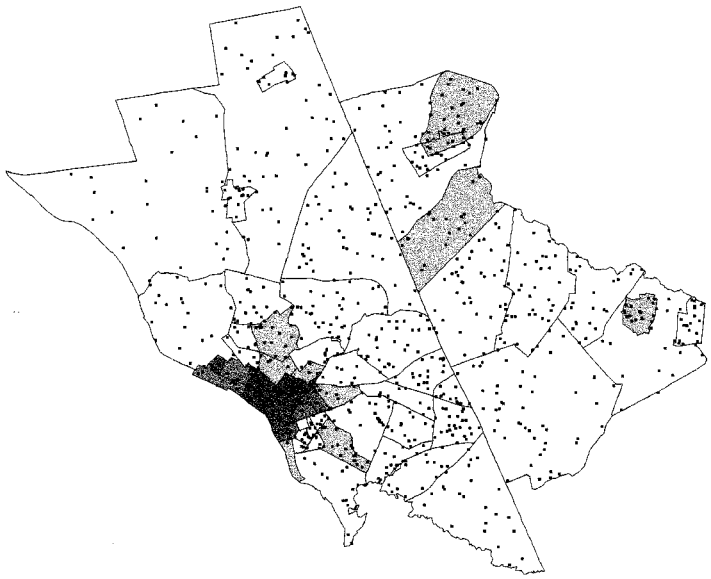
Minority Population
as a % of Tract Population

- <10% minority (187)
- 10%<20% minority (71)
- 20%<50% minority (54)
- 50%<80% minority (43)
- 80%-100% minority (128)

NCRC
Refinance Loans to Owner-Occupants in 1999
By Minority Level of Census Tract
Trenton MSA Subprime Lenders



NCRC
Refinance Loans to Owner-Occupants in 1999
By Minority Level of Census Tract
Trenton MSA Prime Lenders



Dot Density of Loans

1 Dot = 4 Loans

Minority Population
as a % of Tract Population

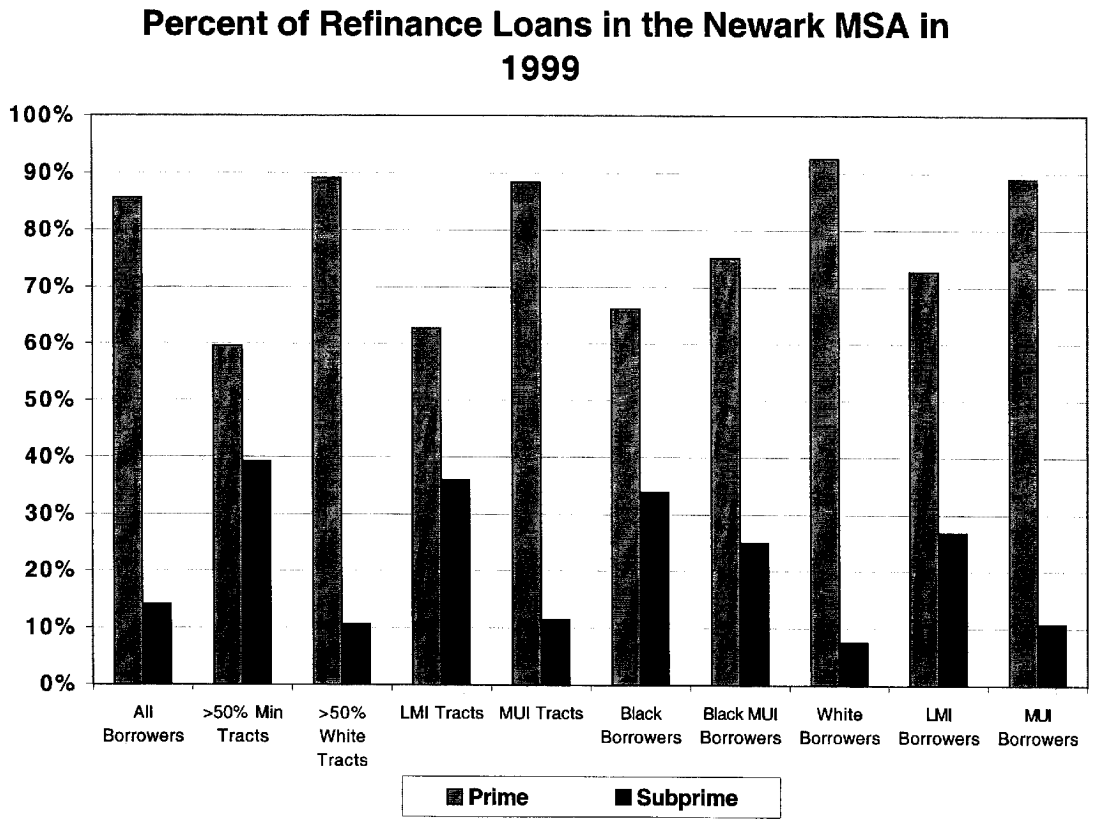
- <10% minority (21)
- 10%<20% minority (16)
- 20%<50% minority (10)
- 50%<80% minority (6)
- 80%-100% minority (10)

Newark MSA Market Share 1999
Conventional Refinance Lending to Owner-Occupants

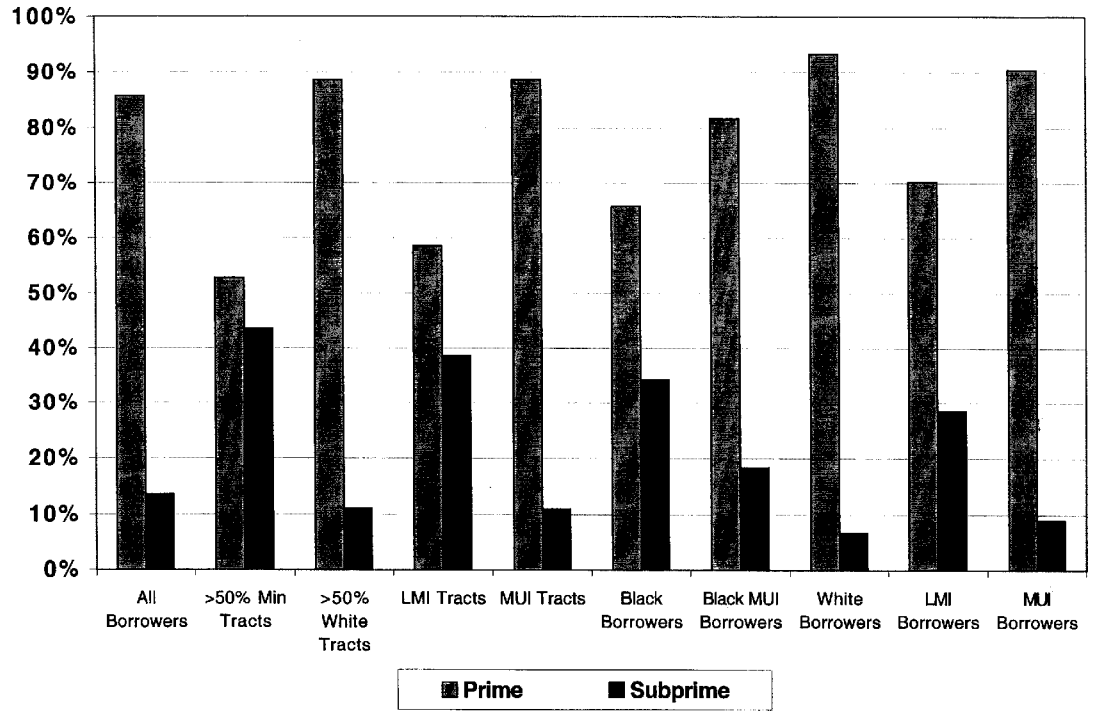
	Subprime Loans	Prime Loans	Total Loans	Subprime Share	Prime Share	Market Share Disparity
All Borrowers	3,543	21,560	25,210	14.1%	85.5%	
>50% Min Tracts	1,192	1,813	3,047	39.1%	59.5%	3.7
>50% White Tracts	2,346	19,731	22,142	10.6%	89.1%	
LMI Tracts	985	1,713	2735	36.0%	62.6%	3.2
MUI Tracts	2,553	19,827	22450	11.4%	88.3%	
Black Borrowers	626	1,225	1,851	33.8%	66.2%	4.5
Black MUI Borrowers	228	687	915	24.9%	75.1%	2.3
White Borrowers	1,121	13,838	14,959	7.5%	92.5%	
LMI Borrowers	1,592	4,327	5,948	26.8%	72.7%	2.5
MUI Borrowers	1,868	15,634	17,580	10.6%	88.9%	

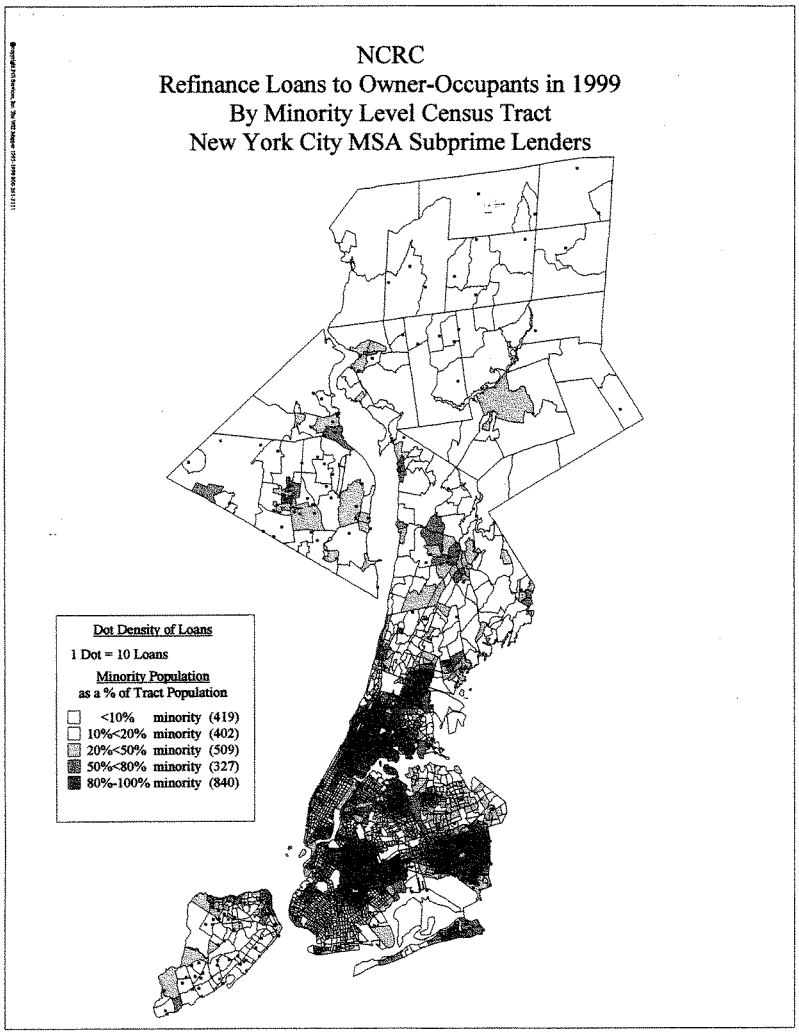
Trenton MSA Market Share 1999
Conventional Refinance Lending to Owner-Occupants

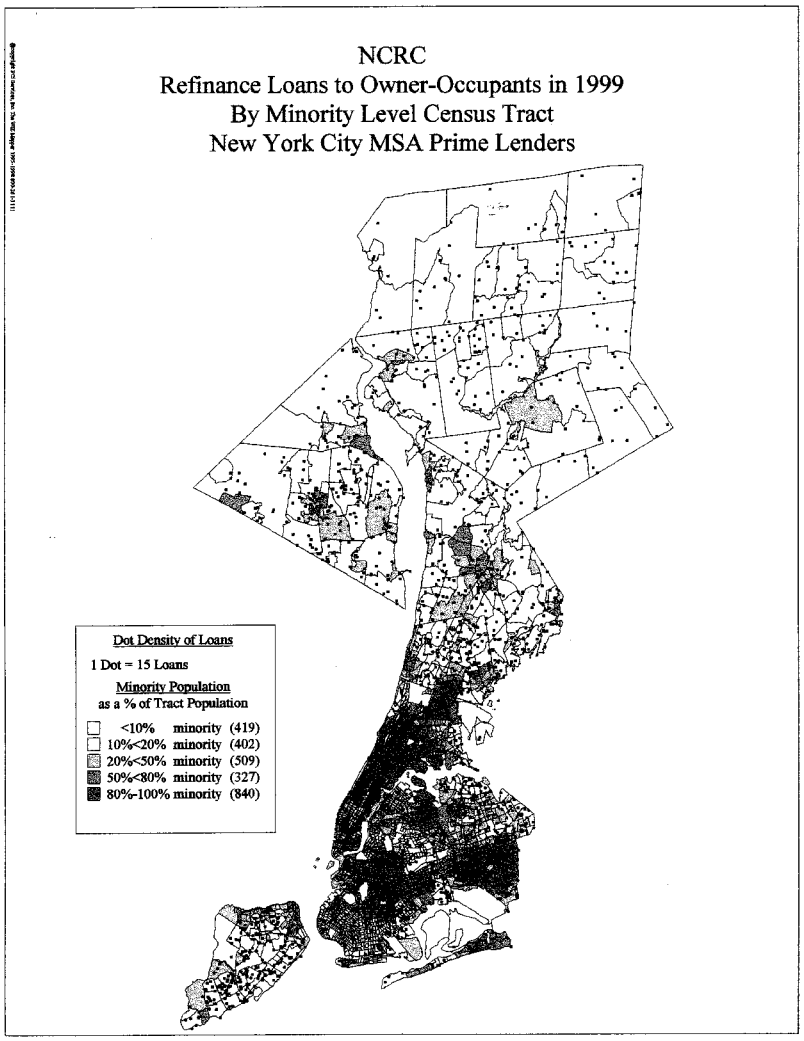
	Subprime Loans	Prime Loans	Total Loans	Subprime Share	Prime Share	Market Share Disparity
All Borrowers	530	3,356	3,915	13.5%	85.7%	
>50% Min Tracts	135	164	311	43.4%	52.7%	4.0
>50% White Tracts	395	3,189	3,601	11.0%	88.6%	
LMI Tracts	145	220	376	38.6%	58.5%	3.5
MUI Tracts	385	3,133	3,536	10.9%	88.6%	
Black Borrowers	77	148	225	34.2%	65.8%	5.1
Black MUI Borrowers	16	71	87	18.4%	81.6%	2.0
White Borrowers	155	2,160	2,315	6.7%	93.3%	
LMI Borrowers	276	679	968	28.5%	70.1%	3.2
MUI Borrowers	242	2,436	2694	9.0%	90.4%	


Percent of Refinance Loans in the Newark MSA in 1999
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
All Borrowers
>50% Min Tracts
>50% White Tracts
LMI Tracts
MUI Tracts
Black Borrowers
Black MUI Borrowers
White Borrowers
LMI Borrowers
MUI Borrowers
Prime
Subprime

Percent of Refinance Loans in the Trenton MSA in 1999



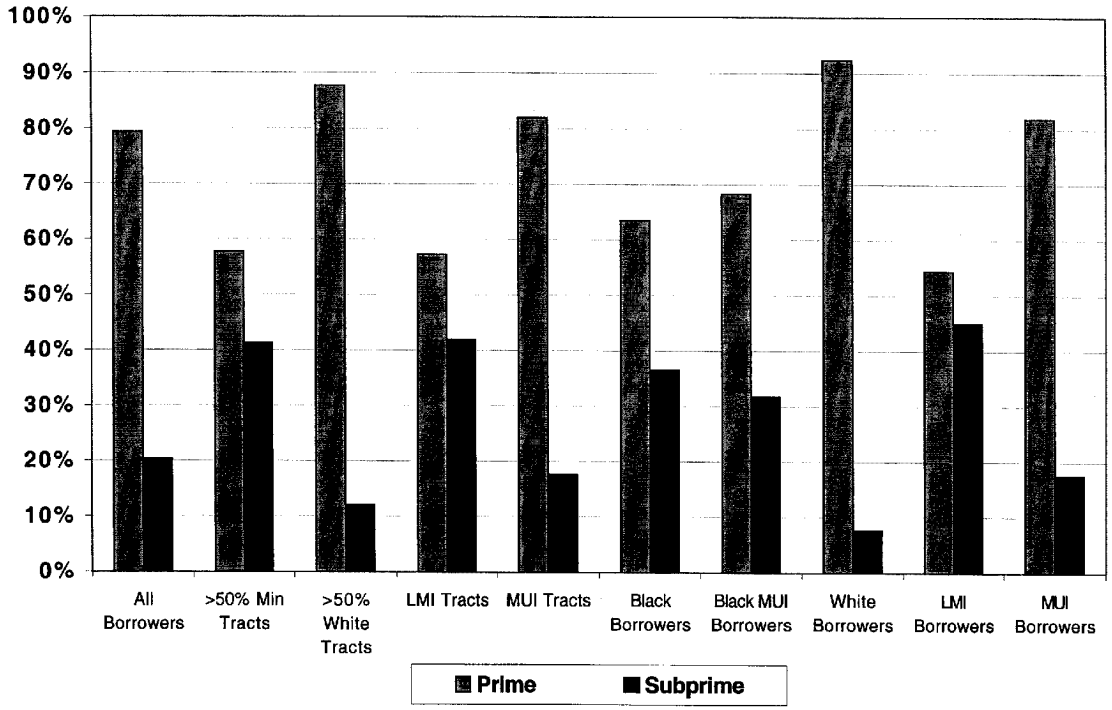

NCRC
Refinance Loans to Owner-Occupants in 1999
By Minority Level Census Tract
New York City MSA Subprime Lenders
Dot Density of Loans
1 Dot = 10 Loans
Minority Population
as a % of Tract Population
<10% minority (419)
10%<20% minority (402)
20%<50% minority (509)
50%<80% minority (327)
80%-100% minority (840)


NCRC
Refinance Loans to Owner-Occupants in 1999
By Minority Level Census Tract
New York City MSA Prime Lenders
Dot Density of Loans
1 Dot = 15 Loans
Minority Population
as a % of Tract Population
<10% minority (419)
10%<20% minority (402)
20%<50% minority (509)
50%<80% minority (327)
80%-100% minority (840)

New York City MSA Market Share 1999
Conventional Refinance Lending to Owner-Occupants

	Subprime Loans	Prime Loans	Total Loans	Subprime Share	Prime Share	Market Share Disparity
All Borrowers	9,668	37,919	47,831	20.2%	79.3%	
>50% Min Tracts	5,523	7,720	13,386	41.3%*	57.7%	3.4
>50% White Tracts	4,136	30,147	34,384	12.0%	87.7%	
LMI Tracts	2,181	2,981	5202	41.9%	57.3%	2.4
MUI Tracts	7,462	34,824	42487	17.6%	82.0%	
Black Borrowers	2,166	3,766	5,932	36.5%	63.5%	4.8
Black MUI Borrowers	1,217	2,623	3,840	31.7%	68.3%	1.8
White Borrowers	1,821	22,122	23,946	7.6%	92.4%	
LMI Borrowers	2,991	3,612	6,644	45.0%	54.4%	2.6
MUI Borrowers	6,291	29,409	35,903	17.5%	81.9%	

Percent of Refinance Loans in the New York City MSA in 1999



PREPARED STATEMENT OF GEORGE J. WALLACE

COUNSEL, AMERICAN FINANCIAL SERVICES ASSOCIATION

JULY 27, 2001

Good morning. I represent the American Financial Services Association (AFSA). AFSA is a trade association for a wide variety of market-funded lenders, many of whom make both prime and subprime loans to American consumers. AFSA looks forward to working with the Committee to examine the issues raised by the hearings held yesterday and today.

Allegations of predatory lending, particularly in the subprime mortgage market, have received a significant level of attention in recent months. Advocates of increased regulation have claimed that stepped up fraudulent or "predatory" marketing practices have persuaded vulnerable consumers to mortgage their homes in unwise loan transactions. Some consumer advocates have gone considerably farther and asserted that various loan products and features common to the mortgage market are "predatory" and should be outlawed.

Most of the regulatory changes sought have a common, very troubling, approach. They impose significantly restrictive new regulation on all mortgage loans, or all loans over a designated interest rate or points threshold, even if there is no evidence of fraudulent marketing. This approach confuses the symptoms with the causes and its adoption would be a serious mistake, because it fails to recognize or address the real causes of the problem, and would seriously undercut the important goal of maintaining the availability of credit for working American families.

Much of this proposed regulation seeks to control credit prices, directly or indirectly, by limiting or discouraging points, fees, and higher interest rates. Some proposals also restrict credit terms or require burdensome new compliance steps, such as extended new disclosures. Several others aim at restricting marketing methods, particularly when refinancing is involved. Finally, several proposals have urged turning the already strong remedial and penalty provisions of present law into extremely broad punitive provisions.

These proposals, taken as a whole, would dramatically reduce loan revenue, increase the risk, and/or increase costs the lender must bear. While initially the resulting burdens fall on the lenders who continue to make loans subject to new regulation, in the long term, the effects will almost always be felt directly by working American families, either because of decreased loan availability, higher credit prices or less flexible loan administration.

Thus this call for increased regulation, well intended as it undoubtedly is, strikes at the very heart of the efforts over the last quarter century of Congress, many States, consumer advocacy groups, and the lending industry to make efficiently priced consumer credit available to working American families, including minorities, single parent families, and others who for so long were unable to obtain credit. In testimony before this Committee in 1993, Deepak Bhargava, Legislative Director for ACORN, spoke of "a credit famine in low- and moderate-income and minority communities in urban and rural areas" demonstrated by "[a]bundant anecdotal and statistical evidence [pointing to] massive problems of credit access in many communities around the country, particularly in minority and low-income areas".[1] He also pointed out that "[l]ack of access to credit thwarts community development efforts, and the creation of employment and housing opportunities for millions of American families."[2]

In 1993, subprime credit was a very small part of the credit market. Today, subprime credit is approximately 25 percent of home equity credit outstanding, and a very significant part of purchase money credit. Yet some of the legislative proposals advanced by consumer advocates this year would unwisely impose stringent new regulations and disclosures, including what amounts to strict price and terms limitations, on virtually all of that credit. Even the pending Federal Reserve Board proposals would impose heavy additional regulatory burdens. A study of AFSA member loans originated over the last 5 years suggests that the pending Federal Reserve Board proposal would increase the number of first mortgages covered by HOEPA from 12.4 percent today to 37.6 percent, and second mortgages from 49.6

[1] Hearings on S. 1275, Community Development Banking and Financial Institutions Act of 1993 before the Senate Banking, Housing, and Urban Affairs Committee, 103d Cong., 1st Sess., 168 (1993) (Written Testimony by Deepak Bhargava, Legislative Director, ACORN on behalf of ACORN, Center for Community Change, Consumer Federation of America, Consumers Union and National Council of LaRaza).

[2] *Id.*

percent to 81.1 percent.[3] The effect, if not the goal, of these proposals will likely be to substantially shrink the subprime mortgage market, a point underlined by Freddie Mac's announcement in the spring of 2000 that it would not purchase any HOEPA loan, a policy now mirrored by Fannie Mae.[4, 5]

Subprime lenders, spurred on by Congress, have been enormously successful in delivering efficiently priced consumer credit to working American families, regardless of race, ethnicity, or background. Such families use mortgage credit for many purposes, among them acquiring homes, working their way out of credit difficulty by consolidation and refinancing, making home improvements, and college education. We are proud to report that during the last 5 years, 96 percent of those who have borrowed from AFSA members using subprime mortgage loans have used the credit successfully. Eighty five percent of those subprime borrowers paid in full and on time. The remaining 11 percent, in varying degree, may have missed a payment here and there, but ultimately used the credit successfully.[6] It is true, of course, that subprime lending does experience higher losses than conventional lending. That is why it is priced as it is. But the basic point is that most Americans who use subprime credit use it successfully. Under what policy prescription would the Government deny to Americans with less than first class credit access to all the benefits of credit that middle class Americans enjoy? The 96 percent of Americans who use the credit extended by AFSA members successfully are not asking for that interference.

There are some people who have been the victims of fraudulent, deceptive, illegal, and unfair practices in the marketing of mortgage loans. Advocates have mistakenly focused on loan products and features as the reason why these victims experienced such adverse outcomes, and reached the faulty conclusion that if regulation just barred certain loan features, the harm would have been avoided. Pursuing that mistaken reasoning, they have tried to label as "predatory," highly regulated loan products and features, which are entirely legal (such as credit insurance, prepayment penalties, balloon payments, arbitration, and higher rates and fees). However, most of the loan features called "predatory" are *not* generally known as "predatory" practices—they are legitimate, legal, and common in mainstream prime and subprime lending. Any legitimate consumer good or service can be marketed fraudulently. Indeed, the scam artist prefers to use legitimate products, like loans, as a cover because consumers want and need the product. The illegality comes in the fraudulent marketing of the good or service, not in the good or service itself.

We urge that Congress not confuse the loan products that consumers want and need, with the fraudulent marketing practices that a few isolated operators have used to prey upon the unfortunate. Predatory lending is fundamentally the result of misleading and fraudulent sales practices already prohibited by a formidable array of Federal and State laws, including Section 5 of the Federal Trade Commission Act, criminal fraud statutes, State deceptive practices statutes, and civil rights laws. Aggressive enforcement efforts by the FTC, HUD, and the Civil Rights Division of the Justice Department, as well as by the States' Attorney Generals are underway. The existing array of State and Federal regulation of fraudulent practices is already sufficient to deal with the deceptive, fraudulent, and unfair practices that make up "predatory lending," and we suggest that there is no better deterrent to this type of behavior than successful prosecution. On the other hand, the subprime market is already very heavily burdened with restrictions and requirements imposed at the State and Federal levels. Additional regulation of the type advocates have proposed will hurt the vast majority of working American families by raising credit prices and reducing credit availability. That is simply not a desirable policy outcome, particularly when it is not likely to deal with the real problem.

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[3] Michael E. Staten and Gregory Elliehausen, *The Impact of The Federal Reserve Board's Proposed Revisions to HOEPA on the Number and Characteristics of HOEPA Loans,* 5–6 (July 24, 2001).

[4] See editorial by David A. Andrukonis, Chief Credit Officer, Freddie Mac, "Freddie Mac Defends Purchase of Subprime Mortgages," *American Banker,* April 6, 2000, also available at *www.freddiemac.com/newsanalysisambankerlet.html.*

[5] A study of the impact on the loan market in North Carolina of impact recent loan legislation there had on the availability of credit to low- and moderate-income borrowers likewise suggests that the approach to reform urged by the advocates is counterproductive. In North Carolina, loans made by 9 AFSA companies to borrowers with incomes under $50,000 shrunk dramatically in the first 6 months after the North Carolina legislation went into effect. Michael E. Staten and Gregory Elliehausen, *The Impact of The Federal Reserve Board's Proposed Revisions to HOEPA on the Number and Characteristics of HOEPA Loans,* 1418 (July 24, 2001).

[6] Analysis of approximately 1.3 million mortgage loans originated between 1995 and July 1, 2000 by 9 AFSA members. The percentages stated in the text are based on all loans in the pool with relevant variables.

If fraudulent and deceptive practices are the root of the problem, what is the appropriate policy to address predatory lending?

- First, Congress should do no harm to the present system which has been extremely successful in delivering consumer credit to America's working families. As said before, more restrictions on credit prices, terms, and practices does not address the fraud which is the root of the problem, and it results in taking away from working American families the lending products they desire and it has been the goal of Congress to provide. Remember that over a 5 year period, 96 percent of those who used subprime lending from AFSA members did so successfully. Such policy prescriptions as lowering HOEPA thresholds and forbidding such features as balloon payments, financed single-premium life, accident, and health insurance and prepayment fees in more and more loans is not appropriate policy, because it takes away legitimate tools to shape credit to the needs of America's working families.
- AFSA has been a leader in developing educational programs to help meet the enormous need American consumers have for greater financial literacy. As a founding member of the Jump Start Coalition, a coalition of industry, Government, and private groups dedicated to increasing financial literacy, it has for several years pushed strongly for increased efforts to educate Americans about credit. We urge Congress to support these and other efforts, because they hold the greatest promise to help over the long run. As we all know, the best defense against fraudulent sales practices is the informed consumer, and informed consumers can best evaluate whether they want or can afford to borrow more.
- Industry self regulation likewise plays an important role. AFSA has developed "Best Practices" which its member companies have voluntarily adopted. They address the controversial terms which consumer advocates have often targeted, and they strike a balance between reasonable limits and providing legitimate consumer benefits in appropriate circumstances. Other associations of lenders, including the Mortgage Bankers Association, have adopted "Best Practices" as well, and they hold a great deal of promise. A copy of AFSA's best practices on home equity lending (Statement of Voluntary Standards for Consumer Mortgage Lending) is attached as Appendix A.
- Government's role is appropriately the vigorous enforcement of the deceptive practices and civil rights laws. Any objective analysis of these laws must reach the conclusion that they provide powerful tools to address both fraudulent sales practices and discrimination. Strong enforcement is appropriate because it addresses the real problem, the fraudulent and discriminatory practices that make an otherwise legitimate loan "predatory," without affecting the overall ability of lenders to make loans available to working American families with less than perfect credit. That is the appropriate policy balance between dealing with the real misfortunes which a few borrowers have experienced and the continued availability of credit to working American families. We urge Congress to encourage that an appropriate balance be maintained.

Thank you for the opportunity to address the Committee, and I look forward to any questions you may have.

Appendix A

American Financial Services Association Statement of Voluntary Standards For Consumer Mortgage Lending

December 12, 2000

The American Financial Services Association (AFSA) has examined the market environment for mortgage lending as defined in the Home Ownership Equity Protection Act (HOEPA) and has adopted the following voluntary standards, effective upon its release, for the conduct of lenders in this market.

AFSA rejects abusive practices, and uniformly condemns violations of law, fraud and unfair and deceptive practices by anyone in the marketplace. In furtherance of this position members will ensure that their employees are appropriately trained and that their customers have access to effective complaint resolution channels.

HOEPA Standards. Uniform standards and triggers embodied in HOEPA represent a level playing field for these mortgage transactions in the United States. Adoption of differing standards and triggers in state legislation are not recommended and could reduce the availability of credit to consumers who need it.

Ability to Repay. The ability of the customer to repay the loan obligation should be the primary focus of underwriting standards. AFSA members will not extend credit to any customer who does not demonstrate the ability to pay when the application is made. Underwriting may be done on a manual basis or with a system that is empirically derived (statistical), and these underwriting decisions consider many factors. However, the amount of equity in the mortgaged property should not take precedent over the borrowers ability to repay the loan.

Credit Insurance Products. Credit life, credit disability, and credit IUI insurance represents a high value to consumers in mortgage lending. Consumers have recognized this value to retire debt or to provide payment continuity in the case of death, disability, or unemployment. Providers of credit insurance must make full and accurate disclosure of credit insurance terms in accordance with state or federal law as the foundation for the customer making an informed decision. Finally, existing law regarding the *optional* nature of credit insurance provides effective protection to consumers.

The AFSA Code of Ethics provides that the offering of any insurance must be done in a clear and informative manner. The purchase of such products must reflect a voluntary.2 choice by the consumer and must never be a condition to the extension of credit. To further strengthen this position, AFSA member companies will offer customers who choose to buy credit insurance the *choice* of single premium or monthly premium insurance products on mortgage loans as state law and data processing systems enhancements will allow for such choices in the future. AFSA members will provide a full refund of single premium insurance charges within 30 days of the loan closing, for those customers who choose to cancel their insurance, thereby providing a 30-day "free

look". AFSA members will refund the unused portion of any single premium credit insurance premium upon cancellation.

Prepayment Penalties. Costly administration of higher risk mortgages often demands that multiple components be included in the risk based pricing of mortgage loans. Prepayment penalties should not be assessed if a loan is to be refinanced by the same lender. If the borrower repays the loan through other sources, the original lender may recover costs through application of a prepayment penalty.

The AFSA standard is a maximum of 5 years for the duration of a prepayment penalty clause in a mortgage loan agreement.

Balloon Loans. AFSA recognizes that balloon loans may be beneficial for some borrowers, provided that either the balloon date is at least 7 years from the date of loan origination or the borrower has provided information in connection with the application indicating that the borrower's financial plans anticipate the need for the loan for only a period shorter than the length of the balloon (e.g. the borrower expects to be transferred within three years and wants a three year balloon). Each AFSA member will agree with its customers that it will refinance a balloon loan at maturity, upon request of the borrower, at its then-available rate, fees and terms, provided that (a) the member still owns the loan, (b) the member still has products that can be offered to the customer, (c) neither governmental nor market forces have restricted the ability of the member to require the rate, fees, and terms it deems necessary and appropriate to the credit involved, (d) the customer has performed well on the balloon loan, and (e) neither the customer's financial situation nor the value of the property has deteriorated.

Call Provisions. AFSA members do not support the introduction of call provisions into consumer mortgage loan contracts.

Refinancing. In the event an AFSA member refinances its loan (or the loan of an affiliate) within 12 months of the refinanced loan's origination, it will either refund pro rata the points on the old loan, or it will charge points only on the new money in the new loan. "New money" is the amount by which the new principal exceeds the payoff amount of the old loan. As a matter of principle AFSA members will only refinance an existing loan if there is a reasonably anticipated present or potential benefit to the customer of the refinance.

AFSA members support prohibition of the refinancing at higher rates of unique, non-conventional,

below market-rate loans that are characterized as publicly assisted, non-.3

profit, or government subsidized. If such a transaction is identified in a member portfolio the AFSA member creditor will cure the finance charge differential, regardless of the origin of the transaction.

Foreclosures. Foreclosure is a remedy of last resort in consumer transactions. It is not the intention of AFSA members to derive profit from the unfortunate circumstances involved in the foreclosure process.

In the unlikely event of a foreclosure on property securing a loan, lenders should return to the consumer any net surplus inclusive of transaction, carry, and direct costs, derived from the sale, upon final sale of the property by the AFSA member company from it's inventory of real estate held as assets.

Home Improvement Lending. Members support the current AFSA voluntary standard on home improvement contracts, which include the following key points:

Loans are restricted to those used to finance improvements for the borrower's principal residence.

- Lenders shall have a standardized completion certificate signed by both the seller and customer before a home improvement retail installment contract can be purchased, or before the final progress payment is made on a direct home improvement loan.
- For any home improvements of $7,500 or more, lenders shall arrange, prior to the purchase of a home improvement retail installment contract or prior to the final progress payment on a direct home improvement loan, for a property inspection by any person who knows the basic parameters of the work contemplated by the customer and who is equipped to visually ascertain that such work has been substantially performed.
- For home improvement retail installment contracts and direct home improvement loans less than $7,500, the lender shall confirm with the customer that the financed home improvements have been completed.
- Lenders will provide disclosures encouraging consumers to contact their lender if they cannot resolve problems with their contractor. In addition, lenders shall respond to a written complaint from a customer under a home improvement retail installment contract or direct home improvement loan regarding problems the customer may have with the contractor within 20 business days, by acknowledging, in writing, receipt of the inquiry. Within 60 business days of receipt of the customer's inquiry, the lender shall investigate the complaint and notify the customer in writing of the lender's determination and proposed course of action.
- Lenders will cooperate with law enforcement agencies in an investigation or prosecution of the perpetrator of any fraudulent acts in connection with any home improvement project.4
- Customers under a home improvement retail installment contract or direct home improvement loan shall be provided with a disclosure by the contractor (before initiating any work), and by the lender at the time of application, which clearly and concisely explains the customer's rights and protections under federal law.

Brokers. AFSA recognizes that many lenders use brokers in originating real estate loans. Broker honesty and skill are important elements in the smooth functioning of the real estate lending market. These principles are embedded in the AFSA Code of Ethics. At the present time real estate mortgage brokers are often not licensed. AFSA supports the licensing and regulation of mortgage brokers. Mortgage brokers are expected to comply with the AFSA voluntary standards.

Consumer Counseling and Education. AFSA actively supports consumer education through the AFSA Education Foundation. AFSA fully supports the availability of voluntary independent credit counseling as one of the many tools available to help consumers understand responsible use of credit. AFSA recommends that lenders take steps to support initiatives for consumer education to improve the financial decisions that consumers make, and to ensure effective use of information.

Credit Reporting. AFSA supports the current voluntary standard on credit reporting. AFSA members shall not selectively report credit information on certain customers and withhold credit information on other customers for the purpose of preventing data on customers from becoming available to other lenders.

Compliance with this voluntary standard on credit reporting will improve fair and complete credit reporting and benefit consumers as they seek credit in the future.

Default Advice. AFSA believes any practice of encouraging consumers to withhold mortgage payments or to default while awaiting a refinance is irresponsible and unethical.

PREPARED STATEMENT OF LEE WILLIAMS

CHAIRPERSON, STATE ISSUES SUBCOMMITTEE
CREDIT UNION NATIONAL ASSOCIATION, AND
PRESIDENT, AVIATION ASSOCIATION CREDIT UNION, WICHITA, KANSAS

JULY 27, 2001

Good morning, Chairman Sarbanes and Members of the Committee. I am Lee Williams, President of Aviation Associates Credit Union, a $38 million State-chartered credit union in Wichita, Kansas. I am testifying this morning on behalf of the Credit Union National Association (CUNA), which represents over 90 percent of the 10,500 State and Federal credit unions nationwide. In my capacity as chair of CUNA's State Issues Subcommittee, I have had the privilege of carefully considering issues surrounding the abusive practices of predatory lending and appreciate the opportunity to present some of our findings.

The credit union system abhors the predatory lending practices that are being used by some mortgage brokers and mortgage lenders across the country. America's more than 10,000 credit unions—member owned, not-for-profit cooperatives—strive to help their 80 million members create a better economic future for themselves and their families.

Predatory lending is a complex and difficult issue to resolve, as evidenced by the many witnesses that have testified before this Committee over the past 2 days. The primary targets of predatory lenders are subprime borrowers. Subprime borrowers are consumers who do not qualify for prime rate loans because of a poor credit history, or in some cases, simply a lack of a credit history. This segment of the population is of particular interest to the credit union industry because historically it is that population that has turned to credit unions for our flexibility and wide range of credit options.

CUNA is concerned that the term "predatory" has become synonymous with "subprime" in the minds of some policymakers. We believe it is important to distinguish the difference between subprime loans and predatory lending practices when formulating laws or regulations to eliminate predatory lending practices. If subprime lending is unintentionally restricted through efforts to prohibit predatory lending practices, the result could be a significant decrease in available credit to borrowers with blemished credit histories.

Credit Unions Are Not Predatory Lenders

Credit unions do not engage in predatory practices. Credit unions are nonprofit, cooperatively owned financial institutions. All profits are returned to the credit union members, after expenses and distribution to reserves. To participate in any activity that would take advantage of our members, who are also our owners, would be counterproductive to our operations, our structure, and our philosophy.

Credit unions are not in business to make money by providing financial services. In part, they are in business to provide financial services because people need them and, all too often, cannot obtain them at reasonable costs and terms. As the so-called "fringe" banking industry, such as payday lenders, pawn shops, and check cashers, has significantly expanded over the past decade, credit unions have been out in front to combat the devastating effects of these high-cost money brokers by offering alternative services at reasonable rates.

CUNA Combats Predatory Lending

America's credit unions support the elimination of lending practices that are intentionally structured in a manner that is deceptive and disadvantageous to borrowers. CUNA and credit unions across the country have been establishing programs to help our members fight back against the effects of high-cost and predatory loans.

At Aviation Associates Credit Union, we recently initiated the "Take Control" program, which provides resources for our members allowing them to take control of their financial well-being and effectively deter the success of payday lenders and the predatory mortgage lenders in our community.

Let me provide an example. Members with high interest mortgage loans acquired from a mortgage broker have asked our credit union for help because they cannot make their monthly payments. My initial response is to refinance these onerous loans and reduce the interest rate. But often that is no solution. Typically, these types of loans have been initially packed with so many fees—paid up front and financed—that the Loan to Value ratio is pushed as high as 125 percent. My credit union, and few others, can refinance such a loan.

Even in such a dire situation, our "Take Control" program can improve the member's financial circumstances. Our program does so through member education.

With the help of an on-site consumer credit counselor (available twice a week), members can learn how to pay down loans faster, obtain lower fees and rates, and—even in the grip of such a "predatory mortgage loan"—learn how to build equity faster so that the credit union can eventually refinance the loan.

This is only a Band-Aid on a serious injury. When the credit union refinances for the member, the predatory lender wins. At Aviation Associates Credit Union, we believe our members must never fall victim to predatory lenders in the first place. That is why the "Take Control" program includes a significant education component to teach our members how to avoid the predatory mortgage trap. We are convinced that education is a critical tool in our efforts to obtain financial independence for our members.

On a national level, CUNA and credit unions are active on several fronts to combat predatory lending. Last summer, CUNA developed "Mortgage Lending Standards and Ethical Guidelines" to be adopted by credit unions across the country. These guidelines were designed to help emphasize credit unions' concern for consumers and further distinguish credit unions as institutions that care more about people than money.

The guidelines prohibit:

- interest rates that are significantly above market rates and which are not justified by the degree of risk involved in providing the credit
- excessive balloon payments that require refinancing at a rate that is more than the rate on the existing note
- lending without regard to whether the borrower has the ability to repay
- requirements for frequent refinancing of the loan resulting in additional costs to the borrower and significant erosion of the borrower's equity;
- repayment penalties, in excess of actual costs incurred and unpaid
- exorbitant fees and insurance premiums that the borrower may be required to finance, further jeopardizing equity
- misleading or false advertising

A copy of these guidelines are attached to this statement.

One of the most important programs CUNA is currently promoting to combat predatory lending practices is financial education of our Nation's youth. Credit unions believe that by educating our young people in the area of personal finance they will learn to make sound financial decisions and choose not to use high-cost or predatory lenders.

CUNA has partnered with the National Endowment for Financial Education (NEFE) and the Cooperative Extension Service (CES) to expand financial education among teens throughout America. Through this partnership CUNA, NEFE, and CES provide an educational curriculum and materials to high schools across the country to combat financial illiteracy.

In addition to providing necessary materials, credit unions actively participate in the classrooms. During the 1999–2000 school year credit unions conducted over 5,000 financial education presentations reaching approximately 130,000 students nationwide.

Because credit unions are an important component of the solution to predatory lending—not part of the problem—CUNA has supported regulatory proposals that would strategically address predatory lending concerns without unduly burdening credit unions in the process. For example, CUNA supports the Federal Reserve Board's proposed change to Regulation Z, which is targeted only to high-cost loans under the scope of the Home Ownership and Equity Protection Act. CUNA has not supported regulatory proposals that are not carefully constructed to address only predatory lending problems, such as the Fed's proposed changes to amend Regulation C, Home Mortgage Disclosure Act (HMDA). This proposal would require all covered lenders, whether they make high-cost loans or not, to face additional, significant and costly reporting burdens not required by the HMDA. CUNA will continue working with the regulators to develop strategies that will protect consumers without imposing broad-based requirements that divert them from their primary mission of serving the financial needs of their members.

Credit Unions Often Use Subprime Lending Programs To Improve Consumers' Credit

A growing number of credit unions offer subprime loans to members who do not qualify for a prime rate loan. Subprime loans are offered to members at rates above the prime rate to offset the higher risk of lending to members with poor credit histories. Credit union subprime loans are not predatory. They are a necessary tool

that gives borrowers with poor credit histories the ability to build, or rebuild, their credit.

To help illustrate some of the alternative subprime lending programs offered by credit unions, CUNA created the Equitable Subprime Lending Task Force last February. The Task Force has recently completed a handbook entitled: *Subprime Doesn't Have to Be Predatory—Credit Union Alternatives,* which is included as an attachment to this statement.

Some credit union subprime loan programs, such as Aberdeen Proving Ground Credit Union's "Credit Builder" program in Aberdeen, Maryland, are designed to help borrowers improve their credit standing. This program offers subprime loans at 2 percent or 4 percent above normal rates, depending on collateral, but these higher rates automatically drop when the borrower makes 12 on-time payments.

In this program, the borrower is well informed that if he or she has one payment that is over 30 days past due any time during the first year of the loan, then the borrower is locked into the higher rate for the life of the loan. But, if the borrower makes the first 12 payments on time, the loan rate will automatically drop to the prime rate. However, the borrower must continue the timely payments for the life of the loan to retain the lower rate. If, after the first year of on-time payments, the borrower misses a payment, then the rate reverts to the higher rate again for the life of the loan. This loan is structured as an incentive to make on-time payments.

In Seattle, Washington, the Washington State Employees Credit Union all too often saw single income families struggling to make ends meet while the American Dream of homeownership remained beyond their grasp. To help more consumers buy homes, the credit union developed the "First Step" program. This program requires only percent down, an interest rate of .50 percent above the standard Fannie Mae 30 year fixed rate, and certification that the borrower has attended a homebuyer education seminar by a local agency or group. To qualify for this loan, the borrower's income cannot be above a certain level and the purchase price of the home must be below maximum limits.

The credit union staff work closely with these borrowers through the life of the loan offering financial guidance and budgeting assistance to promote success for this program, as well as for the borrowers.

The credit union has allocated $20 million to this program and has been very successful getting people into homes that could not ordinarily qualify for a mortgage anywhere else.

And Antioch Schools Federal Credit Union, located in California, offers its subprime borrowers several ways to reduce their interest rates, while picking up smart credit habits in the process. This "Rate Reduction" program includes:

- a ½ percentage rate reduction for attending one consumer credit counseling class;
- a 1 percent rate reduction for attending more than one consumer credit counseling class;
- a 1 percent rate reduction for each year of the term of the loan that there are no draws or escalation of debt during that year;
- and to promote savings, the Antioch Schools Credit Union will drop a subprime borrower's rate one half percent if the borrower makes a deposit of at least $15 a month to a savings account and keeps it on deposit for a year.

With the many positive programs being developed in the subprime lending market to assist consumers of all economic circumstances, credit unions urge policymakers to address the *abuse* of lending practices rather than complete prohibition of practices that, when used legitimately, provide flexibility and credit options to meet individual borrowers' needs.

Credit Unions Urge: Eliminate Predatory Practices, Not Subprime Lending

Credit unions urge policymakers to use a scalpel, not an elephant gun, when drafting legislation to eliminate predatory lending practices. Subprime borrowers need to be served. Credit unions do not want to lose their ability to create flexible subprime loan programs.

For example:

- Bona Fide Discount Points Should Not Be Eliminated. Credit unions are concerned that a definition of "high-cost mortgage" that includes "total points and fees" and lowers the HOEPA threshold to 5 percent could restrict the use of discount points, which in many cases borrowers pay for the purpose of reducing the interest rate or time-price differential applicable to the loan. This is an important loan option for some borrowers who intend to stay in their home for a long time.

  CUNA recommends that bona fide buy down points be excluded from the definition of "high-cost mortgage" where the borrower has a completely free choice among a set of interest rate and point combinations.

- Legitimate Balloon Notes Should Not Be Prohibited. Credit unions are concerned that strictly prohibiting balloon payments will eliminate a legitimate credit option for lenders who wish to extend loans without holding excessive interest rate risk or for borrowers, under specific circumstances, to obtain lower monthly payments.

  CUNA recommends that balloon payments be allowed if the borrower has the option of continuing the loan at the then current interest rate available from that lender for similar borrowers with no additional costs or fees.

- Financing Points and Fees Should Be Allowed When in the Best Interest of the Borrower. There may be cases where it is in the consumer's best interest to refinance an existing high-cost mortgage. Credit unions are concerned that a strict prohibition of the financing of certain points and fees could limit borrowers' options and in many cases, access to credit.

  CUNA recommends that legislation restricting the financing of points and fees include an exception for transactions in which: (a) the action provides a material benefit to the consumer, and (b) the amount of the fee or charge does not exceed, (i) an amount equal to 1.0 percent of the total loan amount, or (ii) $600 in any case in which the total loan amount of the mortgage does not exceed $60,000.

Again, let me say that I am very pleased you are holding these hearings. Credit unions are very anxious to see the abusive practices of predatory lending eliminated. Credit unions have taken positive steps in that direction through their voluntary efforts to educate their members and provide them with fair and sound alternative products. It is our hope that we will have allies in our efforts to assure that all consumers have access to credit products that do not unfairly take advantage of their circumstances.

Thank you, and I will be happy to answer any questions.

CUNA MEMBER CREDIT UNION MORTGAGE LENDING STANDARDS AND ETHICAL GUIDELINES

Issue: Homeowners across the country, seeking to borrow against the equity in their property, may be forced to pay excessive rates and fees, be subjected to other abusive borrowing activity, or be at risk of actually losing their homes, if they fall prey to unscrupulous lending practices known as predatory lending. Such borrowers are often elderly or other individuals facing significant financial demands who are anxious to have access to credit and thus, vulnerable to unconscionable demands and requirements of the predatory lenders.

Credit Unions Concerns/Interests

Credit unions have a proud history of service to their members and provide products that meet members' needs and are in members' best financial interests. As member-owned, democratically controlled financial cooperatives, credit unions want to help protect consumers from abuses of predatory lending in the financial marketplace, even though credit unions themselves offer products that are fairly priced, with reasonable terms and conditions.

Under the Federal Credit Union Act and/or regulations from the National Credit Union Administration, more stringent rules apply to credit union mortgage lending than apply to commercial bank home loan products. For example, federal credit unions are subject to a 15 usury rate ceiling, which may be adjusted up to 21 and now stands at 18. Also, federal credit unions may not charge prepayment penalties. State provisions vary, but many state chartered credit unions operate under similar limitations.

The Credit Union National Association, the largest trade association representing credit unions, condemns the practice of predatory lending. CUNA's Board of Directors calls on every CUNA member credit union to adopt home equity lending standards and ethical guidelines that will help emphasize credit unions' concern for consumers and further distinguish credit unions as institutions that care more about people than money. CUNA will work with key policymakers, including state and federal credit union regulators, to ensure they support an approach that is designed to increase awareness of the predatory lending problem and highlight credit unions' role as not-for-profit, consumer-owned financial institutions.

Guidelines and Ethical Standards

The following guidelines are designed to apply to non-purchase money closed-end home equity loans. Credit unions abhor predatory lending and seek to protect consumers from such abominable practices. Predatory lending **includes home equity- stripping** loan products with one or more of the following characteristics:

- Interest rates that are significantly above market rates and which are not justified by the degree of risk involved in providing the credit;

- Excessive balloon payments that require refinancing at a rate that is more than the rate on the existing note;
- Lending without regard to whether the borrower has the ability to repay;
- Requirements for frequent refinancings of the loan resulting in additional costs to the borrower and significant erosion of the borrower's equity;
- Prepayment penalties, **in excess of actual costs incurred and unpaid;**
- Exorbitant fees and insurance premiums that the borrower may be required to finance, further jeopardizing equity;
- Misleading or false advertising.

Predatory lending does not encompass legitimate products **such as reverse mortgages** or risk-based lending recognized by fair lending and fair credit statutes that allow financial institutions to price loan products by taking into consideration the risk to the institution in making a loan.

Recognizing that predatory lending is fully inconsistent with the philosophy and principles unique to the credit union system, credit unions adopting these home equity lending guidelines and ethical standards agree to:

Emphasize Member Education

- Provide a copy of these standards to member/borrowers, as applicable;
- Educate members regarding the dangers and abuses of predatory lending by offering counseling and other useful information about the lending process;
- Inform members about the differences and advantages associated with credit union lending products, such as applicable usury ceilings, lack of prepayment penalties;
- Inform borrowers about all applicable lending products the credit union offers;
- Assist borrowers in understanding applicable loan disclosures, rates, fees and terms, including any rights of rescission;

Meet Members' Borrowing Needs

- Ensure home equity loan products meet the consumer's borrowing needs and ability to repay, consistent with credit union loan policies and legal requirements;

Prohibit and Refrain From Abusive Practices

- Exclude terms and conditions that are not justified by the documented risk to the credit union of extending the loan;
- Exclude interest rates that are higher than market indices, **except as proportionate to comparable Treasury securities based** on the borrower's credit history, income and other indicators of ability to repay the loan;
- Prohibit refinancing of balloon payments at a higher rate than on the original note when not justified by market conditions or the risk of making the loan;

- Exclude fees and insurance premiums from the amount to be financed; (does not include extended warranty program)
- Prohibit **charging for or financing** insurance products or unrelated goods or services without the consent of the borrower;
- Ensure lending staff are well trained to avoid potentially misleading statements in connection with a loan transaction;
- Prohibit loan "flipping", which is providing a loan to a borrower to refinance an existing home loan when the new loan does not have a net benefit to the borrower, taking into consideration the terms of both loans and the borrower's circumstances;
- Exclude mandatory arbitration clauses that limit the rights of borrowers to seek redress in court should problems arise.

Support Efforts in the Marketplace to Prohibit Predatory Lending

- Follow FNMA and FHLMC anti-predatory lending guidelines, which include key provisions such as:
    - Loans purchased may not have points or fees that generally exceed 5, **excluding discount points;**
    - Prepaid single-premium credit life insurance may not be sold In connection with loans purchased;
    - Lenders which sell to FNMA or FHLMC must report on loans they are servicing each month;
    - Waivers should not be allowed from the requirement that servicers maintain escrow accounts for the payment of taxes, insurance premiums, etc. for borrowers with "blemished" credit records.

For more information on these guidelines, contact Eric Richard at 202-218-7796 or Mary Dunn at 202-218-7765.

CUNA'S
EQUITABLE SUBPRIME LENDING TASK FORCE

OF THE
STATE ISSUES SUBCOMMITTEE
OF THE
GOVERNMENT AFFAIRS COMMITTEE

DALE SPRINGER, CHAIR
1ST CHOICE CU, NEBRASKA

DAVID BECK
SELF HELP CU, NORTH CAROLINA

AMY CARLSON
ABERDEEN PROVING GROUND FCU, MARYLAND

KEVIN FOSTER-KEDDIE
WASHINGTON STATE EMPLOYEES CU, WASHINGTON

LORETTA HUDELSON
ANTIOCH SCHOOLS FCU, CALIFORNIA

Special thanks to George Shipman,
Washington State Employees Credit Union
for his insight and information on this issue.

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Credit Union Commitment to Fair Lending

The credit union system abhors the predatory lending practices that are being used by some mortgage brokers and mortgage lenders across the country. America's more than 10,000 credit unions - member owned, not-for-profit cooperatives - strive to help their 80 million members create a better economic future for themselves and their families.

America's credit unions support the elimination of lending practices that are intentionally structured in a manner that is deceptive and disadvantageous to borrowers. Too often those in our society who are least able to protect themselves from these deceptive practices are preyed upon first, and harmed the most.

During the summer of 2000, CUNA developed "Mortgage Lending Standards and Ethical Guidelines" designed to help emphasize credit unions' concern for consumers and further distinguish credit unions as institutions that care more about people than money.

INTRODUCTION

Members of CUNA's State Issues Subcommittee support the prohibition of predatory lending practices that some mortgage brokers and mortgage lenders across the country are using to harm consumers and, in some cases, foreclose on their homes.

The Subcommittee supports eliminating lending practices that are intentionally structured in a manner that is deceptive and disadvantageous to borrowers, without hampering legitimate mortgage lending programs or consumers' access to credit for home purchases.

Over the past year, the members of the Subcommittee have grown concerned that the term "predatory" is becoming synonymous with "subprime". In fact, on a couple of occasions, consumer advocates have stated: "there is no such thing as a good subprime loan".

Members of the subcommittee are alarmed by such statements and believe it is important to distinguish the characteristics of fair subprime loans from predatory loans. Restricting fair subprime lending would result in a significant decrease in available credit to borrowers with blemished credit histories. The subcommittee created the Equitable Subprime Lending Task Force to investigate and report the positive things credit unions are accomplishing through subprime lending programs.

This booklet is the result of the Task Force's work.

WHAT IS PREDATORY LENDING?

Predatory mortgage lending refers to high-rate, high-fee home equity products that are intentionally structured in a manner that is deceptive and disadvantageous to borrowers. Predatory lending often involves non-sustainable loans, and frequently refinances, without regard to the consumer's ability to repay. Predatory lenders often target the elderly, minorities and the disabled who have accumulated a large amount of equity in their homes. These consumers are often on fixed incomes and usually do not have the ability to repay such high-cost loans. Consequently, some consumers find themselves facing foreclosure on homes they have been loyally paying off for years and in which they have achieved high equity.

The media has highlighted a number of horror stories regarding predatory lending which help illustrate how certain lending practices can be misused or abused to deceive unwary borrowers:

- **"Flipping" a loan leads to higher costs:**

An elderly gentleman, who had never learned to read or write, wanted to purchase meat on credit. A home equity lender loaned him the money for the meat. The gentleman did not understand he was mortgaging his home and pledging 50% of his monthly income. Seventeen days later, the lender contacted the gentleman again and convinced him to take out a larger loan, at a higher rate of 19%, to pay off all of his debts. This gentleman was "flipped" again in 42 days and again 26 days later. Each time he was charged a 10% financing fee. This gentleman was "flipped" 11 times in less than 4 years. By the time he was interviewed by the media, he had a $50,000 mortgage on his home, which he had owned free and clear, and $25,000 of this amount was financing fees.

- ABC News, Prime Time Live, April 23, 1997

- **Undisclosed balloon notes can take borrowers by surprise:**

A single mother refinanced her mortgage to receive $30,000. Three months later she was contacted by the lender and informed that she had a balloon note and would owe the lender a lump sum payment of $27,500 in 15 years. This borrower was unaware and unfamiliar with balloon notes. She had no choice

but to refinance again. After only three months, she paid more fees, closing costs and a greater interest rate.

- WAGA- TV Atlanta, Fox 5 News Investigation, May 5, 1998

- **"Packing" loans can lead to unnecessary loan fees:**

A borrower took out a $43,000 home equity loan. Unbeknownst to the borrower, the mortgage lender "packed" the loan with insurance premiums. For example, the mortgage lender sold the borrower $75,000 worth of credit life insurance, even though the loan was only for $43,000. The cost of the insurance was $5,000 up-front, rolled into the loan and the borrower did not have any living beneficiaries who would benefit from the proceeds of such insurance.

- WAGA - TV Atlanta, Fox 5 News Investigation, May 4, 1998

WHAT IS SUBPRIME LENDING?

Subprime lending involves loans to persons who do not qualify for a financial institution's "prime" rate -- because of a poor credit history, or simply the lack of a credit history. A prime rate is usually the lowest rate of interest a financial institution offers to its best customers for short term unsecured loans.

Subprime loans are offered to consumers at a higher rate of interest, which off-sets the higher risk of lending to consumers with poor credit histories. Fair subprime loans are not structured in a deceptive or disadvantageous manner, but rather are a necessary tool giving borrowers with a poor credit history the ability to build (or rebuild) their credit.

The following are examples of credit union subprime lending programs that benefit consumers:

- **Subprime Loans Can Help Consumers Build Credit**

Some subprime loan programs, such as Aberdeen Proving Ground Credit Union's "Credit Builder" program in Aberdeen, Maryland, are designed to help borrowers improve their credit standing. This program offers subprime loans at 2% or 4% above normal rates, depending on collateral, but these higher rates automatically drop when the borrower makes 12 on time payments.

In this program, the borrower is well informed that if he or she has one payment that is over 30 days past due any time during the first year of the loan, then the borrower is locked into the higher rate for the life of the loan. But, if the borrower makes the first 12 payments on time, the loan rate will automatically drop to the prime rate. However, the borrower must continue the timely payments for the life of the loan to retain the lower rate. If, after the first year of on-time payments, the borrower misses a payment, then the rate reverts to the higher rate again for the life of the loan. This loan is structured as an incentive to make on-time payments.

- **The "First Step" Program Turns Consumers into Homeowners with Only 1% Down**

In Seattle Washington, the Washington State Employees Credit Union, all too often, saw single income families struggling to make ends meet while the American dream of home ownership remained beyond their grasp. To help more consumers buy homes, the credit union developed the "First Step" program. This program requires only 1% down, an interest rate of .50% above the standard Fannie Mae 30 year fixed rate, and certification that the borrower has attended a home buyer education seminar by a local agency or group. To qualify for this loan, the borrower's income cannot be above a certain level and the purchase price of the home must be below maximum limits.

The credit union staff work closely with these borrowers offering financial guidance and budgeting assistance to promote success for this program, as well as for the borrowers.

The credit union has allocated $20 million to this program and has been very successful getting people into homes that could not ordinarily qualify for a mortgage anywhere else.

- **Rate Reduction Options Can Turn a Subprime Loan into a Prime Loan**

Antioch Schools Federal Credit Union, located in California, offers its subprime borrowers several ways to reduce their interest rates, while picking up smart credit habits in the process. This "Rate Reduction" program includes:

- ✓ a 1/2 percentage rate reduction for attending one consumer credit counseling class;
- ✓ a 1% rate reduction for attending more than one consumer credit counseling class;
- ✓ a 1% rate reduction for each year of the term of the loan that there are no draws or escalation of debt during that year;
- ✓ And to promote savings, the Antioch Schools credit union will drop a subprime borrower's rate one half percent if the borrower makes a deposit of at least $15 a month to a savings account and keeps it on deposit for a year.

- **Subprime Loans can be Profitable without Gouging Consumers**

Self-Help Credit Union in North Carolina provides subprime lending products to the community. This credit union does not offer conventional mortgages. The rates for their subprime loans are usually one to two points above conventional rates, with a 1% loan origination fee. The credit union adjusts for the increased risk solely through the interest rate, with no opportunity for hidden costs in fees.

When the subprime borrower has made timely payments for a year or two, the borrower often is encouraged to refinance with a conventional lender.

Self-Help Credit Union finds that reasonably priced subprime loans provide much needed access to credit and perform well without charging exorbitant fees.

- **Not a Perfect Borrower? Find A Way To Do The Loan.**

Credit unions are programmed to be creative and develop unique strategies to meet their members' needs. Many credit unions, like Antioch Schools Federal Credit Union (ASFCU) in California, include these strategies in their loan policies.

Loan officers at ASFCU are instructed to find ways to reduce the risk of lending to some subprime borrowers so that the credit union can make the loan. For example, the loan officer may recommend reducing the amount of the loan, or changing the term of the loan. Another suggestion may be for the borrower to obtain a co-signer or to find additional collateral for the loan. Any of these strategies could turn a lender's "no" into a "yes".

The ASFCU also encourages its members to come back to the credit union each year to have their situation re-evaluated. An improved credit history may result in a better loan rate, the elimination of the need for a co-signor or other favorable changes in the loan's terms.

- **Credit Unions Partner with Fannie Mae to Provide "Timely Rewards" Loans**

Fannie Mae has developed a loan program in which credit unions, and other lenders, can participate to provide subprime loans to consumers. Fannie Mae acts as the investor, buying the subprime loans from the credit unions. The credit unions have the necessary funds to continue offering subprime loans to their members.

The Washington State Employees Credit Union (WSECU) has partnered with Fannie Mae in this program. WSECU calls its loan program the "Credit Builder" loan. When a borrower has less than perfect credit, he or she may qualify for the Credit Builder loan. For the almost perfect lender (a level one borrower) the rate is typically one half a percentage point above the credit union's standard 30 year fixed rate.

For borrowers with more problematic credit histories, considered level 2 and level 3 borrowers, rates will be slightly higher, reaching typically 1% to 1.5% above the credit union's standard 30 year fixed rate. However, when a level 2 or 3 borrower exhibits an improved payment history, by making 24 consecutive on time payments, the subprime interest rate will be reduced by one percent.

When level one borrowers exhibit improved credit histories, they are encouraged to refinance at the prime rate.

- **A Subprime Loan will not Always be the Solution for Non-qualifying Borrowers**

Subprime loans are not the solution for every consumer who does not qualify for a conventional loan at the prime rate. Qualifying criteria must also exist for subprime borrowers to ensure that the borrower has the ability to repay the loan.

Credit unions recognize that some consumers should not have mortgage loans until they are sufficiently prepared to take on the commitment of home ownership. Often first time home buyers are not prepared for the unexpected costs incurred from property taxes, home maintenance, home repairs, and furnishing a new home. It is important that any new home owner have adequate savings on hand for unexpected costs and emergencies.

Even if a borrower has a sufficient monthly income to make a mortgage payment, he or she could still be a poor candidate for a mortgage loan. If this borrower has no reserves, has demonstrated no pattern of savings, has no retirement plan nor has invested funds in assets that will appreciate, he or she may have difficulty making monthly mortgage payments while keeping up with the additional expenses incurred with home ownership.

Credit unions support the inclusion of life-of-the-loan financial assistance for subprime borrowers to ensure that they can meet their monthly financial obligations.

A similar argument can be made for refinance loans. Some home owners with substantial equity may have adequate loan-to-value ratios to qualify for a refinance loan but would not benefit from the additional debt. These consumers are often encouraged to refinance their mortgage loans to pay off credit card and other unsecured debts. The short term benefit of lower monthly payments can be enticing, but often is deceptive to consumers who do not understand the full cost of refinancing and the danger of securing unsecured debt.

CREDIT UNIONS COMBAT PREDATORY LENDERS

- **Focusing on Foreclosure Prevention**

Self Help Credit Union in North Carolina believes that increased foreclosure prevention strategies are vital to sustaining homeownership for low-income families who have less savings to buffer unforeseen expenses and loss of income. The credit union is developing foreclosure alternatives to keep people in their homes. Self-Help Credit Union is also helping to establish a non-profit law center to provide legal services to predatory lending victims.

- **Financial Education in High Schools**

One of the most important programs CUNA, the state credit union leagues and credit unions are currently promoting is financial education of our nation's youth. Credit unions believe that by educating our young people in the area of personal finance they will learn to make sound financial decisions and choose not to use high cost or predatory lenders.

CUNA has partnered with the National Endowment for Financial Education (NEFE) to expand financial education among teens throughout America. Through this partnership CUNA and NEFE provide an educational curriculum and materials to high schools across the country to combat financial illiteracy.

In addition to providing the necessary materials, credit unions actively participate in the classrooms. During the 1999-2000 school year credit unions conducted over 5,000 financial education presentations reaching almost 130,000 students nationwide.

Currently, only a handful of states have either a mandate for personal finance education in schools or include personal finance concepts in state assessment tests. These numbers are expected to increase over the next few years and credit unions plan to continue providing the support necessary to meet these educational objectives.

- **Credit Rating Education**

Many consumers do not understand why they have to pay more for credit. They may know that they have missed a payment a few times but they often do not understand the many other factors that effect their credit rating.

Some credit unions try to build credit education into the loan process - sometimes by offering incentives such as the rate reduction program described previously in this booklet. Credit education informs borrowers about the several factors that can effect their credit status, such as:

- ✓ Their level of unsecured debt;
- ✓ The length of time they have been with the same employer;
- ✓ How many times there have been inquiries on their credit rating; and
- ✓ How many times they have made a late payment.

LEGISLATIVE & REGULATORY ACTIVITY

In 1999, the North Carolina state legislature was the first to pass an anti-predatory lending law. Since then, other states, local governments, and Congress, have introduced legislation, regulations and ordinances that would prohibit mortgage lending practices that are intentionally structured to take advantage of borrowers.

State Government: During the 2000 state legislative sessions, at least ten states considered legislation to address predatory lending practices. By 2001 this number had increased to 24 states. Illinois, Massachusetts, and New York have passed regulations that will curb several lending practices associated with high cost loans.

City Governments: The cities of Chicago, *Philadelphia and Denver have all passed ordinances that prohibit city agencies from doing business with financial institutions or businesses that directly or indirectly participate in predatory lending practices.

Additionally, the District of Columbia passed a law to prohibit financial institutions from using predatory lending practices.

**The Pennsylvania state legislature later passed a predatory lending law that pre-empts the city ordinance.*

County Government: DeKalb County, Georgia, passed a county ordinance that prohibits county agencies from doing business with entities that are defined as participating in predatory lending practices.

Federal Government: Several members of Congress have introduced bills to curb predatory lending practices. The Federal Reserve Board recently issued a proposal which will define a larger number of mortgages as "high cost" and consequently subject them to additional disclosure and reporting requirements. Credit unions joined more than 160 consumer groups and advocates in signing a letter to Federal Reserve Chairman Greenspan urging the agency to take action against predatory lending.

GLOSSARY

Balloon payment: A scheduled final payment that is more than twice as large as the average of earlier scheduled monthly payments.

Call provision: A call provision permits the lender, in its sole discretion, to accelerate the indebtedness. A "no call" provision prohibits a call provision but does not apply when the repayment of the loan has been accelerated by default, pursuant to a due-on-sale provision, or pursuant to some other provision of the loan documents unrelated to the payment schedule.

Equity stripping: Offering a home equity loan without regard to the borrower's ability to repay the loan based on monthly income, expenses and employment status. Such loans often result in foreclosure and the loss of accrued equity to the borrower.

Financing insurance premiums: Financing, directly or indirectly, any credit life, credit disability, or credit unemployment insurance, or any other life or health insurance premiums. (Insurance premiums calculated and paid on a monthly basis are not considered to be financed by the lender.)

Flipping: The making of a home loan to a borrower to refinance an existing home loan when the new loan does not have a reasonable, tangible net benefit to the borrower considering all of the circumstances, including the terms of both the new and refinanced loans, the cost of the new loan, and the borrower's circumstances.

HOEPA: *Home Ownership and Equity Protection Act.* This law was passed in 1994 to address the problem of "reverse redlining". "Reverse redlining" is described as targeting residents of certain geographic boundaries, often based on income, race, or ethnicity for credit on unfair terms.

HOEPA amended the *Truth in Lending Act* to define a class of non-purchase, non-construction, closed-end loans with high interest rates or up-front fees as "High Cost Mortgages". The Act seeks to ensure that consumers understand the terms of such loans and are protected from high pressure sales tactics. The law requires creditors making High Cost Mortgages to provide a special, streamlined High Cost Mortgage disclosure three days before consummation of the transaction. The law also prohibits High Cost Mortgages from including certain terms such a prepayment penalties and balloon payments. Finally the law provides increased civil liability for failure to comply with the requirements for High Cost Mortgages and enables a borrower to assert all claims and defenses against an assignee of the High Cost Mortgages that could be asserted against the originator. *Pub. L. 103-325, 108 Stat. 2160.*

Packing: The practice of selling unnecessary and overpriced products or unrelated goods or services in conjunction with a high-cost home loan.

Prepayment penalties: Terms under which a consumer must pay a prepayment penalty for paying all or part of the principal before the date on which the principal is due.

PREPARED STATEMENT OF MIKE SHEA

EXECUTIVE DIRECTOR, ACORN HOUSING

JULY 27, 2001

Good morning, Chairman Sarbanes and Members of the Banking Committee. My name is Mike Shea, and I am Executive Director of ACORN Housing Corporation, which has worked for the past 17 years to build equity through increased homeownership in low- and moderate-income communities and communities of color. We have been fighting to allow people in our neighborhoods to buy their own homes, and worked with some of the major banks to make that happen. AHC now has offices providing housing counseling in 27 cities across the country and last year alone helped 9,400 families close on home purchase loans.

The subprime industry likes to claim credit for increasing homeownership among minorities and low- and moderate-income families. but the vast majority of their business is in refinancing loans and making second mortgages, not helping people buy homes. According to last year's HUD/Treasury report, of first-lien mortgages made by subprime lenders. Eighty two percent were refinances.

The increased rates of homeownership among underserved populations over the last decade are due almost entirely to banks starting to live up to their obligations under the Community Reinvestment Act. That is happening for a variety of reasons—continued pressure from community organizations like ACORN, somewhat more effective monitoring of CRA preformance, and, most importantly, the banks' realization that they had been neglecting good business opportunities. Do not get me wrong—there is a tremendous amount yet to be done and many banks that receive passing grades are not living up to their CRA obligations, but we have made progress and that needs to be recognized.

Increasingly, however, we are finding that predator lending abuses are threatening that progress. As soon as families in our communities start to build up some equity, they are bombarded with offers to refinance their mortgages or take out additional debt—receiving three or four letters a week and regular phone calls.

We know people have heard the numbers before, but we really need to seriously think through the consequences of more than half of refinance loans in communities of color being made by subprime lenders. Now not all subprime lending is predatory, but it is a sad fact that abusive practices are running rampant in the subprime industry.

When you consider that number in combination with the observations that Fannie Mae and Freddie Mac and others have made about the market—that 30 percent, 40 percent, or more of borrowers in subprime loans could have qualified for "A" loans, you are clearly talking about an incredible drain of equity from those communities which can least afford it. At a minimum, these numbers represent huge numbers of borrowers paying interest rates 2 to 3 percent higher than they would be if they instead had gotten an "A" loan. Over the life of a 30 year mortgage for $100,000, the difference in payments between interest rates of 8 percent and 10.5 percent is over $65,000.

Too often, however, predatory features make this bad situation even worse—by stripping the equity from borrowers homes with high financed fees, prepayment penalties, and add-ons like financed single-premium credit insurance. Borrowers are effectively trapped in unfair high-rate loans by these features, or they lose tens of thousands of dollars of equity from the encounter. Sometimes, they even lose their homes entirely. The lender wins and wins, the borrower loses and loses.

There is a desperate need for Federal legislation to prevent the abuses, cut down on the stripping of equity, and help families keep their homes. While it is impossible to prevent every bad loan, good legislation could solve a lot of the problems in the subprime industry and make a huge difference in protecting homeowners.

If we want a subprime market that works for consumers' interests, we cannot have huge fees financed into home loans—six times what banks are charging for providing the same service. We cannot have long extended prepayment penalties for several thousand dollars that trap borrowers in high-cost loans. As more lenders are recognizing in response to public pressure, we cannot have single-premium credit insurance policies that strip equity and tack on additional interest charges to an already overpriced product. If we want a market that works for borrowers, we cannot have loans being flipped over and over. That means taking away the current incentive for lenders to keep profiting from huge fees and other add-ons and make lenders' income streams more dependent on their loans actually being repaid.

In short, we have to get rid of all the tricks and hidden practices that make it impossible for borrowers to know what kind of loan they are getting into. What you have now is a situation where it is very difficult for even trained loan counselors

sometimes to understand all the damaging bells and whistles in many subprime loans—let alone a borrower trying to look for their own interests. That should not be how getting a home loan should work. It is not what happens in the "A" market. But that is what happens everyday in the subprime market. And despite the industry's substantial public relations efforts, the market has not taken care of it. We need a strong, clear set of rules that will allow homeowners to navigate the subprime market with some basic assurances of safety. Without such rules, large numbers of borrowers will not stand a chance.

We hear the argument that we do not need legislation, but just more education and financial literacy for borrowers. We certainly support financial literacy efforts—in fact I would venture that we have, in fact, done more to inform people in lower-income and minority communities about these issues than most. Part of what we have learned from this experience, though is what the limits of this approach are. First, there is the question of resources—until we are ready to spend the $1,500 to $2,000 per borrower that lenders can spend hawking their products we will never catch up. And second, no advertisement, or bus billboard, or even workbook, is going to compete with the one-on-one sales pitch of a lender—who still knows more about the process.

We have also heard the argument that all that is needed is better enforcement of existing laws. We see a lot of borrowers in heartbreaking situations, and we have tried to use current laws to help protect them, applying all the pressure we know how to get it enforced. But by and large, this has not worked. HOEPA covers only a tiny fraction of loans, and even there it mostly requires disclosures—as long as the right paper was slipped somewhere into the pile, there is often little the borrower can do. Fraud and deceit are against the law, but they have also been extraordinarily difficult to prove. It turns into a matter of "he said, she said" and when the lender knows more about the transaction, and has the paperwork, the borrower loses. And when we hear certain industry groups suggest the solution is better enforcement of current law, we are left wondering how they expect that to happen if they routinely include mandatory arbitration clauses in their loans.

What we need are some basic rules covering a broader group of high-cost loans that create a level playing field where a borrower in the subprime market, like a borrower in the "A" market, has a set of understandable options to choose between.

Buying or refinancing a home is a lot more like buying medicine than like buying a pair of shoes; if you are misled and buy the wrong one, the consequences are pretty serious. We do not expect every patient to read the *New England Journal of Medicine* and evaluate for themselves which drugs are safe and which are not. Instead, the FDA makes some rules about what is too dangerous to be sold. And then inside that relatively safer space, patients still have plenty of work to do to figure out what is best for them. We need to make some rules in the same way about home loans.

With regard to regulation, I should add that we were pleased that the Federal Reserve Board issued a proposed rule on HOEPA and one on HMDA. And that we are now growing extremely concerned about their silence since then. The Board needs to issue their rule, and they need to insist on the limited steps laid out in the proposed version—like improving the collection of HMDA data to include APR information. That said, the proposed rules were silent on many crucial areas crying out for action, and which we need legislation to address.

In the spirit of comity, I will end on an issue of clear agreement with the lending industry. We share the industry's belief that a variety of State and local anti-predatory lending legislation is not the ideal solution. We would like to see Federal protections for all Americans, and that is why we strongly support legislation the Chairman will be introducing in the near future.

As long as there is not Federal legislation, though, it is clear to us that our members, and community residents and State and city officials around the country will not, and cannot, sit by idly while borrowers are so badly hurt by predatory loans. The list of States and localities where antipredatory lending measures have been considered, or are presently being considered, include California, New York, Massachusetts, North Carolina, Philadelphia, Sacramento, DeKalb County (Georgia), and the list will keep growing. Just on Tuesday, the Oakland city council voted unanimously for a strong local ordinance restricting predatory lending practices, and there are many more like that to come. We are going to keep pushing our Senators and Representatives to get on board, but we are not going to wait for you. The stakes are too high.

Predatory Lending Stories

Margaret D – St. Louis, Missouri

Margaret D has lived in her home for nine years. She has very good credit (as indicated by her recent FICO score of 672) and had a 30-year mortgage from First Bank. After she refinanced a few years ago because of lower interest rates, she was paying an interest rate of 7.5% with monthly payments of $485.

By the summer of 2000, Ms. D had built up some other debts and was paying a total of $1,500 a month, including her house payment. She still owed about $38,000 on her home. Household began soliciting her to refinance her loans, and when she talked to the loan officer he said they could cut her payments in half to between $700 and $800. When she went into his office and talked to him, he changed that amount to lowering her payments by $300.

That August, Ms. D agreed to refinance her debts with Household. The company gave her both a first and second mortgage at the same time. The first mortgage, which did not provide any cash to Ms. D, had an interest rate of 12.5%, and she was charged an origination fee of $5,190.04. If she wants to refinance or sell her home within five years, she will have to pay Household a prepayment penalty of six months interest – around $4,000. She was told she had to

take out a single-premium credit life insurance policy in order to take out the loan, which cost $5,700. With ACORN's assistance, she requested and received a $4,700 refund on this policy.

Her second mortgage is a revolving line of credit for $15,000, with that amount advanced to her in full, including a cash-out of $1,141. It contains an interest rate of 21.9%, and she was charged $750 and will be assessed further annual fees of $50. To refinance her loans, Ms. D was charged fees and credit insurance premiums totaling well over $12,000.

With much more debt now secured by her home, Ms. D's total monthly payments have in fact gone up rather than down. Her total monthly payments to Household are slightly less than the $1,500 she was paying on all of her debts before. But unlike her previous mortgage, her Household loans do not pay for her annual taxes of $722 or the $460 annually for her insurance. Including these monthly costs brings her monthly total above its previous level, plus it is all now secured by her home, and all now streched out over 30 years. Between the two loans, she currently owes about $92,000, which is substantially more than her house's appraised value of $66,000 in June 2000. Because of her high loan-to-value ratio, it will be extremely difficult for her to refinance into a loan at a better rate.

Mamie W – Los Angeles, California

Ms. W has lived in her Los Angeles home for over twenty years. She has a first mortgage with an interest rate of 7% from Ocwen. In October 1999, she responded to a solicitation from Beneficial and took out a second mortgage on her house. Although she was initially promised an interest rate of 16%, the interest rate on her loan ended up being 22.9%. She was charged an origination fee of $750, third party fees of $110, and a subsequent annual fee of $50. In addition, her loan included credit life and disability insurance policies, which she later cancelled.

Beneficial structured Ms. W's loan as an open-end loan with a credit limit of $14,000 and an initial advance of $14,910. Beneficial repeatedly assured her that there would be no penalty if she paid off her loan but kept the credit line open. But when she later tried to do so, they charged

her a penalty, pointing to the five-year prepayment penalty of six months' interest on all principal beyond 20% of the original loan amount that they had slipped into her paperwork.

For four months, Ms. W's daughter called Household over and over and was shifted around repeatedly among employees who refused to address her concerns before a manager at the headquarters office in Illinois finally removed it. Throughout this time, Ms. W received dozens of harassing phone calls from Household employees.

Willie and Margaret B – Oakland, California

Mr. and Mrs. B have lived in their Oakland home for the past five years. They bought the house with a mortgage from Fleet Finance with monthly payments of $1,662 and a remaining balance of about $183,000. Their house has significantly increased in value and was recently appraised at $350,000. Mrs. B is on disability because she has leukemia, and Mr. B has been unable to keep working as a janitor since having neck surgery last year. He is now looking for a different line of work.

Last year, Household called Mr. and Mrs. B about taking out a personal loan to help pay some bills, which they did. With the couple's medical problems, they were short on cash and were happy to get a call from Household offering a $25,000 loan. When they went down to the Household office in October 2000, they told the Household representative that they couldn't afford payments higher than $200 or $300 a month. At present, their income is drawn from Mrs. B's $600 disability check each month, whatever odd jobs Mr. B is able to find, and assistance from their relatives. Despite their limited income, the Bs have never been late on a single mortgage payment.

While the Household employee promised their monthly payments would be below $300, the first monthly deduction from the B's checking account was for $645, primarily due to a 24% interest rate and monthly credit insurance charges of $75. Their loan was set up as an open-end second mortgage with a credit limit of $25,000 and an initial advance of $26,050. After fifteen years, Household is able to call in any remaining balance as a single balloon payment, which the

Bs were never told. Also, the loan was supposed to pay off a car loan for $12,700, a previous Household loan, and provide a cash-out of $3,775, but the car loan was never paid off and the Bs are still making separate payments on that loan. Their loan amount also included an origination fee of $1,500, and they will assessed future annual fees of $50. In addition, the Bs were never told that their loan had a five-year prepayment penalty for six months' interest on all principal beyond 20% of the original loan amount – around $2,400 – if they were able to refinance to a lower rate.

Separate and Unequal: Predatory Lending in America

An October 2000 ACORN study

INTRODUCTION

Mr. and Mrs. D. had paid off their mortgage in full and owned their house outright. They had a personal loan with Conseco with a balance of $1,500, when Conseco contacted them about taking out another loan to consolidate their other bills and get money for home improvements. They received a $61,715 loan from Conseco which included $10,913 in credit insurance, fees and closing costs – 18% of the loan. $7,715 of this went for credit insurance to Green Tree Agency, which is owned by Conseco. The Conseco representative told Mr. and Mrs. D. that they had to buy the credit insurance in order to get the loan. The fees and closing costs were financed into their 12.7% interest loan, which means that $125 of their monthly payment is from these fees alone and the $10,913 will actually cost them a total of $30,000 over the twenty year term of the loan. If they want to refinance, in order to get a better interest rate, during the first three years of the loan, they will have to pay approximately $4,000 to Conseco for a pre-payment penalty. Conseco also referred them to Wright Siding Company to do the work on their house. Conseco paid $14,800 directly to the siding company, which then did a shoddy job on the work, and, having already been paid in full, refused to even talk to Mr. and Mrs. D. about the problems.

Mrs. G. and her late husband had owned their home since the 1940's. She had a developmentally disabled 30 year old son, Steve, living with her and hoped to be able to leave the house to him so that he could always have a place to live after she died. Mrs. G. had a credit card from Associates with an unpaid balance of $1,000. Associates then sent her a check for $2,500 along with her monthly statement. When she cashed the check, she accepted a loan with Associates which had an APR of 37.71% and a monthly payment of $499. One month later, Associates solicited her for a new loan to refinance the existing mortgage on the house and consolidate other debts. The new loan was for $90,859, which included $6,730 in loan discount points and $1,740 for Credit Disability Insurance. The loan was at 13.49%, with monthly payments of $1,091.69. Eight months later, Associates persuaded her to refinance again and consolidate additional debts. This new loan was for $140,510, which included another $10,408 in discount points, $13,572 for Credit Life Insurance, $1,026 for Credit Accident Insurance, and $3,355 for Credit Unemployment Insurance. This loan had monthly payments of $1,298.90, not including taxes or homeowners insurance. This was more than Mrs. G and her son could afford on their combined monthly income of $2,200. A few months after this refinance, Ms. G. had heart surgery, which was followed by a stroke. After she died, it was clear that Steve would not be able to afford the monthly payment on his own, and the house was sold. After Associates received their money, including a prepayment penalty on the loan, and other family debts and medical bills were paid, Steve was left homeless and broke. He now rents a room in a barn and continues to work delivering pizzas.

The dramatic increase in subprime loan originations in the last decade and the concurrent rise in the incidence of abusive lending practices have created a crisis of epidemic proportions for and communities of color, elderly homeowners, and low-income neighborhoods – the plague of predatory mortgage lending. The above stories are just two of the hundreds of thousands of unsuspecting homeowners and homebuyers who have been robbed by a predatory lender, and these modern day loan sharks continue to sink their teeth into new victims every day.

Nationally, the level of subprime lending has skyrocketed, growing 900% from just over 100,000 home purchase and refinance loans in 1993 to almost a million loans in 1999. During this same period, all other home purchase and refinance loans have declined 10%[1]. The rise in subprime and predatory lending has been most dramatic in minority communities. Subprime lenders now account for half, 51 percent, of all refinance loans made in predominantly black neighborhoods, compared to just 9 percent of the refinance loans made in predominantly white neighborhoods[2]. Subprime lending, with its higher prices and attendant abuses, is becoming the dominant form of lending in minority communities. At the same time, although minority communities suffer from an extreme concentration of higher cost, harmful loans, the problem should not be viewed as one that only affects minorities, for the vast majority of subprime borrowers, and thus predatory lending victims, are white.

As HUD and others have remarked, while not all subprime lenders are predatory, the overwhelming majority of predatory loans are subprime, and the subprime industry is a fertile breeding ground for predatory practices. Subprime loans are intended for people who are unable to obtain a conventional prime loan at the standard bank rate. The loans have higher interest rates to compensate for the potentially greater risk that these borrowers represent. There is a legitimate place for flexible loan products for those whose credit or other circumstances will not permit them to get loans on "A" terms. The problem arises when loan terms or conditions become abusive or when borrowers who would qualify for credit on better terms are targeted instead for higher cost loans. Unfortunately, these problems pervade too much of the subprime industry.

The Chairman of Fannie Mae recently estimated that as many as half of the borrowers who receive a high cost subprime loan could have instead qualified for a traditional mortgage at a lower interest rate[3]. Other borrowers who are not in a position to qualify for an "A" loan are also

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[1] Randall M. Scheesele, U.S. Department of Housing and Urban Development.
[2] "Curbing Predatory Home Mortgage Lending: A Joint Report," June 2000, U.S. Department of Treasury and U.S. Department of Housing and Development.
[3] Business Wire,"Fannie Mae has Played Critical Role in Expansion of Minority Homeownership,"

routinely overcharged in the subprime market, with rates and fees which reflect what a lender or broker thought they could get away with, rather than any careful assessment of the actual credit risk. Incentive systems which reward brokers and loan officers for charging more make this a widespread problem.

Other abusive loan practices include: making loans without regard to a borrower's ability to repay; padding loans with exorbitant fees; requiring borrowers to purchase unnecessary credit insurance; using high-pressure tactics to encourage repeated refinancing by existing customers and tacking on extra fees each time, a practice known as "flipping"; saddling borrowers in high cost loans with onerous terms such as balloon payments and prepayment penalties; obstructing customers from refinancing with other companies to gain better terms; and misrepresenting the specifics of the loan.

Predatory lending practices are even more insidious because they specifically target members of our society who can least afford to be stripped of their equity or life savings, and have the fewest resources to fight back when they have been cheated. As detailed in this report, subprime lending is disproportionately concentrated in minority and low-income communities. Predatory lenders seek to take advantage of homeowners who, after years of bank discrimination, may feel that they have no other options. The historical neglect by banks and Wall Street investment firms have effectively shut these communities out of the economic mainstream and created a credit void which is now too often being filled by unscrupulous, overpriced lending.

The statistics discussed in this report demonstrate that we are still very much a nation of two separate and very unequal financial systems: one for whites and one for minorities, one for the rich and one for the poor.

SUMMARY OF FINDINGS

March 2, 2000.

Subprime Refinance Loans

The vast majority of subprime loans are for refinances, rather than purchases, and a significant number of predatory practices are linked to refinances.

• **Minorities are much more likely than whites to receive a subprime loan when refinancing.** In 1999, 45.1% of all conventional refinance loans, excluding loans for manufactured housing, received by African-Americans were from subprime lenders, as were 19.5% of the refinance loans received by Latinos, compared to just 12.1% of the refinance loans received by whites. In comparative terms, African-Americans were 3.7 times more likely to receive a subprime loan, and Latinos were 1.6 times more likely.

• **The concentration of subprime loans is greatest among lower income minorities.** Not including loans for manufactured hosing, two out of every three conventional refinance loans (61.3 percent) received by low-income African-Americans were from subprime lenders, and more than half (52.6 percent) of the conventional refinance loans received by moderate-income African-Americans were from subprime lenders. Almost one in three conventional refinance loans (30.3%) made to low-income Latinos were subprime.

• **The racial disparity is still present when comparing minority borrowers with white borrowers of the same incomes, and it persists among higher income borrowers.** 30.5% of the refinance loans received by upper-income African-Americans were from subprime lenders, as were 13.1% of the refinance loans received by upper-income Latinos. In contrast, only 8.2% of the refinance loans received by upper-income whites were from subprime lenders. In addition, upper-income African-Americans were even more likely than low-income whites to receive a subprime loan when refinancing.

• **Subprime lenders also target lower income white homeowners.** Subprime lenders made 24.4% of all conventional refinance loans, excluding loans for manufactured housing loans, received by low-income white homeowners, and 18.5% of all refinance loan received by

moderate-income white homeowners. In contrast, subprime lenders made just 8.2% of the refinance loans to upper-income white homeowners.

• **African-Americans Receive a Much Larger Share of Subprime Refinance Loans Than of Other Refinance Loans.** In 1999, African-Americans received 13.8% of all the subprime refinance loans made in the United States, more than a 3 times larger share than the 4.3% they received of all other refinance loans. Latinos received roughly the same percentage of both subprime and other refinance loans. In contrast, whites received 43.5% of the subprime refinance loans, but 71.7% of all other loans.

• **The share of subprime refinance loans received by both African-Americans and Latinos increased in from 1998 to 1999, while the share received by whites declined.** The share received by African-Americans rose from 12.7% to 13.8%, and the share received by Latinos grew from 4.1% to 4.8%. The share received by whites fell from 47.4% to 43.5%.

• **From 1993 to 1999, the rate of growth in the number of subprime refinance loans to minorities was larger than the growth to whites.** The number of subprime refinance loans has risen 959% to African-American homeowners, 695% to Latino homeowners, and 569% to white homeowners, almost half of the African-American increase.

• **The rate of growth in subprime refinance lending slowed from 1998 to 1999.** The number of subprime refinance loans received by Latino homeowners rose 5.2%, while the number of subprime refinance loans received by African-American homeowners declined slightly, 3.1%, and the number received by white homeowners fell significantly more, 18.1%.

Subprime Purchase Loans

While refinance loans make up the greatest portion of subprime lending, subprime lenders have made a serious entry into the home purchase market. In 1993, subprime lenders made just 24,000 home purchase loans, which was 1% of all the conventional home purchase loans made in the country. In 1999, subprime lenders made over ten times more -- almost 250,000 home purchase loans, 6.6% of all the conventional home purchase loans.

As discussed in this report, there has been a rapid growth in subprime purchase loans to minorities. This is particularly alarming when viewed in comparison to changes in the number of prime loans issued to minorities. Although there was substantial growth in prime home purchase loans to minorities from 1993 to 1995, the level of prime loans then stagnated while the level of subprime purchase lending skyrocketed. There is reason for concern, rather than celebration, in the fact that the growth in lending to minority homebuyers in recent years has been overwhelmingly in the form of subprime loans. It demonstrates the failure by banks and traditional mortgage companies to make credit available equitably. As a result, minority homebuyers are disproportionately vulnerable to predatory practices.

• **The rate of growth of subprime purchase loans to minorities has been substantially faster than the rate of growth of prime loans, especially since 1995.** The number of subprime purchase loans to African-American homebuyers has risen 631% from 1995 to 1999, while the number of prime conventional purchase loans received by African-American homebuyers in 1999 was actually lower than in 1995. Subprime purchase loans increased 509% to Latino homebuyers during this time, while prime loans rose just 29%. White homebuyers also saw a larger percentage increase in subprime loans than in prime loans during this time, although the difference was not nearly as great – a 285% increase in the number of subprime loans and a 22.0% increase in the number of prime loans.

• **African-Americans were three times more likely than whites to use a subprime loan when buying a home, and Latino homebuyers were 1.7 times more likely than white homebuyers to receive a subprime loan.** In 1999, subprime loans accounted for 10.9% of all purchase loans (conventional and government-backed) received by African-American homebuyers, 6.1% of the purchase loans received by Latino homebuyers, and 3.6% of the loans received by whites. This disparity has steadily risen since 1995.

• **1999 was the first year since 1995 when both African-American and Latino homebuyers had larger rates of increase than white homebuyers in the number of prime conventional**

purchase loans. The number of prime conventional rose 8.8% for African-Americans, 21.5% for Latinos, and 1.0% for whites. While this is an encouraging development, both African-American and Latino homebuyers had larger rates of increase in the number of subprime loans they received than in the number of prime loans received. In contrast, although white homebuyers had only minimal growth in prime loans from 1998 to 1999, they had a decrease in the number of subprime loans received.

• If we look at only conventional loans and exclude government loans and loans for manufactured housing, African-American homebuyers were 4.8 times more likely than white homebuyers to receive a subprime loan, and Latinos were 2.5 times more likely. In 1999, subprime loans made up 23.1% of conventional home purchase loans, excluding loans for manufactured housing, received by African-Americans, and 12.0% of the loans to Latinos, but just 4.8% of the loans to whites.

• **Minorities Receive a Much Larger Share of Subprime Purchase Loans Than of Prime Conventional Loans.** In 1999, African-Americans received 13.5% of all the subprime purchase loans made in the United States, a four times larger share than the 3.5% they received of prime purchase loans. Latinos received 8.5% of the subprime loans, almost double their 4.8% share of prime loans. In contrast, whites received 49.7% of the subprime purchase loans, but 75.4% of the prime loans.

Equity Strippers: The Impact of Subprime Lending in Philadelphia

A report by Pennsylvania ACORN May 18, 2000

Executive Summary

ACORN has been fighting for increased access to credit for lower-income and minority families for three decades. While this fight has concentrated on traditional bank lenders, a new form of lending is taking hold of our communities--predatory lending. Dorothy Smith is not alone in falling victim to predatory lenders. Where traditional lenders have left a void, subprime

lenders have aggressively moved in. Too many of these lenders engage in predatory lending activities that line their pockets with money while stripping our communities of the equity they built in their homes.

ACORN members have become increasingly concerned about this problem in recent years, as it has wrought havoc on families and our communities. The neighborhoods hardest hit by the predatory lending plague are minority communities with a stable homeownership base. This study is an attempt to quantify the damage by looking at the effects on two census tracts in the Kingsessing Neighborhood in Southwest Philadelphia as an example of the impact of predatory lending. This neighborhood has had a stable African-American population since the 1950s. Homeowners include older families who purchased houses years ago and their children who have chosen to remain in the community. Findings include:

• Increased lending in the Kingsessing Neighborhood was accomplished primarily by subprime lenders. While all lending increased 400% from 1992 to 1998 in this neighborhood, conventional lending increased only 61% compared to a subprime lending increase of 4800%.

• In Kingsessing, subprime loans grew from only 5.3% of all loans originated in 1992 to 63% of all loans originated in 1998.

• Foreclosures have increased 93% since 1990 in this community. Of the foreclosures for which it was possible to identify the original lender, 79% were non-bank lenders.[4]

Background: The Absence of Traditional Lenders

The absence of traditional bank lending in our communities creates the opportunity for predatory lenders to peddle their wares. Earlier ACORN studies document this absence in low- and moderate-income and minority neighborhoods in Philadelphia and the disproportionate role played by subprime lenders in these communities.

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[4] Many of these non-bank lenders are on HUD's list of subprime lenders. Many other non-bank lenders fail to report mortgage data, even when they are required to do so, and as a result, are not on HUD's list.

- In the Philadelphia MSA[5], African-Americans were rejected 338% as frequently as white applicants when applying for conventional home purchase loans in 1998.
- The share of conventional purchase loans received by African-Americans in Philadelphia has steadily decreased from a high of 7.9% in 1995 down to only 6% in 1998. African-Americans make up 19.1% of the population in the MSA.
- The top subprime lenders in Philadelphia made 22% of their home purchase loans to African-American home buyers, compared to only 6% of the conventional home purchase loans made by all other Philadelphia lenders -- almost a 4 times greater percentage.
- Low- and moderate-income neighborhoods[6] received 29% of the conventional loans made by the top subprime lenders in Philadelphia, compared to only 8% of the loans made by all other lenders--nearly a four times greater percentage.
- Although the top ten subprime lenders made only 6% of all refinance and home improvement loans originated in the Philadelphia MSA, these lenders made 31% of all the home improvement and refinance loans made in census tracts in which minority residents make up over 80% of the population.

A Closer Look at the Kingsessing Neighborhood

Our focus area includes the part of Kingsessing Neighborhood that is home to one of ACORN's first chapters in Philadelphia, People's Action Community Organization (PACO). The target area's two census tracts are between Kingsessing Avenue and Woodland from 46th Street to 58th Street. According to the 1990 census, the homeownership rate is 58% in these two census tracts, lower than the metro-area homeownership rate of 74% in that year, yet higher than the average 54% homeownership rate for Philadelphia communities with a minority population of at least 80%. Many residents have lived in the community since the 1940's; others were raised in

[5] Metropolitan Statistical Area

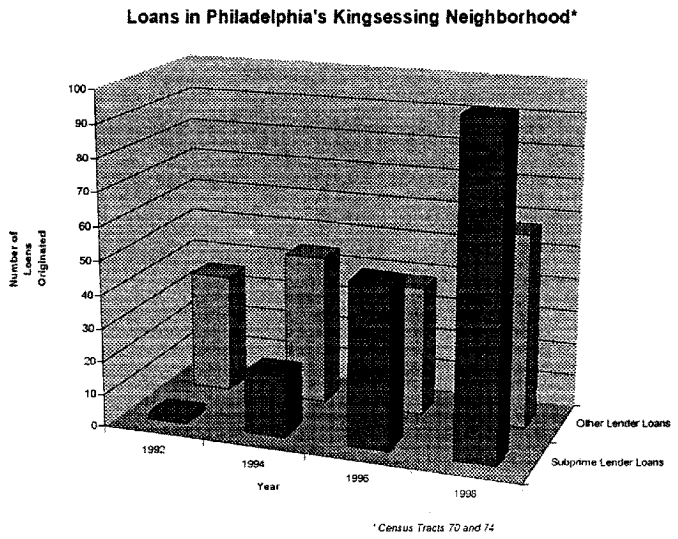
[6] Low-income neighborhoods are defined as census tracts in which the median income is below 50% of the MSA's median income. Medium-income neighborhoods are defined as census tracts in which the median income is between 50% and 80% of the MSA's median income.

the community and decided to remain. The average age of housing is only 60 years old but the number of vacant houses is on the rise.

Mortgage Lending in Kingsessing

Mortgage lending in our two census tracts in the Kingsessing Neighborhood grew 400%--from 38 loans in 1992 to 156 loans 1998. While this would normally be cause for celebration, a closer look reveals that this increase is almost entirely due to growth in subprime lending. In 1992, subprime lenders originated only 2 loans, 5.3% of the total 38 loans in this neighborhood. In 1998, subprime lenders originated 98 loans, 63% of all loans originated. In fact, subprime lenders now originate 60% more loans than other lenders in this community.

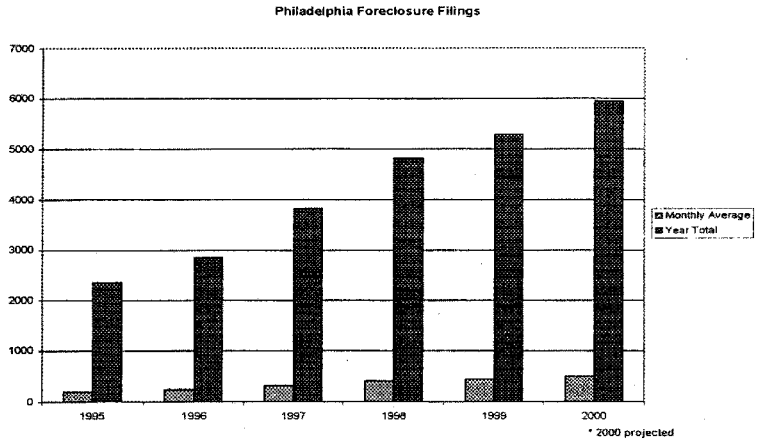
Foreclosure Epidemic



One unfortunate result of the explosion in subprime lending, and the predatory practices, which are only too commonly a part of it, has been a parallel explosion in foreclosure filings. Once a loan is in default, the lender or its agent files for foreclosure at the Prothonotary office.

These filings are the first step in taking the home. If arrangements fail to be made between the homeowner and the creditor, the end result is a judgement in favor of the creditor and the property is scheduled for sale through the sheriff's department.

In 1995, there were 2347 foreclosure filings at Prothonotary Office for the City of Philadelphia, an average of 196 each month. By 1999, the number of foreclosure filings increased 125% to 5293 filings for the year at a monthly average of 441. The pace for 2000 of 495 each month indicates the increase will continue to almost 6000 foreclosures this year.



These increases in foreclosures are the result of practices common in the world of predatory lending like extending loans based on the value of a house, rather than a borrower's ability to repay. A host of other deceptive and misleading sales practices lead borrowers into loans they did not understand and would not have chosen. Borrowers in foreclosure are also targets for other lenders to refinance, generally postponing the inevitable foreclosure, but with a different lender and more money paid for the loan. Officials at Philadelphia Sheriff's Department have noticed many properties scheduled for sale are listed again merely one year later. The 1999 Sheriff Sale listings reveal the same--many properties taken off the sale at the last minute or

"stayed" because the lender has accepted payment arrangements are again scheduled for sale 6-8 months later, indicating a new foreclosure on the same property.

Records of sheriff's sales of mortgage foreclosures mirror the data on initial foreclosure filings. In 1990, sheriff sale listings for the city averaged 241 homes each month compared to the 1999 average of 491 each month. The attached map of sheriff sale listing in 1999 demonstrates that foreclosures are happening throughout the city but largely in minority homeowner communities like the Northwest and the Southwest sections of the city. Kingsessing is typical of neighborhoods hit by increasing foreclosure rates. In 1990, there were 15 sheriff's sales compared to 29 in 1999, an increase of 93%.

Unfortunately, the property records which should tell us which lenders were involved in these loans are incomplete. Only 13 of the 29 sheriff's sales in our target area were recorded in the property records. We believe this is a simple failure of the property record listings to keep up with the massive number of sales completed.

We have however, looked at 67 foreclosure sales from 1995 to 1999 for which complete information is available. Out of these 67, almost one third were made by government agencies: 11 were made by the U.S. Department of Housing or the Veteran's Adminstration, nine by Fannie Mae or Freddie Mac. Out of 43 foreclosure sales where the original lender could be identified, 34 or 79% were non-bank lenders.

According to the 1990 census, there were 290 vacant houses in our target area of the Kingsessing Neighborhood. A recent neighborhood survey by ACORN members reveals an increase to 480 vacant houses, with an additional 100 vacant lots. Many of the vacant houses have been vacant for 10-20 years or more. Yet, some of the properties foreclosed on since 1995 have already been demolished. While predatory loans are not the only and perhaps not even the most frequent source of vacancy in this community, every possible home needs to be saved in order to save Philadelphia's communities.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MILLER FROM JUDITH A. KENNEDY

Q.1. Is there a definition for predatory lending? Or do you know it when you see it?

A.1. NAAHL recently conducted a symposium for advocates, lenders, and policymakers on developing workable solutions to predatory lending. Based on remarks at the symposium, a profile of predatory lending emerged. Loan flipping, home improvement scams, asset-based and unaffordable mortgage loans, repetitive financings with no borrower benefit, packing single-premium credit life insurance and other products into the loan amount, all of which can strip equity and trigger foreclosures.

Q.2. What can be done about the unregulated brokers and home improvement contractors who are bad actors?

A.2. More needs to be done at the Federal level. Currently, a significant amount of mortgage lending is not covered by a Federal framework. As the Federal Reserve has pointed out, only about 30 percent of all subprime loans are made by depository institutions that have periodic exams. To stop the predators, we need to close the barn doors on examination and reporting. In addition, increased Federal resources for expanding existing public and private sector consumer education programs in neighborhoods that are vulnerable to predators could be extremely helpful in combating predators.

Q.3. In the securities industry, there is a "suitability standard" for brokers putting clients into appropriate brokerage activities. What do you think about applying a suitability standard for brokers/lenders who put low-income borrowers into subprime loans?

A.3. We believe such standards would be appropriate. In NAAHL's comment letter earlier this year to the Federal Reserve on proposed changes to the Homeowners Equity Protection Act (HOEPA), we supported a number of proposals by the Fed that would help ensure that subprime loans are appropriate for borrowers. Frequent refinancings, commonly known as "loan flipping," generally are not in the borrower's best interest. Therefore, we strongly supported the proposed prohibition on refinancing loans within the first 12 months, unless the creditor can demonstrate that the refinancing is in the borrower's best interest.

Similarly, we are in favor of the proposed prohibition on refinancing zero-rate or other low-cost loans within 5 years unless the creditor can demonstrate that the refinancing is in the borrower's best interest. In addition, we believe there is merit in the proposal to require creditors to demonstrate a consumer's ability to repay HOEPA loans to mitigate the practice of making asset-based HOEPA loans. We also supported the proposed prohibition on HOEPA demand loans and the structuring of what, in reality, are closed-end loans into open-end financing merely to avoid HOPEA restrictions on asset-based loans.

Q.4. Why are better disclosures and/or financial education not sufficient remedies for predatory lending problems?

A.4. NAAHL's recent symposium on solutions to predatory lending showed that predatory lending is a multifaceted problem requiring

a multifaceted response. Better disclosure and additional financial education are certainly part of the solution, but the problem is broader. As I indicated earlier, the Federal Reserve estimates that only 30 percent of subprime loans are made by institutions that have periodic exams. If the Federal Reserve were to do periodic compliance exams of the subsidiaries of financial holding companies, that would take it up to about 40 percent. Nonetheless, the majority of subprime loans still would not be covered. In a town with no sheriff, the bandits are in charge.

Q.5. I understand Philadelphia enacted a city ordinance regarding predatory lending and the Pennsylvania legislature passed a law preempting county and/or city ordinances. What do you think about State legislatures preempting county and/or city ordinances regarding predatory lending?

A.5. The broader issue is the need for a level playing field in oversight and enforcement. Insured depository institutions, the vast majority of whom engage in best practices in the subprime lending market, are of course subject to regulatory oversight and compliance. But the majority of subprime lenders are not subject to the same regulatory oversight, do not have the same level of compliance management and often do not even file HMDA reports. The growing plethora of widely varying State and local laws only exacerbates this disparity—and threatens to drive out responsible lenders who will choose not to offer legitimate subprime loans. The solution is to bring all lenders under a uniform Federal framework that eliminates predatory practices without turning off the flow of legitimate subprime credit.

Q.6. Is your concern about SPCLI related to the product or the marketing of the product?

A.6. We are concerned with the product itself, which has been associated with high-cost loans that strip equity from the home.

If I can provide any additional information, please call me. Our members are very committed to working with policymakers on addressing this critical problem, and we would be happy to help you in any way.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MILLER FROM ESTHER "TESS" CANJA

Q.1. Is there a definition for predatory lending? Or do you know it when you see it?

A.1. Conceptually, a higher-interest rate premium paid by an appropriately classified subprime borrower should be proportionate to the added risk the borrower may pose to a lender. Anything in excess of that proportionate premium is exploitive. Of course, to misrate a borrower as being a subprime risk when in fact the borrower should be "A"-minus rated, would also be exploitive and thus predatory in nature. In direct response to your question: The four principal Federal banking regulators (FRB, OCC, RTS, and FDIC) issued guidance to their examiners in January 2001 in which they provide a common threshold definition of predatory lending as:

- making loans that a borrower will be unable to repay;

- inducing borrowers to refinance a loan in order to charge high fees or points (so-called "loan flipping"); and
- engaging in fraud or deception to conceal the true nature/features of a loan.

While AARP believes that this definition is too narrow in scope, it does identify the core features of a predatory loan.

Q.2. What can be done about the unregulated brokers and home improvement contractors who are bad actors?

A.2. Older homeowners have lost their homes because of home repair or consolidation loans made at exorbitant interest rates and fees by unscrupulous lenders and brokers. AARP believes that the U.S. Department of Housing and Urban Development's regulations should require that lenders disclose to consumers the amount and source of mortgage broker fees before any agreement is reached. Special premiums or other kickbacks paid by lenders to mortgage brokers for steering customers to higher-yield loans should be outlawed or, at a minimum, disclosed upfront before consumers apply for a loan. Clearly, new protections need to be enacted for home improvement borrowers victimized by contractor nonperformance or malfeasance.

Q.3. In the securities industry there is a "suitability standard" for brokers putting clients into appropriate brokerage activities. What do you think about applying a suitability standard for brokers/lenders who put low-income borrowers into subprime loans?

A.3. The notion of a suitability standard for brokers and lenders has some appeal if it is based on concrete protective provisions. Specifically, mortgage brokers and lenders should be required to comply with fair-lending rules addressing, among other things, interest rates, fees, marketing, service areas and application acceptance procedures. Mortgage brokers/lenders should be required to provide a binding offer of mortgage terms and costs that would be good for a set period of time after issuance. The binding offer would include the principal amount of the loan; the interest rate, points, and any other costs; the type and term of the mortgage; a consolidated rate or price tag similar to an annual percentage rate; and the amount of the monthly payment. A lock-in of terms (as reflected in the binding offer) should be required once a consumer applies for the loan.

In addition to these standards, AARP believes that the Home Ownership and Equity Protection Act of 1994 (HOEPA) should be strengthened by lowering current trigger mechanisms (interest rates, points, and fees) so that the protections of the Act apply to more loans. More effective measures should be enacted for policing unscrupulous loan practices that typically target older homeowners with low incomes. And finally, enhanced protections and remedies need to be created to make the standards effective.

Q.4. Why are better disclosures and/or financial education not sufficient remedies for predatory lending problems?

A.4. AARP does believe that both better disclosures and financial education are important and necessary tools that can help many consumers avoid being victimized by predatory lenders. However, better disclosure and education alone are not sufficient remedies

for preventing the financial exploitation of many of those who are among the most vulnerable. Limiting the remedy to disclosures and nonmandatory, nonstandardized financial literacy campaigns would have the effect of shifting the burden for prevention to a portion of the population with the fewest skills to benefit from these remedies, that is, those with the least formal education.

Consider the complexity of mortgage finance documentation and processes and the frequent disconnect between the level and timing of and limits of exposure to financial literacy campaigns. On the other hand, what part of the remedy would hold the predatory lender accountable? The right to protection against predatory lending practices should be equally valid for all consumers who have or may be victimized, and lenders/brokers that use these tactics should be held accountable for their acts and for harm done.

Q.5. I understand Philadelphia enacted a city ordinance regarding predatory lending and the Pennsylvania legislature passed a law preempting county and/or city ordinances. What do you think about State legislatures preempting county and/or city ordinances regarding predatory lending?

A.5. On the issue of preemption, AARP recognizes that cities and counties derive their authority from the State government. The State of Pennsylvania can and did act. We are disappointed, however, that after looking at the apparent prevalence of predatory lending practices in the Philadelphia area, the State did not move to protect vulnerable consumers—especially the elderly, throughout the State. It is the gaps in State level protection of consumers across the Nation from the practices of predatory lenders that is stimulating the desire for minimum Federal standards.

Q.6. Is your concern about single-premium credit life insurance (SPCLI) related to the product or the marketing of the product?

A.6. Both. On the one hand, we are concerned that brokers and lenders be prohibited from engaging in unfair, deceptive, or unconscionable practices in connection with a consumer credit transaction. And on the other hand, we have questions about why SPCLI is needed and how SPCLI is being financed. The packing of "lump-sum" insurance products is a commonly used tactic of high-cost lenders to inflate the mortgage loan amount, and thus, the monthly payments of at-risk borrowers, while evading HOEPA's reach. This practice is particularly problematic because this type of insurance is generally packed onto mortgage loans without the borrower's knowledge or actual consent. Moreover, credit insurance can be the most expensive component of the loan.

Q.7. If SPCLI is removed from the marketplace, what are subprime borrowers to do when they wish to insure their financial obligations and monthly alternatives have not been approved in their States?

A.7. AARP believes that credit insurance and insurance substitutes should be optional, but if accepted as part of the loan, should be included in the HOEPA points and fees trigger. In the latter case, however, one important issue would remain: If the borrower were given the ability to cancel the insurance and receive a "full refund," it would still not adequately address the problem of insurance packing. Unless the refund is structured so that the refund is ap-

plied to reduce the amount of the loan, the borrower continues to pay interest on it over the life of the loan. It is AARP's view that if the borrower truly wants insurance, it can be sold on a monthly basis—easily cancelable—and without HOEPA implications.

Q.8. Yesterday [July 26], we had a lively discussion about the cost of SPCLI. One witness said that if you go to a Monthly Outstanding Balance basis it is more expensive than over the term of the loan. Another witness disputed that. Do you have a view on this issue?

A.8. We have not done the calculations, and so do not have a recommendation to offer. As we mentioned above, AARP's principal concern is that this type of insurance or its substitutes be optional, and that it not be financed as part of a home equity loan.

Q.9. I have heard that SPCLI is a better deal for consumers over 41 years of age because it is cheaper and it is generally more available than the traditional term life insurance. Would anyone care to comment on that view?

A.9. AARP believes that borrowers must first be informed of any requirement and/or need for SPCLI or its substitutes as part of securing a home equity loan, their options and alternatives, before cost comparisons become meaningful.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MILLER FROM IRV ACKELSBERG

Q.1. Is there a definition for predatory lending? Or do you know it when you see it?

A.1. Much like the term "unfair and deceptive practices," predatory lending encompasses a range of abusive activities that, when present, enable someone who knows what to look for, to "know it when he sees it." But it certainly can be defined, to varying degrees of precision, with the understanding that no definition could ever exhaust all imaginable lending abuses. A recent New Jersey appellate decision adopted a simple guidepost: predatory lending is the "target[ing] of certain populations for onerous credit terms." *Associates Home Equily Services, Inc.* v. *Troup,* 2001 N.J. Super. LEXIS 318 (decided July 25, 2001). This is a good place to start. Predatory lending encompasses lending that takes advantage of certain borrowers, involving both targeting of vulnerable "prey," and credit products that carry onerous terms. This definition can be refined by looking, alternatively, at each of these two perspectives, (1) the targeting behavior of the lenders and (2) credit terms that are "onerous" under agreed upon standards.

Regarding the use of targeting, it is important to distinguish targeting from marketing. Often, a predatory lending scenario involves an offer of money that seeks out a borrower, rather than a borrower with a particular credit need who is shopping for the best product. Predatory lenders tend to target rather than market, identifying individuals or neighborhoods as having characteristics that make them vulnerable. For example, many lenders or brokers target borrowers who already have a subprime mortgage recorded on their property, a fact that identifies a consumer who might be vulnerable to sales pitches laced with promises to improve on the existing loan and to "put cash in your pocket." Sometimes the tar-

geting is done by intermediaries, such as brokers, contractors, or collectors, rather than by the lenders. For example, in depositions of Equicredit employees we have learned that this lender regards the "customer" as the broker who brings it the loan, not the borrower, with whom the lender has no direct communications at all prior to a closing.

From the perspective of the loans themselves, a predatory loan involves a *mismatch* between the cost of the credit, on the one hand, and the risk to the lender or the needs of the borrower, on the other. These loans tend to be extremely costly, containing price components that are well in excess of any calculated risks. Often, loans that are already priced with rates that reflect higher risk are also packed with excessive points, fees, and insurance products. Fannie Mae and Freddie Mac have determined that a substantial segment of the subprime mortgage market actually involves borrowers who have credit decent enough to qualify for prime products. This mismatch between cost and risk can also be apparent in loan terms other than price, where, for example, balloon clauses, prepayment penalties and "no doc" income verifications are imposed in clearly inappropriate circumstances. In addition to seeing loans containing costs and terms disproportionate to risk, we also see costs disproportionate to the actual benefit obtained by the consumer. Every day we see cases of borrowers paying extremely high transaction costs for credit that is providing them with little or no discernible benefit, as for example, when borrowers refinance to higher rates, or consolidate obligations that they have no reason to pay, such as utility bills deferred by low-income assistance programs.

Finally, predatory lending can also be defined in terms of the "equity stripping" that results from including excessive fees and charges in loan principals and from unnecessary consolidations of unsecured debt. This effect is multiplied each time a refinancing occurs.

Q.2. What can be done about the unregulated brokers and home improvement contractors who are bad actors?

A.2. One clear thing that could be done would be to pin responsibility for their bad acts on the lenders who utilize these intermediaries as "bird dogs." Section 3(f)(2) of S. 2415 would subject "any assignee or holder" of a covered mortgage "which was made, arranged, or assigned by a person financing home improvements" to all claims and defenses which the consumer could assert against the contractor and, if a broker were involved, to claims against the broker, as well. I describe this issue at some length in my written testimony. In analyzing the problem of bad brokers, one additional obstacle to developing consumer remedies is the insistence of many mortgage brokers—often supported by State regulators—that they have no fiduciary obligations toward borrowers. Indeed, I have frequently heard the brokers claim that they are neither agents of the borrowers or the lenders and that they somehow are representing only themselves. Congress could certainly put a stop to such claims by requiring brokers to represent either the borrower or the lender and to disclose the nature of their role.

Q.3. In the securities industry there is a "suitability standard" for brokers putting clients into appropriate brokerage activities. What do you think about applying a suitability standard for brokers/lenders who put low-income borrowers into subprime loans?

A.3. Your question directly addresses the "mismatches" in predatory lending scenarios that I discussed in response to your first question, namely, the need to do something about the clash between credit terms that are imposed and what seems appropriate under the circumstances. I am familiar with proposals to impose a "suitability standard" on brokers and or lenders. I think each of these actors should be looked at separately.

There certainly is a need to make explicit the legal responsibility of mortgage brokers toward the borrowers whose loans they are arranging. The simplest way to do this is make clear that brokers have fiduciary relationships with borrowers. If Congress were to do that, there would be ample common law on the duty of fiduciaries that would then be applicable to mortgage brokers. While a Federal suitability standard would be an improvement over the current state of affairs, I fear that "suitability" would be regarded similarly as the "unconscionability" doctrine in contract law, namely, a vague standard that would give little comfort to lenders and judges who are generally looking for more bright lines to guide their decisions. I realize that "fiduciary relationship" has some vagueness to it as well, but I believe that the extensive common law development of this concept would lend itself to be a more effective tool. I also suspect that lenders would prefer this approach because if a broker were a fiduciary of a borrower, a court would likely not characterize the broker as an agent of the lender.

While lenders are not ordinarily viewed as having fiduciary-like obligations toward applicants for credit, I do believe that lenders should be more accountable for the credit terms they impose in the case of loans that exceed agreed upon levels of cost. This is the existing approach under HOEPA, and is much easier to apply to lenders than a "suitability" standard. Any lender that prices a loan beyond statutory cost thresholds should simply be prohibited from including certain features in a loan, like, for example, repayment terms that the borrower cannot verifiably afford.

Q.4. Why are better disclosures and/or financial education not sufficient remedies for predatory lending problem?

A.4. The best way I can answer this is to make the comparison to other dangerous products in the marketplace. Should consumer education about the danger of SUV's tipping over on the highway be a sufficient response to manufacturer greed and negligence? Should a "just say no" campaign be the only policy response to the drug pushers on urban streetcomers? Predatory loans are poisonous. While we need to educate vulnerable homeowners about the dangers, we should also be attempting to address the abusive practices directly.

As for improving the disclosures that are part of the paperwork in a mortgage transaction, it is difficult for me to see this as an effective strategy. Presently there are about five or six pieces of paper in a typical transaction that contain Federally mandated disclosures. These papers are among the 30 or so loan documents pre-

sented to a borrower at a loan closing, in a paperwork stack at least an inch thick, and their usefulness is often undermined by the order of signing and the oral explanation that is provided by the party conducting the closing. Tinkering with the five or six disclosure documents is not going to effect the size or readability of the entire stack, or these other contextual impediments to the information in the disclosures actually getting to the consumers.

From my experience, the bad actors would be very happy to see Congress impose new disclosures and support consumer education, while leaving them free to continue the stripping of equity out of vulnerable communities.

Q.5. I understand Philadelphia enacted a city ordinance regarding predatory lending and the Pennsylvania legislature passed a law preempting county and/or city ordinances. What do you think about State legislatures preempting county and/or city ordinances regarding predatory lending?

A.5. For me the important question is whether Government is adequately protecting those consumers who are in need of protection, not whether this protection comes from local, State or Federal policymakers. Uniform protections are better than local ones, but local protections are better than none.

In April 2001, the Philadelphia City Council unanimously enacted antipredatory lending to protect the homeowners of Philadelphia. Philadelphia is a home rule city that retains the power to legislate in all areas not preempted by State legislation. In June, the legislature passed preemption legislation on the last night of the legislative session; they did so as an amendment to an already passed bill, without any study and without any public hearing. The State legislation does nothing to protect vulnerable homeowners. It duplicated the coverage and protection under HOEPA, and limited consumer remedies to a damage action that must prove "pattern and practice" and actual intent to violate the law. Thus, for example, a consumer who gets a balloon payment prohibited by the law cannot do anything to undo the transaction. Because the State superceded strong local legislation with nonexistent State protections, the preemption ended up hurting Philadelphia consumers under the banner of "uniformity."

The Pennsylvania lesson is an important one for Congress. State and local laws that protect consumers should not be preempted without ensuring that adequate Federal restrictions and remedies are in place to combat predatory practices.

Q.6. Is your concern about single-premium credit life insurance (SPCLI) related to the product or the marketing of the product?

A.6. Both. The product itself is overpriced because its pricing builds in too much profit for the middlemen. Further, it is not even really known how overpriced it is, because in addition to upfront commissions, there are back-end revenue sharing mechanisms, which may not show up as commissions. State insurance departments have a difficult time in monitoring the true reasonableness of the rates, because the insurers sometimes "fog" the data and, because of insufficient enforcement resources, credit insurance ends up being a lower priority for those limited resources than the much larger standard life, health, and property insurance.

Until there is pricing reform on the product itself, marketing reforms will not work, as three decades of effort in that regard have proven. When the profit is too great, a way will be found to sell the product. Indeed, it is not even accurate to refer to the selling as "marketing," given the ever-present "packing" of insurance products into the loans of lenders who have been most involved in the sale of SPCLI. Affidavits from former employees of The Associates, for example, have made very clear that loan officer job performance and compensation were dependent on their getting borrowers to sign up for SPCLI, just like car salesmen are expected to sell "extras" like rustproofing or service contracts.

Q.7. If SPCLI is removed from the marketplace, what are subprime borrowers to do when they wish to insure their financial obligations and monthly alternatives have not been approved in their States?

A.7. Few borrowers who truly understood the full financial impact of SPCLI, and the often limited benefits it provides, would choose to purchase it. It is only because the full cost and the limited benefits are obscured, or because borrowers are fooled into purchasing it, that the product is sold. Even, an industry-financed study indicated that fully 40 percent of borrowers thought that SPCLI was required, strongly urged, or that there would be delays if they did not buy it. Consequently, the number of borrowers who do purchase it cannot, with statistics like that, be considered a valid indicator of "demand."

As for alternatives, noncredit term life insurance is more value for the dollar, and most objective advisors (for example those who do not make money from the product) advise to use the noncredit insurance. As for delays in State approvals of monthly alternatives to SPCLI, it is typically the providers who approach the insurance departments for approval when they want to sell the monthly alternative. And, once this occurs, there is no reason to expect long delays. On the contrary, for example, when Household Finance announced last month that it would stop selling SPCLI in favor of monthly premium insurance, it announced at the same time that it already had obtained the approval of 34 States to offer this monthly alternative.

Q.8. Yesterday [July 26], we had a lively discussion about the costs of SPCLI. One witness said that if you go to a Monthly Outstanding Balance basis it is more expensive than over the term of the loan. Another witness disputed that. Do you have a view on this issue?

A.8. The witness who made that claim never explained his calculations, and, quite frankly, I do not believe he had any supportable basis for that claim. Paying the real price of something without paying interest on it will always be less expensive than paying that price with interest, especially at rates that range from 10 percent to 22 percent. If his point was that it is cheaper to spread out the cost of 5 years of coverage for an extra 15 years after the insurance has lapsed, ask yourself whether anyone would freely choose to pay an extra $66,000 of interest to purchase $10,000 of insurance for 14 years after it no longer protects the borrower. My understanding is that is exactly what happened in the case described by Iowa Attorney General Miller in his testimony.

Q.9. I have heard that SPCLI is a better deal for consumers over 41 years of age because it is cheaper and it is generally more available than the traditional term life insurance. Would anyone care to comment on that view?

A.9. I sincerely doubt that SPCLI is ever a better deal and would suggest that you look carefully at the calculations of anyone making this claim. (Obviously, you also have to make sure that you are comparing apples to apples. Often, unlike term insurance which provides benefits in a fixed amount, SPCLI is structured to provide declining benefits over time, sometimes at a rate that results in benefits not high enough to pay off the outstanding balance.). It can only be cheaper when you do not factor in the time value of the money paid for future insurance coverage and when you do not factor in the cost of financing it. This latter point is particularly important. When an insurance premium is added to the principal of the loan, the borrower pays two ways in addition to the inflated cost of the insurance itself. First, when the cost of the premium is added to the principal, then percentage-based fees ("points" and broker fees) are also increased. Second, interest is then applied, over the life of the loan to that extra principal. As for SPCLI being "more available," that argument is usually predicated on lenders not conducting underwriting before they sell the insurance. This argument ignores the fact that the insurers often engage in post-claim underwriting by denying coverage and then refunding the premium. Thus, the "availability" advantage can be little more than an illusion.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MILLER FROM NEILL A. FENDLY, CMC

Q.1. Is there a definition for predatory lending? Or do you know it when you see it?

A.1. There is no generally accepted, succinct definition of "predatory lending." Whether or not an individual loan can be considered "predatory" depends on a number of circumstances and even then is largely in the eye of the beholder. While some consumer advocates believe that certain loan terms and products are always "predatory," mortgage professionals generally believe that "predatory lending" is a problem of deceptive sales practices, not products. Predatory practices could include, but are not necessarily limited to, such practices as fraudulent and deceptive marketing of loans; deliberate failure to provide disclosures of costs and loan terms to the customer as required by law; and high-pressure sales tactics that cause consumers to accept loans, especially repeated and frequent refinancings, that are offered to the borrower primarily to generate more fees for the lender or broker and may not be beneficial to the borrower given his/her financial circumstances and goals. Responsible mortgage professionals do not engage in such practices.

Q.2. What can be done about the unregulated brokers and home improvement contractors who are bad actors?

A.2. Mortgage brokers are regulated, by State licensing laws in all but two States and by more than 10 Federal statutes. Mortgage brokers in most States are subject to regular examinations, and

many States recently have enacted new laws requiring basic and continuing education and minimum experience requirements for mortgage brokers. NAMB and its State affiliates have been at the forefront of efforts to impose and strengthen State mortgage broker licensing laws.

Eliminating "bad actors" is largely a function of enforcing these existing laws. NAMB is working with the National Association of Attorneys General and the American Association of Residential Mortgage Regulators to improve enforcement of State laws, and State enforcement of Federal laws such as RESPA. NAMB also supports increased enforcement of existing Federal laws, including RESPA, TILA, HOEPA, and the FTC Act, all of which address most types of abusive lending practices.

Q.3. In the securities industry there is a "suitability standard" for brokers putting clients into appropriate brokerage activities. What do you think about applying a suitability standard for brokers/lenders who put low-income borrowers into subprime loans?

A.3. While the concept of a "suitability standard" may have some intuitive appeal, in fact such a standard would be impossible to develop for mortgages. In the investment market, customers are looking for only one thing—a certain return on their investment, consistent with their tolerance for risk. It is relatively easy to set standards of risk for various investments and then to determine whether a particular investment is suitable for an investor given his/her assets and risk tolerance. On the other hand, people may seek mortgages for a variety of reasons, including obtaining cash quickly, reducing monthly debt payments, financing home improvements, etc., and therefore people judge the suitability of a mortgage according to their own needs and financial goals. For example, a borrower may choose a higher-rate subprime mortgage even if he qualifies for a lower rate, because he does not want to reveal all the sources of his income as is required by most conforming mortgage lenders. A borrower may choose to accept a prepayment penalty because the loan with the penalty has a substantially lower interest rate and lower monthly payments than does the loan without the penalty, and the borrower's only goal is to reduce his monthly payments as much as possible. Mortgages can be structured with various terms, lengths, documentation requirements, and other features that are tailored to the needs and goals of almost any borrower, even though some of these mortgages might appear to others as "unsuitable." Thus the suitability of a particular mortgage product for an individual borrower can really be defined only by the borrower, and it is impossible to impose a "bright-line test" for mortgages. Any attempts to impose an arbitrary suitability standard for subprime mortgages would necessarily involve prohibiting or limiting certain loan terms, and this would have a perverse effect of reducing choices for borrowers and reducing the availability of credit to low- and moderate-income borrowers.

Q.4. Why are better disclosures and/or financial education not sufficient remedies for predatory lending problems?

A.4. These are, in fact, very important parts of the overall solution to abusive lending problems. Simpler and more meaningful disclosures will empower consumers to be better shoppers, reduce the

ability of unscrupulous lenders to hide fees and onerous terms in "fine print" and prevent lenders from surprising consumers with large fees at the closing table. More consumer education will also help people avoid being victims of unscrupulous lenders and better understand their rights to disclosures, limitations on fees, and their right to rescind certain types of loans even after closing. Congress can be most effective in eliminating abusive lending by simplifying the mortgage lending disclosure statutes and encouraging more financial education in Federally funded education programs.

However, the third element we believe must be addressed is better enforcement of existing laws, at the State and Federal level. Even if consumers are fully informed and armed with better disclosures, there may still be unscrupulous people who will continue to try to hide excessive fees, trick people into buying unnecessary ancillary products, and deceive or pressure people into borrowing more than they really want at higher costs. Existing laws prohibit such practices but need to be better enforced to send the message to these people that they cannot continue to abuse consumers.

Q.5. I understand Philadelphia enacted a city ordinance regarding predatory lending and the Pennsylvania legislature passed a law preempting county and/or city ordinances. What do you think about State legislatures preempting county and/or city ordinances regarding predatory lending?

A.5. NAMB strongly supported the Pennsylvania legislation and supports other efforts, including litigation, to overturn other similar local ordinances. It is absurd for local governments to decide that arbitrary city or county borders should govern whether or not someone can get a certain kind of mortgage. Such regulation of financial services and products has never been considered the purview of local governments. Consumer advocates are supporting these ordinances only because they have failed to win the restrictive legislation they want at the Federal or State levels. If any of these ordinances succeed, all they will do is drive mainstream subprime lenders out of those localities and leave borrowers within the localities far fewer choices for home financing. In fact, some major lenders have already stopped making certain subprime loans in localities that have passed these ordinances, including DeKalb County, Georgia.

Q.6. Is your concern about single-premium credit life insurance (SPCLI) related to the product or the marketing of the product?

A.6. Mortgage brokers generally do not sell credit life insurance of any kind and so NAMB does not offer an opinion on the value of the product. However, it seems clear that there have been some abuses in marketing this product, and other forms of credit life insurance may be available or developed soon that offer equally good protection to borrowers without eating up so much of their equity.

Q.7. If SPCLI is removed from the marketplace, what are subprime borrowers to do when they wish to insure their financial obligations and monthly alternatives have not been approved in their States?

A.7. The fact is that if this occurs, some consumers will not have the choices they want. Low-income people are generally underinsured and credit life insurance can be a good product for them.

If monthly premium products are not available, a borrower could be at risk of losing the home if a coborrower passes away and had no other form of life insurance. This illustrates the problem with complete prohibition of any products or terms in the subprime market. Almost no product or term is always abusive, and a wide range of product choices most helps consumers at all income levels to achieve their financial goals and minimize their risks.

Q.8. Yesterday [July 26] we had a lively discussion about the cost of SPCLI. One witness said that if you go to a Monthly Outstanding Balance basis it is more expensive than over the term of the loan. Another witness disputed that. Do you have a view on this issue?

A.8. We have no opinion on this issue, except that we believe consumers should have choices of different types of products and payment plans and choose for themselves which one is most cost-effective for them.

Q.9. I have heard that SPCLI is a better deal for consumers over 41 years of age because it is cheaper and it is generally more available than the traditional term life insurance. Would anyone care to comment on that view?

A.9. We would answer this question the same as question 8.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MILLER FROM DAVID BERENBAUM

Q.1. Is there a definition for predatory lending? Or do you know it when you see it?

A.1. Contrary to industry representation, there is a definition of predatory lending. It is important, however, to first clarify and distinguish between subprime lending and predatory lending. A subprime loan is defined as a loan to a borrower with less than perfect credit. In order to compensate for the added risk associated with subprime loans, lending institutions charge higher interest rates. In contrast, a prime loan is a loan made to a creditworthy borrower at prevailing interest rates. Loans are classified as "A," "A-minus," "B," "C," and "D" loans. "A" loans are prime loans that are made at the going rate while "A-minus" loans are loans made at slightly higher interest rates to borrowers with only a few blemishes on their credit report. The so-called B, C and D loans are made to borrowers with significant imperfections in their credit history. "D" loans carry the highest interest rates because they are made to borrowers with the worst credit histories that include bankruptcies.

In contrast, a predatory loan is defined as an unsuitable loan designed to exploit vulnerable and unsophisticated borrowers. Predatory loans are a subset of subprime loans. They carry higher in-terest rates and fees than is required to cover the added risk of lending to borrowers with credit imperfections. They contain abusive terms and conditions that trap borrowers and lead to increased indebtedness. They have fees and products packed onto loan transactions that consumers cannot afford. They do not take into account the borrower's ability to repay the loan. They prey upon unsophisticated borrowers who rely in good faith on the expertise

of the loan originator or their agent. Ultimately, predatory loans strip equity and wealth from communities.

Q.2. What can be done about the unregulated brokers and home improvement contractors who are bad actors?

A.2. While it is extremely important to combat unregulated bad actors, it is important to focus on the more overt problem of brokers and contractors who fall within the existing State and local regulatory framework. Currently, mortgage brokers originate over 50 percent of subprime loans, yet only about 41 States regulate mortgage lending and brokering. State regulations for mortgage brokers are minimal and are in most cases promulgated with little to no enforcement authority. Some States only require brokers to be registered while others go far in requiring licensing, brick and mortar, education and experience. The result is a very complex statutory and regulatory framework that unfortunately allows the bad actors to conduct business virtually unchecked.

During the question and answer portion of the hearing, NCRC addressed the issue of mortgage brokers from a slightly different perspective: the collusion factor. From the initiation of the transaction, borrowers are immediately thrown into a realm of bad actors all working together to bilk individuals of their money and property. The real estate agent, the appraiser, the mortgage broker, and the subprime lender all work together on the same predatory transaction. In most cases, these collaborators operate under the radar of existing fair lending laws, particularly as it applies to the nondisclosure of brokers fees and compensation prior to the Good Faith Estimate (GFE).

NCRC believes that although Federal fair lending laws (Equal Credit Opportunity Act, Truth in Lending Act, Home Ownership and Equity Protection Act and Real Estate Settlement Protection Act) have established a framework to protect certain consumers, they by no means go far enough to protect all consumers. It is our position that the only way to combat bad actors is to expand the scope of current legislation/regulation to cover their business lines together with enacting some comprehensive antipredatory lending legislation.

Q.3. In the securities industry there is a "suitability standard" for brokers putting clients into appropriate brokerage activities. What do you think about applying a suitability standard for brokers/lenders who put low-income borrowers into subprime loans?

A.3. NCRC has strongly supported the prohibition under HOEPA of making loans without regard for the consumer's ability to pay. We would favor a "suitability standard" that takes into account whether or not a particular loan is suitable for a particular borrower and helps meet his/her needs without undue financial hardship.

NCRC also has advocated for policy that affords protections against a borrower being misled regarding his/her ability to qualify for a prime loan. In that regard, we would disagree with a standard limited to brokers/lenders who put low-income borrowers into subprime loans. Suitability should be afforded to all borrowers in both prime and subprime markets.

Q.4. Why are better disclosures and/or financial education not sufficient remedies for predatory lending problems?

A.4. NCRC has strongly supported increased financial education and better disclosures; in fact, our financial education program is highly regarded by industry and community groups throughout the country. However, it is our longstanding position that education and disclosure, in and of themselves, are not adequate to foster compliance of existing fair lending laws on a voluntary, statutory, or regulatory level.

Financial education is invaluable, but much like the car owner who relies on the mechanic for his/her technical expertise and professional judgement and guidance, mortgage applicants too must rely on the honesty and knowledge of the officer processing the loan. No amount of financial education can equip a mortgage applicant to combat predatory lending; it can only help the consumer identify what might be predatory practices. Financial education may help alert the consumer that he/she is not being treated fairly, but without any enforcement of regulation of unfair practices, the only recourse left for the consumer is to refuse the offer of the predatory loan, leaving the consumer no access to credit. The consumer is left to hope that free-market forces will eventually force predatory lenders to change their practices. Relying on financial education and disclosure alone, without regulatory and/or statutory enforcement, diffuses the responsibility of enforcement to consumers. Financial education must be accompanied by strong regulatory and/or statutory enforcement policies.

Q.5. I understand Philadelphia enacted a city ordinance regarding predatory lending and the Pennsylvania legislature passed a law preempting county and/or city ordinances. What do you think about State legislatures preempting county and/or city ordinances regarding predatory lending?

A.5. To date in 2001, 31 States have introduced over 60 legislative measures attempting to combat predatory lending practices. Additionally, nine major metropolitan cities and counties have introduced local ordinances to deal with predatory lending. In that regard, NCRC supports a national standard and strongly advocates for Congress, on a bi-partisan basis, to pass the strongest legislation possible to end the unscrupulous lending practices of predatory lenders.

A very similar situation to what happened in Philadelphia has now started in DeKalb County. In both cases, the American Financial Services Association filed lawsuits to stay effective dates of already enacted local legislation. In its Philadelphia suit, AFSA stated: "the ordinance is an attempt by the municipality to directly regulate the lending activity of financial institutions." In commenting on the suit, AFSA's president stated: "Financial services legislative activity must be remanded to the appropriate venue of the State legislature or, where appropriate, to the U.S. Congress or appropriate Federal agency."

Local predatory lending ordinances are important examples of where policymakers at one level are tired of waiting for another level to take action in protecting consumers. And perhaps the same

can be said true of the increase in State legislative measures—actions initiated as a result of neglect by the Federal Government.

Q.6. Is your concern about SPCLI related to the product or the marketing of the product?

A.6. NCRC is very concerned about *both* the marketing of SPCLI and the product itself. It is our position that credit insurance which is paid through a single up-front payment and financed into the total loan amount is a serious abusive lending practice (that is, predatory).

NCRC does not take issue with credit insurance when presented to the consumer as an option and choice: up-front lump sum or monthly pay option. And when it is presented in such a manner that the consumer can compare the final/total costs of both products prior to closing.

Our opposition to the SPCLI product is that in the majority of cases, the consumer's monthly payment for the financed SPCLI is more than the monthly payment under monthly options. The only scenario in which the SPCLI monthly payment is less than the month-to-month product is when the period of coverage is significantly shorter than the term of the loan (that is, a 5 year SPCLI term on a 30 year loan). NCRC strongly supports Martin Eakes' testimony that cost savings calculations comparing SPCLI and month-to-month almost *never* favor SPCLI, and SPCLI almost *always* results in a bad deal for consumers.

Scenario: The 1999 average subprime loan in the United States to a low- to moderate-income borrower is $91,000 via a 30 year mortgage. Using a typical subprime rate of 12 percent, the total interest cost of that loan would be $245,973.

But if the lender sells the consumer a $5,000, 5 year SPCLI policy rolling that amount into the mortgage balance, the total interest cost rises $13,516, which is almost three times the effective cost of the insurance.

We oppose SPCLI marketing because in the majority of predatory lending victims we work with, the following practices are regular occurrences:

- The consumer did not know he/she purchased credit insurance.
- The consumer was never told it was an option and not required to close the loan.
- The consumer was pressured into agreeing to SPCLI because he/she was told they would not get the loan without it.
- The consumer was coerced by the lender/broker saying: "If you die, will your spouse have the income to make the monthly payments? Would you want your family to assume your financial obligations? You need this product to protect your family."
- The consumer was never told that the SPCLI was a policy with a term significantly shorter than the duration of the loan.
- The consumer could not cancel the insurance product.

Q.7. If SPCLI is removed from the marketplace, what are subprime borrowers to do when they wish to insure their financial obligations and monthly alternatives have not been approved in their States.

A.7. The major players in subprime lending market have sent a collective signal supporting consumer rights on this issue via the discontinuation of SPCLI products. CitiFinancial, who dropped its

SPCLI in June, has since gained approval in 35 States to sell its monthly premium policy. In July, Household, the Nation's largest issuer of subprime loans, also dropped its SPCLI on real estate secured loans and has gained approval in 34 States. These major subprime lenders are actively working with State insurance departments to secure approval for their consumer choice products.

If SPCLI is removed from the marketplace and the borrower would like the financial security of a credit insurance product in a State where monthly payment options are not approved, one solution could be to refer the consumer to an outside insurance counselor who can then work with the consumer on buying life insurance for the loan amount.

Q.8. Yesterday, [July 26], we had a lively discussion about the cost of SPCLI. One witness said that if you go to a Monthly Outstanding Balance basis over the term of the loan it is more expensive. Another witness disputed that. Do you have a view on this issue?

A.8. It is NCRC's position that, if the borrower chooses to purchase credit life insurance, the monthly outstanding balance (MOB) payment option is the only viable option. After reviewing the written testimony of both witnesses in addition to studies from other organizations, frankly, we do not understand the assertion made by Charles Calomiris that "the monthly cost of single-premium insurance is much lower than the cost of monthly insurance."

For example, assume a credit insurance policy is purchased that covers the entire loan period of 10 years with a total premium of $10,000. With MOB, monthly payments will be calculated as the premium divided by the number of months covering the term of the loan, or $83.33 per month. With any single-premium policy, the amount paid each month will increase because the numerator is increased based on the interest rate, yet the denominator remains the same. For a loan just under the HOPEA threshold at 15.5 percent, the monthly payment would increase to $164, almost twice the amount paid with MOB. When comparing the same premium amount over the same term, it is impossible for a payment method that charges any interest to be less expensive than one that charges zero interest. (See Exhibit 1).

Only in a situation where the term of the credit insurance is substantially shorter than the term of the mortgage can SPCLI have monthly payments lower than MOB. Even so, payments on the truncated credit insurance over the longer life of the loan in no way offsets the nominal monthly savings to the borrower because of the interest payments. (See Exhibit 2). The borrower is covered for a period of time much shorter than the life of the loan, yet continues to pay off the credit insurance for the remainder of the loan.

SPCLI also precludes the borrower from canceling the insurance. With monthly payments, the borrower pays each month and is covered for that month. The borrower can choose to continue or cancel the insurance each month. Because credit insurance can only be purchased from the lender and not an outside party, the borrower has but one choice. With MOB, the borrower has more choice, such as traditional life insurance. With SPCLI, because the premium is paid in full upfront and financed, the borrower is locked in for the

life of the insurance. Canceling SPCLI entitles the borrower to a refund much lower than the remaining value of the insurance because of the interest owed on the policy. Additionally, a report issued by the Coalition for Responsible Lending entitled *Single Premium Credit Insurance Should be Banned Outright* notes that for SPCLI "in most States, lenders are not obligated to cancel credit insurance coverage after a grace period, generally 30 days." If a borrower finds that he/she cannot pay for credit insurance for a particular month, under MOB, he/she can cancel the policy. With SPCLI, the borrower is delinquent on the mortgage payment and risks foreclosure.

Lenders have no monetary incentive to offer borrowers credit insurance on the most favorable terms to the borrower. Underwritten by an insurer, credit life insurance is structured as a group policy sold to the lender who in turn issues the insurance to the borrower, the ultimate consumer of the insurance. Credit insurers market their products to lenders, not borrowers. Borrowers generally have no say in the choice of insurance products, and certainly have no voice in negotiating the terms of the insurance. They can either accept or decline the credit insurance package offered by the lender.

The lender sells the insurance on behalf of the insurer, and receives compensation for each sale in the form of a commission, which in some cases is based on the profitability (higher rates) of the insurance. Most States establish *prima facie* rates that are the maximum rates that can be levied on credit insurance and these are generally the rates that are charged. According to a joint report published by Consumers Union and the Center for Economic Justice in 1999, entitled *Credit Insurance: The $2 Billion A Year Rip-Off,* "creditor compensation averaged more than 30 percent of the premium dollar for credit life." The report further notes that in some cases, the lender was rewarded additional compensation in the form of personal computers, software, and calculators.

While the lenders and the insurers are benefiting from the sale credit life insurance, the Consumers Union/Center for Economic Justice report found that borrowers have been excessively overcharged. The report notes that the loss ratio on credit life insurance nationally was 41.6 percent in 1997. The National Association of Insurance Commissioners sets a 60 percent loss ratio threshold as the minimum level considered to provide reasonable benefits to consumers. In Georgia, the loss ratio in 1997 was slightly better than the national figure at 48.9 percent. With the reverse competition prevalent in the credit insurance market, it is always the borrower who pays the most dearly.

Q.9. I have heard that SPCLI is a better deal for consumers over 41 years of age because it is cheaper and it is generally more available than the traditional term life insurance. Would anyone care to comment on that view?

A.9. Through our research on the available options for a given 41-year old male borrower living in Georgia, we found that term life insurance is generally a better option than credit life insurance. Assuming that the borrower is a nonsmoker, a $100,000 policy for a 10 year term will cost between $12 and $17 a month (quotes obtained from term life insurance broker Term.com at *www.term.com*.

Applying the Georgia prima facie rate of $.45 per annum per $100 of indebtedness for decreasing term credit life insurance, the borrower would be charged a total premium of $11,610.25 for a 10 year policy on a $100,000, 30 year mortgage with an interest rate of 10 percent. With MOB, monthly payments would be $96.75, while for a single-premium payment financed into the loan, monthly payments would be $101.89. Traditional term life insurance is clearly a much better deal. Even for those borrowers with health problems who may not qualify for premium health insurance rates and credit life insurance is the only available option, MOB payments make more sense than SPCLI. (See Exhibit 3).

Additionally, with credit life insurance, the bank is named the beneficiary of the policy. If the borrower dies, the lender is repaid the remainder of the loan. Under tradition term life insurance, the insured designates a beneficiary. It is possible that the beneficiary would not want to pay off the loan balance, but would prefer to continue monthly loan payments and apply the insurance benefits elsewhere. Traditional term life insurance provides a great deal more flexibility for the beneficiaries of the estate.

NATIONAL COMMUNITY REINVESTMENT COALITION NCRC

Exhibit 1
Monthly Payments versus Financing Credit Insurance

Scenario: $10,000 Credit Insurance for a 10-Year Loan

	Total Monthly Payment	Total Payments Over 1 Year	Total Interest Payments
Monthly Outstanding Balance	$83.33	$10,000.00	$0.00
Single-Premium[1]			
10-Year Mortgage at 7.5% rate	$118.00	$14,160.00	$4,160.00
10-Year Mortgage at 9.5% rate	$129.00	$15,480.00	$5,480.00
10-Year Mortgage at 11.5% rate	$140.00	$16,800.00	$6,800.00
10-Year Mortgage at 13.5% rate	$152.00	$18,240.00	$8,240.00
10-Year Mortgage at 15.5% rate[2]	$164.00	$19,680.00	$9,680.00

[1] Single-premium payments calculated using a mortgage calculator.
[2] 15.5% is just below the HOPEA threshold.

NATIONAL COMMUNITY REINVESTMENT COALITION NCRC

Exhibit 2
Cost of Truncated Credit Life Insurance

Scenario 1 *: $10,000 Credit Insurance over 5 Years on a 30-Year Mortgage*

	Monthly Payment	Total Payments	Total Months of Coverage	Total Payments	Total Interest Payments
Monthly Outstanding Balance	$167	60	60	$10,000	$0
Single-Premium[1]					
30-Year Mortgage at 12% rate	$103	360	60	$37,029.60	$27,030
30-Year Mortgage at 13% rate	$111	360	60	$39,823.20	$29,823
30-Year Mortgage at 15% rate[2]	$126	360	60	$45,518.40	$35,518
30-Year Mortgage at 16% rate[3]	$134	360	60	$48,412.80	$38,413

Scenario 2 *: $14,000 Credit Insurance over 7 Years on a 30-Year Mortgage*

	Monthly Payment	Total Payments	Total Months of Coverage	Total Payment	Total Interest Payment
Monthly Outstanding Balance	$167	84	84	$14,000	$0
Single-Premium[1]					
30-Year Mortgage at 12% rate	$144	360	84	$51,844	$37,844
30-Year Mortgage at 13% rate	$155	360	84	$55,753	$41,753
30-Year Mortgage at 15% rate[2]	$177	360	84	$63,727	$49,727
30-Year Mortgage at 16% rate[3]	$188	360	84	$67,777	$53,777

Scenario 3 *: $20,000 Credit Insurance over 10 Years on a 30-Year Mortgage*

	Monthly Payment	Total Payments	Total Months of Coverage	Total Payment	Total Interest Payment
Monthly Outstanding Balance	$167	120	120	$20,000	$0
Single-Premium[1]					
30-Year Mortgage at 12% rate	$206	360	120	$74,059	$54,059
30-Year Mortgage at 13% rate	$221	360	120	$79,646	$59,646
30-Year Mortgage at 15% rate[2]	$253	360	120	$91,040	$71,040
30-Year Mortgage at 16% rate[3]	$269	360	120	$96,822	$76,822

[1] Single-premium payments calculated using a mortgage calculator.
[2] 15% is just below the HOPEA threshold.
[3] 16% is just above the HOPEA threshold.

NATIONAL COMMUNITY REINVESTMENT COALITION NCRC

Exhibit 3
Credit Life Insurance versus Traditional Term Life Insurance

Scenario: 10-year $100,000 mortgage at 10% interest; single borrower only. Applying Georgia prima facie rate.

	SPCLI	Traditional Term Life[1]	MOB
Period of Coverage	120 months	120 months	120 months
Monthly Payments	$102	$12 - $17	$97
Total Payments	**$12,227**	**$1,440 - $2,040**	**$11,610**

[1] Rates obtained for a 41-year old male non-smoker residing in Georgia.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MILLER FROM LEE WILLIAMS

Q.1. Is there a definition for predatory lending? Or do you know it when you see it?

A.1. We define predatory loans as those that are high-rate, high-fee home equity products that are intentionally structured in a manner that is deceptive and disadvantageous to borrowers.

Q.2. What can be done about the unregulated brokers and home improvement contractors who are bad actors?

A.2. They should be licensed and regulated.

Q.3. In the securities industry, is there a "suitability standard" for brokers putting clients into inappropriate brokerage activities. What do you think about applying a suitability standard for brokers/lenders who put low-income borrowers into subprime loans?

A.3. We would agree with this if we are correct in assuming that a "suitability standard" requires brokers to explain to consumers fully that they must obtain a subprime loan instead of a prime rate.

Q.4. Why are better disclosures and/or financial education not sufficient remedies for predatory lending problems?

A.4. While financial education may not be a sufficient remedy for predatory lending problems in the short run, we are convinced that, combined with disclosure, it will be an extremely important tool in combating this problem over the long run. As stated in our Ethical Guidelines that are attached to our written testimony, we also support voluntary and other means of prohibiting some abusive practices.

Q.5. I understand Philadelphia enacted a city ordinance regarding predatory lending and the Pennsylvania legislature passed a law preempting county and/or city ordinances. What do you think about State legislatures preempting county and/or city ordinances regarding predatory lending?

A.5. We are pleased that the State legislatures are recognizing the importance of this issue and passing Statewide legislation to combat predatory practices in our communities.

Q.6. Is your concern about SPCLI related to the product or the marketing of the product?

A.6. Both—the product is unnecessarily expensive, and in some cases it is included without any disclosure to the borrower.

Q.7. If SPCLI is removed from the marketplace, what are subprime borrowers to do when they wish to insure their financial obligations, and monthly alternatives have not been approved in their States?

A.7. One alternative might be the purchase of term life insurance or reliance on existing life insurance; another option may be to work with the State legislatures to provide a monthly alternative as a way to combat predatory lending practices.

Q.8. Yesterday [July 26], we had a lively discussion about the cost of SPCLI. One witness said that if you go to a Monthly Outstanding Balance basis, it is more expensive that over the term of

the loan. Another witness disputed that. Do you have a view on this issue?

A.8. It would seem that the witness arguing that single-premium credit life is cheaper than the monthly alternative was in error.

Q.9. I have heard that SPCLI is a better deal for consumers over 41 years of age because it is cheaper and it is generally more available that the traditional term life insurance. Would anyone care to comment on that view?

A.9. If that is true, then the consumer, with a little knowledge and perhaps disclosure, would seem to have a viable alternative, but this does not indicate if SPCLI for those over 41 years of age is cheaper than the monthly alternative, which is always a better deal for the consumer.

STATEMENT OF THE AMERICAN LAND TITLE ASSOCIATION

JULY 27, 2001

The American Land Title Association (ALTA) membership is composed of more than 2,000 title insurance companies, their agents, independent abstracters and attorneys who search, examine, and insure land titles to protect owners and mortgage lenders against losses from defects in titles. Many of these companies also provide additional real estate information services, such as tax search, flood certification, tax filing, and credit reporting services. These firms and individuals employ nearly 100,000 individuals and operate in every county in the country.

ALTA appreciates the concerns that have prompted the Committee to engage in oversight hearings on the issue of "predatory lending" and the introduction of the Predatory Lending Consumer Protection Act of 2000 (S. 2415; H.R. 4250) and other legislation. Predatory lending practices can be a source of substantial claims loss to title insurers. In general, we support reasonable legislative and regulatory action to address the problems and abuses that may exist with regard to "predatory" lending practices targeted at vulnerable consumers. We recognize that there is a fine line between subprime and predatory lending. We are therefore concerned that Congress, in reducing the thresholds for determining when loans are subject to the additional limitations and restrictions imposed by the HOEPA (Homeownership and Equity Protection Act) amendments to the Truth in Lending Act (TILA) and in eliminating the current exclusion for "residential mortgage transactions," does not inadvertently reduce the availability of legitimate financing to low income or less-than-prime borrowers.

We hope that the Congress, the agencies, and the lending industry develop a fair, reasonable, solution to these problems. Because we are clearly not central to the lending decisions, and only see the results of these loans at closing, or in limited situations, where claims arise, we are limiting our comments to those provisions of S. 2415, one of the major proposals before the Committee, which directly affect the title insurance industry.

If the Committee ultimately concludes that legislation is needed, we would like to draw your attention to three aspects of the "Predatory Lending Consumer Protection Act of 2000" (S. 2415) which cause concern.

First, we do not believe that the current exclusion for "residential mortgage transactions"—transactions in which the loan is being used to acquire or construct the dwelling—contained in the current language of TILA § 103(aa)(1) should be eliminated. The concerns raised about predatory lending practices have related to refinance and second mortgage transactions. There is simply no reason to extend HOEPA to potentially millions of purchase money mortgage transactions in which there has been no evidence of the kind of abuses to which HOEPA is addressed.

Second, the bill eliminates a current provision of HOEPA that we believe should be retained. Under the current law, a second mortgage or loan refinance is subject to the HOEPA requirements if it bears a high annual percentage rate (that is, more than 10 percentage points higher than the yield on Treasury securities having a comparable maturity) or if "the total points and fees payable by the consumer at or before closing will exceed the greater of (i) 8 percent of the total loan amount; or (ii) $400."[1] In determining what constitutes "points and fees" for purposes of this provision, HOEPA provides that certain settlement charges, including "[f]ees or premiums for title examination, title insurance, or similar purposes" are not included if:

- the charge is reasonable;
- the creditor receives no direct or indirect compensation; and
- the charge is paid to a third party unaffiliated with the creditor.[2]

ALTA believes that this current exclusion is both reasonable and appropriate. Some ALTA members do engage in independent operations, and participate in affiliated business arrangements, and we do recognize the policy rationale behind the inclusion of affiliated business arrangement fees under current law. As the Senate Banking Committee report on the 1994 HOEPA legislation made clear, the purpose of imposing a trigger based on points and fees charged in the transaction was to "prevent unscrupulous creditors from using grossly inflated fees and charges to take advantage of unwitting customers."[3] On the other hand, if the lender is not benefiting from the charge, the charge is made by an unaffiliated third party, and the charge is reasonable, the charge does not affect in any way whether the loan is

[1] TILA, § 103(aa)(1).
[2] TILA, §§ 103(aa)(4)(C) and 106(e).
[3] S. Rep. 103–169 at 24 (1993).

"predatory." Congress concluded in 1994, that there was no reason why such charges should be included in determining the trigger for HOEPA coverage. We hope that the Committee keeps in mind that title insurance fees are regulated in most States, and that these fees are based on costs and risk, and that adherence is required to ensure solvency and consumer protection.

Unfortunately, S. 2415, eliminates this aspect of HOEPA. In fact, the rationale for maintaining the current language is even stronger in light of the other changes made to HOEPA by S. 2415. S. 2415 would modify the total amount of points and fees that triggers HOEPA coverage from 8 percent of the loan, or $400, whichever is higher, to 5 percent of the total loan amount, or $1,000, whichever is higher. The reduction from 8 percent to 5 percent would mean that, on a $50,000 refinance loan or second mortgage (for example), total fees and points of $2,500 would trigger HOEPA coverage, whereas under current law the total points and fees would have to exceed $4,000 before the loan would be deemed a "high-cost" loan triggering HOEPA coverage.

While Congress may conclude that this reduction is justified where the lender is pocketing the $2,500 in points and fees (and therefore may have an incentive to engage in equity stripping and repetitive refinancings), there is no justification in also eliminating the current exclusion for reasonable third-party charges in which the lender does not participate. Indeed, by reducing the trigger amount and eliminating that exclusion, S. 2415 risks converting many nonpredatory, nonabusive loans into HOEPA-covered loans. This prospect could adversely affect the availability of financing to higher-risk borrowers.

Accordingly, we recommend that § 2(b)(3) of the bill, to the extent that it eliminates the third-party charge exemption from the current language of § 103(aa)(4)(C) of TILA, be changed so as to leave in place the current language of § 103(aa)(4)(C).

Our third concern relates to new § 129(k) of TILA that would be added by section 4(a) of S. 2415. The new provision would prohibit a creditor, in connection with a HOEPA-covered mortgage loan, from charging a borrower for credit insurance or a debt cancellation contract on a single premium basis through an upfront charge paid by the borrower at the outset of the loan. We express no views on whether such a prohibition is desirable or appropriate. What we are concerned about is that the language of new § 129(k)(1) states that "no creditor or other person may require or allow" the collection of such premiums. The "no . . . other person may . . . allow" language is unnecessary, ambiguous, and would set a questionable legislative precedent.

The language is unnecessary because the provision, without the additional words, would still prohibit lenders from collecting single premiums for credit insurance. The language is ambiguous, because it imposes obligations on unidentified "other persons" not to "allow"—whatever that means—lenders to collect such premiums. Finally, it would set an unfortunate precedent for Congress, when it imposes direct obligations or requirements on particular parties (in this context, on lenders), to extend such obligations to "other persons" who may be deemed to have "allowed" an action to take place.

Our members are involved in the closing of mortgage loans. Accordingly, we are concerned about impractical obligations being imposed on us because title companies who close loans or who issue title insurance policies to lenders might be viewed as "other persons" who have "allowed" the lender to obtain the single premium in connection with the transaction. Neither TILA, nor indeed other comparable consumer protection statutes, have sought to impose such obligations on third parties, and Congress should not start down that road in this bill. Further, in some States, mortgage loans are "net funded" and checks are not written for the lender items. In addition, in many instances, there may not be enough detail for a closing agent to determine that there is a single-premium credit insurance premium. There is no need for this additional language and we urge the Committee to delete the reference to "or other person" on page 14, line 24, of the bill.

We thank the Chairman and the Committee for the opportunity to submit this statement.

STATEMENT OF THE CONSUMER BANKERS ASSOCIATION

JULY 27, 2001

The Consumer Bankers Association (CBA) is pleased to submit this testimony to the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate, in response to the hearings entitled "Predatory Mortgage Lending: The Problem, Impact, and Responses."

CBA was founded in 1919 and represents the majority of the major banks engaged in consumer lending. It provides leadership and representation on retail banking issues such as privacy, fair lending, and consumer protection legislation and regulation. Member institutions are the leaders in consumer home equity finance, electronic retail delivery systems, bank sales of investment products, small business services, and community development. The CBA comprises the Nation's largest bank holding companies. CBA members hold two-thirds of the industry's total assets and make billions of dollars of loans to borrowers who could not qualify for prime loans. Our membership actively participates in the nonprime lending industry in the United States. We are proud of the role our members have played in expanding the availability of mortgage credit to borrowers not qualified for conventional mortgage financing due to little or poor credit experience.

We appreciate the opportunity to share with this Committee the position of our members with respect to the complex issues and challenges facing the mortgage lending industry. We are hopeful that the spotlight this Committee is placing on these issues will be helpful to our membership as they seek to continue to expand home ownership opportunities through fair and nondiscriminatory lending practices.

The growth in responsible nonprime lending over the last decade has been celebrated as "the democratization of credit" by Federal Reserve Board Chairman Alan Greenspan and lauded as "one of the great success stories of American economics" by Director of the Office of Thrift Supervision Ellen Seidman.[1] It has enabled many consumers to obtain home loans who previously would have had limited, if any, access to the credit market due to impaired credit histories. This access to credit is instrumental to helping borrowers purchase and improve their homes, access equity for emergencies, and obtain basic goods and services.

Nonprime lending is generally described as the extension of credit to borrowers exhibiting higher delinquency or default characteristics than those of traditional borrowers. For example, the U.S. Department of Housing and Urban Development and the U.S. Department of Treasury reports that nonprime mortgages were five times more likely to be delinquent than prime mortgages.[2] Because of the fact that delinquency rises significantly as credit scores decline, interest rates in the nonprime market are tied to the risk of delinquency posed by nonprime borrowers.[3] Thus, nonprime lending involves lending at rates above the prime rate to cover the increased risk and transaction costs of lending to borrowers who pose greater credit risks. When done the right way, the loan is structured to correlate with the borrower's income stream and promotes the borrower's ability to repay the loan.

In the last decade, lower-income and minority consumers, who historically had difficulty in getting mortgage credit, have been granted loans at unprecedented levels. Indeed, Federal Reserve Governor Gramlich recently observed that conventional home mortgage lending to low income borrowers between 1993 and 1998 increased nearly 75 percent, compared with a 52 percent increase for upper income borrowers. At the same time, conventional home mortgage lending to African-Americans increased 95 percent, and to Hispanics 78 percent, compared to a 40 percent increase overall.[4]

Much of this democratization of credit can be attributed to the development of the nonprime mortgage market. Notably, in their Joint Report, the U.S. Department of Housing and Urban Development and the U.S. Department of Treasury indicate that the number of nonprime loans has gone from 80,000 in 1993 to 790,000 in 1998, an 880 percent increase.[5] Nonprime loan originations increased from $35 billion in 1994 to $160 billion in 1999, representing a 360 percent increase.[6]

Unfortunately, these very positive developments have become overshadowed by the conduct of a few unscrupulous brokers and lenders, who in many cases are not subject to Federal supervision and oversight. These brokers and lenders sometimes

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[1] *See* Remarks of Ellen Seidman, Director, Office of Thrift Supervision, The Financial Service and E–Commerce Practice Group of the Federalist Society Presents A Lunch Exchange on the Predatory Lending Debate: "Are Banks Empowering or Robbing Customers?" October 20, 2000; Kathleen Day, Raising the Roof on Riskier Lending, *The Washington Post,* February 6, 2001, at 2 (quoting Alan Greenspan).

[2] *See* Curbing Predatory Home Mortgage Lending: A Joint Report, U.S. Department of Treasury and U.S. Department of Housing and Urban Development, June 2000, at 33–35 (hereinafter "HUD-Treasury Report").

[3] *See* Robert E. Litan, Vice President and Director, Economic Studies Program, The Brookings Institution, A Prudent Approach to Preventing Predatory Lending, February 2001, at 9.

[4] *See* Remarks of Edward M. Gramlich, Governor, The Federal Reserve Board, before the Federal Reserve Bank of Philadelphia, Community and Consumer Affairs Department Conference on Predatory Lending, December 6, 2000.

[5] *See* HUD-Treasury Report at 29.

[6] *See* id. at 2.

impose unfair and unreasonable loan terms on vulnerable borrowers, often by deceit and misinformation. Our members are greatly concerned about the harm this causes to consumers. Furthermore, such conduct has tarred the entire lending community and is now undermining our members' efforts to expand credit access through fairly priced and adequately disclosed nonprime loan products. Thus, CBA joins this Committee in condemning these abusive sales practices and in seeking effective solutions.

It would be unfortunate, however, if in the quest to root out the deplorable conduct of a relatively few unscrupulous lenders, continuing progress in the democratization of credit is halted. We are concerned that the current blurring in the distinction between the nonprime mortgage lending activities of responsible lenders and the lending practices of predatory lenders may cause such a result. It is critically important that this Committee recognize the need for responsible nonprime lending and the importance of expanding credit access from responsible nonprime lenders, such as those represented within the CBA membership.[7] Abusive lending must be eradicated, but not at the cost of severely constricting responsible nonprime lending.

CBA members understand that they have an important role in ensuring the continuing availability of responsible nonprime loan products. Our members are good, well-intentioned companies who are committed to industry best practices. CBA members must, and will, lead by example.

Three of the initiatives the CBA and its members have supported to enhance consumer protections and promote industry best practices are efforts to: (i) expand financial literacy; (ii) streamline and simplify mortgage lending; and (iii) improve oversight and registration of mortgage brokers and home improvement contractors.

I. The CBA believes that comprehensive consumer financial education is the key to consumer protection. Consumer education and better consumer counseling can help consumers avoid becoming the victims of abusive lending practices. Recent studies, however, show that most American children and young adults have not mastered the most basic personal financial skills. For example, a survey of 12-year-olds conducted by Consumer Reports in 1997 found that only 58 percent of the respondents knew that if one borrowed $100 from a bank, one would have to pay back a greater amount.[8]

Many consumers tend to be unfamiliar with financial concepts, lack an understanding of the loan products offered on the market and do not understand the benefit of shopping for mortgage credit. According to a University of Michigan Survey of Consumers, at least 40 percent of mortgage borrowers do not understand the relationship between the contract interest rate and the annual percentage rate (APR).[9] In another survey, 12 percent of nonprime borrowers said they were not familiar with basic financial terms such as the interest rate and the principal of the loan. One-third of nonprime borrowers said they were not familiar with the types of mortgage products available.[10]

The CBA believes that industry regulators and consumer groups should work together on this issue to ensure that borrowers understand the mortgage lending process and the terms of their loans. We believe that an uninformed consumer is more likely to fall victim to an unscrupulous lender than one who has even a basic understanding of the products and services available. Thus, it follows that the more consumers understand finance, the better equipped they will be to make informed judgments.

Congress has clearly taken an interest in financial literacy as well, and CBA has been a supporter of efforts to provide funding in this area. For example, CBA supports the concepts in the education reform bills, S. 1 and H.R. 1, which have passed their respective Houses and are expected to go to Conference. Both contain language authorizing the use of funds to promote financial literacy in a number of ways. We

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[7] *See,* for example, Remarks of Edward M. Gramlich, Governor, The Federal Reserve Board, before the Community Affairs Research Conference of the Federal Reserve System, Washington, DC, April 5, 2001, at 2; Press Release of Office of the Comptroller of the Currency, OCC Addresses Subprime Lending Risk Issues (quoting John D. Hawke, Jr., Comptroller), April 5, 1999; Jim Peterson, Lender Beware, American Banking Journal, Vol. 93, Issue 2, February 1, 2001, at 27 (quoting Senator Gramm).

[8] *See* Max Jarman, U.S. Youths Flunking Credit 101, The Arizona Republic, May 5, 1998 at 1.

[9] *See* Jinhook Lee and Jeanne M. Hogarth, The Price of Money: Consumers' Understanding of APR's and Contract Interest Rates, 18 J. Publ. Pol'y & Mkt. 66, April 1, 1999, at 1.

[10] *See* Curbing Predatory Home Mortgage Lending: A Joint Report, U.S. Department of Treasury and U.S. Department of Housing and Urban Development, June 2000, at 59 (citing Howard Lax, Michael Manti, Paul Raca and Peter Zom, Subprime Lending: An Investigation of Economic Efficiency (unpublished paper), February 25, 2000).

also support a variety of Government financial literacy initiatives that are under consideration by the Federal Reserve Board, the Federal Trade Commission, and the U.S. Department of Treasury, and others.

Moreover, CBA is releasing a report examining banking industry financial education initiatives for consumers. A copy of the report is attached to this testimony. (This report is held in the Senate Banking Committee files.) It documents the types of programs and products banks routinely offer, in an effort to educate consumers on managing their finances. It shows that CBA member institutions are substantially engaged in various financial literacy efforts, including mortgage, credit, and foreclosure prevention counseling to borrowers, small business development training, and financial literacy for students in grades K–12 and college. Virtually all of the 48 banks that participated in the survey, representing more than half of the banking industry's assets, said they contribute to financial literacy efforts in some way. In particular, 98 percent offer mortgage or homeownership counseling and affordable mortgage programs with flexible terms, typically for lower income, first-time homebuyers. Most of the banks that responded serve as the primary sponsor of some homeownership counseling programs, and many also indicated that they financially support literacy programs delivered by nonprofit and/or community organizations. Further, some banks have created full-time positions within their institutions to manage financial literacy efforts. CBA will continue to track the activities of banks in this area, to encourage further efforts, and to share with the entire lending industry examples of bank programs that prove effective.

II. The CBA has long believed that a more streamlined mortgage process, with a greater opportunity to shop for credit terms, would eliminate some of the possibility of abuse by making mortgage loans more transparent to consumers. For instance, CBA was an active participant in the broad-based "Mortgage Reform Working Group" that worked toward just such a goal. This group, comprising many industry and consumer representatives, sought to refine various reform options in the financial services industry to streamline the lending process. A key recommendation that emerged from the process—endorsed at the time by the Federal Reserve Board and many consumer advocates—is to permit lenders to provide a guaranteed closing cost disclosure early in the application process, giving the consumers better information on which to shop for credit.

In press reports, HUD Secretary Martinez has recently expressed support for efforts to make the mortgage lending process more accessible to consumers. CBA will continue to work on this effort, so that the complexity of the mortgage lending process cannot be used by unscrupulous brokers and lenders to further their aims, and so that the information can be better used by consumers to shop for credit.

III. Many of the abusive practices in our industry appear to involve mortgage brokers or home improvement contractors, yet we believe insufficient attention has been paid to this part of the marketing and sale of mortgage loans. CBA supports efforts to improve the oversight of these entities. For example, we recommend that States adopt minimum licensing requirements for brokers and contractors, which might be encouraged by Federal law. Such licensing criteria might include, among other things: demonstration of financial responsibility and specified net worth, continuing education requirements, and a restriction on licensing of persons with criminal or civil judgments within certain time periods for fraud, dishonesty, or deceit. CBA also supports a national registry for mortgage brokers and home improvement contractors. This would allow the States, consumers and community organizations to monitor individual mortgage brokers and home improvement contractors so that "bad actors" are identified, even if they move from State to State. Further, CBA members support consumer education efforts that include information on the role of mortgage brokers and home improvement contractors in the mortgage lending process.

For these reasons, we believe the activities of CBA members, including reputable nonprime mortgage lending and efforts to protect consumers through outreach and education, are part of the solution—not the problem. CBA and its members are committed to working with this Committee and the regulatory community to resolve the challenges we face. We recognize that the mortgage lending system is not perfect and that additional steps are necessary to root out predatory lending practices.

Later this year, CBA will be sponsoring an industry forum, at which a cross-section of industry representatives with knowledge and experience in this area, will be invited to convene. One of the goals of the forum will be to permit a wide array of industry participants to share information, in order to learn about those best practices and innovative programs that are working in communities to combat abusive practices. We will discuss financial literacy, community development programs, regulatory oversight or enforcement, and other activities. By facilitating the sharing

of such information among industry participants from all over the country, we hope to allow the more effective steps to be replicated.

In closing, the CBA is proud of the contribution it and its members have made to expanding mortgage credit access to Americans who, until recently, had few opportunities in the financial services industry. We encourage this Committee to proceed with caution when reviewing any proposal for new legislation or regulatory change in this area. It is important to remain mindful, as recognized by Governor Gramlich and others, that expansive regulatory action may have the unintended consequence of discouraging or even prohibiting legitimate lenders from providing nonprime loans and could impede access to credit in the nonprime market.[11] While there may be disagreement about what regulatory changes and enforcement efforts are desirable in this industry, we welcome the opportunity to work with you to develop appropriate solutions.

STATEMENT OF THE CONSUMER MORTGAGE COALITION

JULY 27, 2001

The Consumer Mortgage Coalition (CMC), a trade association of national residential mortgage lenders and servicers, appreciates the opportunity to submit its written testimony concerning predatory mortgage lending to the Senate Committee on Banking, Housing, and Urban Affairs.

In considering the problem and impact of, and possible responses to, "predatory lending," we emphasize the following key points:

- Many abusive practices are the result of outright fraud. As we examine the anecdotal descriptions of borrowers being abused, it is clear that many of the abuses resulted from misrepresentation, deception and other practices that violate existing laws. New laws are not needed to address these problems. Rather, there must be a renewed emphasis on devoting the necessary resources to enforce existing law.
- Predatory lending is hard to define. Practices (other than those constituting current illegal conduct) that are often labeled predatory can have both adverse and beneficial consequences for consumers. As policymakers consider restricting individual terms and provisions, such as prepayment penalties and yield spread premiums, they must understand that these terms have legitimate uses that can benefit consumers, for example, by reducing interest rates or upfront costs.
- It is not in the interests of lenders and servicers to make loans, whether prime or subprime, which result in default or foreclosure. Lenders and services do not benefit from defaulted loans. Rather they lose money often significant amounts. Simply put, a lender whose loans that go into default represent more than a small proportion of its total loans will not long be in the lending business. In fact, because subprime borrowers by definition present a greater risk, subprime lenders must devote additional resources to ensuring that they will not end up with a defaulted loan.
- The goal of policymakers in addressing "predatory lending" should be to educate and empower consumers to make appropriate decisions about their financial affairs, not to restrict consumers' option. The CMC is convinced that both consumers and lenders are better off if lenders have the freedom to offer and consumers have the freedom to choose from the widest range of financial options. Consumers, however, must be put in a position to make an informed decision that is most appropriate for their needs and situation.
- Current regulatory requirements do not allow consumers to understand their choices. They often act as barriers to competition that could reduce costs. Studies have shown that the innumerable disclosures required by a variety of Federal and State laws often confuse, and sometimes mislead, consumers who are attempting to shop for loans. In addition, while lenders compete on their offerings based on interest rate and points, because of regulatory restrictions, there is little incentive to compete on the basis of ancillary settlement costs.

The CMC, working with other trade groups, has developed a five-part program that we believe best addresses "predatory lending" without unduly restricting consumer's options or unduly burdening the efficient operation of the mortgage market. The program consists of the following:

- Adequate enforcement of existing law

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[11] *See* Remarks of Edward M. Gramlich, before the Community Affairs Research Conference, supra note 7, at 2.

- A nationwide licensing registry that allows constant monitoring by state regulators and consumers of licensing complaints, suspensions and revocations
- A comprehensive public awareness and education campaign
- Implementation of Federal regulators' existing authority to address predatory practices
- Reform of mortgage origination regulatory requirements to give consumers simpler, more uniform disclosures that allow them to understand and effectively comparison shop for loans, to give lenders the ability to offer ancillary settlement services at lower cost, and to provide certain substantive protections.

Following a brief note describing our coalition, we examine each component of this comprehensive solution. In addition, in Tab 1 of this testimony, we describe the subprime market. In Tab 2, we describe the products and practices that often are labeled "predatory," and show how they can be used to the benefit of borrowers and how our solutions would mitigate any abuses they could cause. Finally, in Tab 3, we describe the mortgage origination process, its participants and the compensation each receives for their role.

About the CMC

The CMC was formed, in large part, to pursue reform of the mortgage origination process. From our perspective, one of the principal goals of mortgage reform is to streamline the mortgage origination process so that consumers would be better informed when making credit choices. Complementary to our goal of streamlining the mortgage origination process is the goal of reducing abusive lending practices. We believe that better disclosures and substantive protections can enhance consumer protection. The goal should be to allow consumers to make educated choices in the credit market.

We commend the Committee for its continued attention to the issue of predatory lending. The CMC is particularly concerned because of the damage caused by deceptive lenders to consumers and to the image of our industry. We support the goal of protecting consumers from unscrupulous lending practices and recognize that some elderly and other vulnerable consumers have been subjected to abuses by a small number of mortgage lenders, brokers and home contractors. We share the Committee's objective of developing approaches that prevent predatory lending practices without restricting the supply of credit to consumers or unduly burdening the mortgage lending industry.

The CMC's Alternative: A Comprehensive Solution to Predatory Lending

Rather than further restrictions on products, terms and provisions, the CMC favors a multitiered, comprehensive solution to predatory lending, including increased enforcement of existing prohibitions against fraud and deception, coordinated, nationwide enforcement of licensing requirements, and better consumer education on the mortgage process.

Most significantly, the CMC believes that comprehensive reform of the regulation of the mortgage origination process is needed so that all consumers, but particularly those most vulnerable to predatory lending practices, can better protect themselves. As noted above, our solution has five parts.

Part I: Devoting Adequate Resources To Enforcing Existing Laws

We agree with Federal Reserve Board Chairman Alan Greenspan's comments that enforcement of existing laws is the first step that should be taken. Many examples of predatory lending involve fraudulent practices that are clearly illegal under current law. Adequate resources at both the Federal and State levels of government need to be devoted to pursuing those committing fraud. Therefore, the appropriate Federal and State agencies should advise policymakers of the resources they need to combat mortgage fraud.

Part II: A Nationwide Licensing Registry

We recommend that all mortgage brokers and companies be licensed, and that a Federal system be established to ensure that if a broker or company loses its license in one State as a result of predatory practices, all licenses would be revoked, suspended, or put on regulatory alert nationally. A "Consumer Mortgage Protection Board" could be established to maintain a clearinghouse to identify mortgage brokers and companies whose licenses have been revoked or suspended in any State.

The goal of this recommendation is to prevent those engaging in predatory practices from being able to move from one jurisdiction to the next and continuing to prey upon vulnerable consumers while keeping one-step ahead of law enforcement authorities in prior jurisdictions.

This new Consumer Mortgage Protection Board could also be responsible for, among other things, reviewing all new and existing Federal regulations and proce-

dures relating to the mortgage origination process and make recommendations that will simplify and streamline the lending process and make the costs of the process more understandable to consumers. The Board could also be used to initiate and oversee public awareness media programs (described below) that will help consumers evaluate the terms of loan products they are considering.

Part III: Increasing Public Awareness and Improving Consumer Education

Consumer advocates have long advised industry and Government officials that certain consumers, particularly elderly seniors, were not able to clearly understand the loan terms disclosed in the innumerable disclosures provided to consumers during the mortgage process.

We recommend a three-step program to increase public awareness and improve consumer understanding of their loan obligation:

1. *Public Service Campaign.* Federal policymakers should implement an ongoing, nationwide public service campaign to advise consumers, but particularly the more vulnerable such as senior citizens and the poorly educated, that they should seek the advice of an independent third party before signing any loan agreements. Public service announcements could be made on radio and television, and articles and notices could be run in local newspapers and selected publications.

2. *Public Awareness Infrastructure.* Once alerted, consumers will need to be able to avail themselves of counseling services from unbiased sources. Those sources can always include family and friends and industry participants. In addition, however, a nationwide network should be put in place to ensure that all consumers can easily access advice and counseling to help them determine the loan product that best fits their financial needs. A public awareness infrastructure could be built out that would include 1–800 numbers with independent counselors, using sophisticated computer software, to help consumers talk through the loan product they are considering. In addition, programs could be developed with community organizations and other organizations serving senior citizens to provide on-site counseling assistance at local senior and community centers and churches. HUD's 800 number for counseling could be listed on required mortgage disclosures as an initial step to increase awareness of available advice.

3. *"Good Housekeeping Seal of Approval" for On-Line Mortgage Calculators.* The Joint Report on the Real Estate Settlement Procedures Act and Truth in Lending Act of the Board of Governors of the Federal Reserve System and the Department of Housing and Urban Development, issued in 1998 (Joint Fed/HUD Report) recommended that the Government develop "smart" computer programs to help consumers determine the loan product that best meets their individual needs. Since this idea was first discussed in the Mortgage Reform Working Group,[1] mortgage calculators or "smart" computer programs have become available online. Since these computer programs were already developed by the private sector and are widely available, a more appropriate role for the Government today would be for the Federal Government to approve a limited and unbiased generic mortgage calculator module that could be incorporated into any online site that helps consumers evaluate various loan products. (Legislation may be needed to advance this initiative. But there may be resources in agencies' current budgets that could be tapped to implement this recommendation.)

Part IV: Use Existing Federal Regulatory Authority to Stop Abusive Practices

Regulators may have existing authority to implement changes to existing regulations to prevent loan flipping and other questionable practices. Where such authority exists, action should be taken to change existing regulations. Regulators may also be able to use their rulemaking powers under existing law to implement some of the mortgage reform proposals discussed in Part V.

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[1] The Mortagage Reform Working Group (MRWG) was an *ad hoc* group, comprised of over 20 trade associations and consumer advocate organization, that was organized at the request of Former Congressman Rick Lazio (R–NY) with the goal of reaching a compromise on a conprehensive mortgage reform proposal that would streamline and simplify the mortgage process for consumers while simultaneously reducing the liability for the industry. While all parties did not reach an agreement, many of the recommendations that were developed in that process formed the basis for the recommendations made in the Joint Report issued by the Federal Reserve Board and the Department of Housing and Urban Development.

Part V: Comprehensive Mortgage Reform

The Joint Fed/HUD Report found that consumers do not understand the disclosures required by the current TILA and Real Estate Settlement Procedures Act (RESPA). There is widespread agreement that the mortgage loan origination process is overly complex and that the current legal structure is often an obstacle to improving that process.

Comprehensive mortgage reform would reduce confusion and improve competition, lowering prices for all consumers while discouraging predatory lending. The CMC has been at the forefront of industry efforts to reform and improve the laws and regulations governing the home mortgage origination process in this country. The mortgage reform that we, along with others in the industry, have advocated would directly address many of the weaknesses in current law that allow predatory lenders to operate. We note that some of these reforms can be achieved through regulatory changes while others will require legislation.

Some of the features of mortgage reform that bear directly on the predatory lending problem include:

- Early disclosure of firm closing costs, leading to greater certainty for consumers on closing costs and increased price competition for both loans and ancillary services required to make the loan. A common feature of most allegations of predatory lending is that the borrower was either confused or deliberately misled about the amount of closing costs that he or she would have to pay. The central feature of mortgage reform is a proposal that mortgage originators disclose to consumers the firm, not estimated, costs of the ancillary services needed to make the loan for which the consumer has applied. If the borrower receives a clear disclosure of firm closing costs early in the transaction, it will be more difficult for an abusive lender or broker to misrepresent the terms of the loan and the borrower will have time to seek financing from other sources if the terms are unfavorable.

  Offering guaranteed closing cost packages will not work without a corresponding exemption from Section 8 of RESPA for arrangements negotiated between the lender or mortgage broker and the providers of ancillary services whose costs are included in the firm closing costs disclosure. Thus, for example, lenders would be free to negotiate volume discounts or other pricing arrangements with their service providers without the restrictions of Section 8. If a lender or broker charged more than the total listed on the firm closing costs disclosure, other than those few items, such as taxes and *per diem* interest, which are not included in the disclosure, it would risk losing its Section 8 exemption. Under current law, the constraints imposed by Section 8 give lenders little incentive to reduce third-party closing costs.
- Simplified, understandable disclosures of key information about the loan. Mortgage reform would consolidate and highlight disclosures of the key terms of a mortgage credit product so that applicants could easily comparison-shop for loans. It would eliminate confusing disclosures such as the "Amount Financed," which has actually been used to mislead consumers about the true amount of the obligation. The disclosure of firm closing costs, noted above, would include any mortgage broker fee paid by the borrower.
- Proportional remedies so that lenders are the targets of less litigation over harmless or minor errors while consumers can be compensated for actual harms. The remedies in the mortgage reform proposal, in contrast to current law, are structured to ensure that the borrower receives a loan on the terms that were disclosed. Lenders that detect and correct errors quickly will not be penalized, while those that engage in knowing and willful violations will be penalized more severely than under current law.
- Substantive protections against loan flipping to protect the most vulnerable consumers from abusive loans. The focus of the mortgage reform effort is on reforming the mortgage process for all consumers, but we include an enhancement to the Home Ownership and Equity Protection Act (HOEPA) in the form of protections against loan flipping. Under the proposal, when making a HOEPA loan that refinances an existing mortgage loan and that is entered into within 12 months of the closing of that loan, the originator may not finance points or fees payable to the originator or broker that are required to close the loan in an amount that exceeds 3 percent of the loan amount. This limitation does not apply to voluntary items such as credit insurance, nor to taxes and typical closing costs for settlement services such as appraisal, credit report, title, flood, property insurance, attorney, document preparation, and notary and closing services provided by a third party, whether or not an affiliate.

  Limiting the financing of points will mean that borrowers would have to bring cash to closing to pay high points and fees. This will mean that borrowers of

HOEPA loans will be less likely to be "flipped" numerous times. Consistent with regulations adopted by the New York State Banking Department, the limit on refinancing points does not apply to typical third-party closing costs. Significantly, this restriction is not limited to refinances by the same lender and would thus apply to a much broader number of loans that may not be in the category of "flipped" loans. For this reason, it is appropriate that a reasonable amount of points and fees be eligible to be financed in order to meet real credit needs.

- Substantive protections affecting prepayment penalties. On non–HOEPA loans, no prepayment penalty would be permitted after 5 years from the date of the loan. However, prepayment penalties would be authorized during this 5 year period, notwithstanding State law. Any prepayment penalty permitted would be limited to a maximum of 6 months' interest on the original principal balance.
- Foreclosure reforms to provide additional protections to borrowers facing the loss of their home without reducing the value of lender's security interest in the property. Lenders and servicers have in recent years significantly changed their procedures for dealing with delinquent borrowers. Workouts, forbearance, and other loss mitigation tools are employed and foreclosure is increasingly seen as an expensive (for everyone) last resort. In addition to this business trend, we would support the enactment of a new Homeowner's Equity Recovery Act (HERA), which would apply at the time lender notifies consumer of consumer's default and rights under HERA.

  HERA protections would apply if the consumer's indebtedness (origination balance and interest, junior liens, etc.) is not more than 80 percent of the origination valuation. A consumer would have the right to list the property with a real estate broker or otherwise make a good faith effort to sell the property.

  We believe that the consumer protections made available through HERA strike a reasonable balance between the rights of lenders and investors for repayment of amounts owed and the consumer's right to "breathing room" if the consumer is attempting to resolve the default. However, we do not support the expansion of mandatory judicial foreclosure because it is costly both to the consumer and lender, and is too time consuming, which, among other things, puts the collateral at risk. In addition, we note that the Federal tax code (REMIC provisions), under which loans are sold to the secondary market, places limitations on types of compromise that a lender can offer to a defaulting borrower.
- Substantive protections affecting collection practices. Under the proposal, the prohibitions contained in Section 806 of the Fair Debt Collection Practices Act (FDCPA) concerning harassment and abuse would be extended to the collection of mortgage loan debts by a creditor or its affiliates. The law would be clarified to ensure that loan servicers that collect debts as part of their servicing function would not be treated as debt collectors.
- Federal preemption of State laws so that lenders can comply with a uniform set of disclosure requirements that will adequately protect consumers and result in lower costs to lenders and lower rates for borrowers. Imposing uniform laws and regulations ensures that consumers—across the Nation—are afforded the same protections. Preemption would also reduce the number of documents to be signed by consumers at closing. "Information overload" is an almost universal feature of complaints about predatory lending.

  Federal preemption is particularly important because the need for uniformity has never been greater. There has recently been a proliferation of State and local legislation to combat predatory lending practices. Although well-intentioned, these initiatives can be counterproductive because they can impose very high-costs on lenders in comparison to the potential number of loans affected.

  In one recent example, the city of Philadelphia enacted antipredatory-lending legislation that was so broad in its sweep that it threatened to cut off much legitimate, mainstream lending as well as the practices at which it was targeted. Last-minute legislative intervention at the State level was necessary to prevent this legislation from taking effect and shutting down most mortgage lending in Philadelphia.

  Another example of the unintended negative effects of State and local regulation has recently occurred in Chicago, where the city of Chicago, Cook County, and the State of Illinois have all enacted new laws aimed at preventing predatory lending. Name-brand, well-capitalized lenders and servicers are reluctant to put their capital and reputation at risk to make new loans in Chicago because of the risk that they could be found to be making predatory loans under one of the three, varying, and sometimes conflicting and/or unclear definitions (or under the Federal HOEPA).

If the Committee decides that clarification of the existing legislation prohibiting abusive practices is needed, we strongly urge that it create a single, nationwide standard that cannot be undermined by myriad local initiatives.

The CMC appreciates the opportunity to submit its views on the problem of, and appropriate responses to, "predatory lending." We look forward to working with the Committee on constructive, practical solutions to address abuse practices without restricting the availability of credit, reducing consumers' options, or burdening the efficient operation of the mortgage market.

DESCRIPTION OF SUBPRIME MARKET

(Tab 1)

Although the involvement of CMC's members in subprime lending varies, all CMC members share an interest in the efficient operation of the mortgage lending market. Subprime lending plays a crucial part in that market, allowing individuals who do not qualify for "prime" loans to make use of the equity in their homes to obtain credit at reasonable rates. As Comptroller of the Currency John D. Hawke, Jr., noted last year in a letter to this Committee—

> "One problem with the fact that 'predatory lending' is not susceptible to precise definition is that many people make the mistake of equating subprime lending to predatory lending. Responsible, risk-based subprime lending, that provides access to credit for individuals with less than perfect credit histories, should not, in and of itself, be considered predatory. The OCC encourages national banks to engage in responsible subprime lending, and has issued guidance to ensure that banks engaging in this type of business do so in a safe and sound manner and consistent with applicable consumer protection law."[2]

Legitimate subprime lending offers many benefits to consumers. A subprime home loan provides financial options to borrowers who cannot obtain prime loans because of problems with their credit history or for other reasons such as a reduction in income or other change in financial circumstances. Subprime credit gives such individuals a chance to buy a home. In other instances, the availability of subprime home-equity credit gives credit-impaired borrowers financial options that would not otherwise be available, including debt consolidation or other purposes.

The Subprime Mortgage Industry

Mortgages are the largest component of the U.S. debt market with over $5 trillion in outstandings. Total first mortgage origination volume in 2000 was over $1 trillion. Subprime mortgage lending accounted for approximately 13% of the entire mortgage industry's production in 2000.

Scale, capital and risk management requirements are driving rapid consolidation in the mortgage banking and servicing sectors of the industry. However, the mortgage origination business remains relatively fragmented.

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[2] Letter from John D. Hawke, Jr., Comptroller of the Currency, to the Honorable Phil Gramm, Chairman, Committee on Banking, Housing, and Urban Affairs, United States Senate, May 5, 2000.

Subprime Credit Borrowers and the Use of Subprime Credit

Subprime borrowers are like any other borrowers in the U.S. economy. In fact, a study of nearly one million subprime and manufactured housing loans originated in 1998 shows a racial and ethnic borrower profile similar to the racial and ethnic composition of the total U.S. population.[3]

As practiced by mainstream lenders, including those CMC members who participate in the subprime market, subprime lending is also not conceptually different from lending to "prime" borrowers. The process begins when the borrower identifies a need for financing, either for a home purchase or for cash for other purposes. Although a significant portion of subprime loans are made to finance the purchase of a home, the proportion is lower than for prime loans.[4]

More frequently, a subprime borrower will seek cash to consolidate existing debt—the most common use of subprime credit. Home equity financing often allows the borrower to reduce monthly payments dramatically, allowing an overextended consumer to gain control of his or her budget. In addition, subprime loans carry significantly lower interest rates than other forms of credit. Although subprime loans average about 250 basis points (2.5 percentage points) above prime loans, at around 9.5%-10% they are still much less expensive than credit cards and other sources of credit (when those alternative sources are even available to credit-impaired borrowers).

Other common uses of subprime home equity loans include—

- Financing a college education;
- Paying medical bills;
- Providing alternatives for homeowners who fall behind on their mortgage payments; and
- Home improvement and repair.

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[3] An April 2000 SMR Research study of 1998 HMDA data.

[4] An April 2000 SMR Research study of 1998 HMDA data showed the following distribution of loans by loan purpose:

Purchase	Refinancing	Home Improvement	Total
Subprime loans			
197,917	661,876	94,116	953,909
20.75%	69.39%	9.87%	100.00%
Prime loans			
3,968,766	5,863,187	819,393	10,651,346
37.26%	55.05%	7.69%	100.00%

Subprime Credit Grades

In the mortgage industry, loans are graded from "A" (a prime loan) to "D" (the riskiest subprime loan). An "A" loan is a "prime" loan, or a loan of the highest credit value. Typical factors that determine a consumers credit grade are:

- Mortgage delinquency history
- Consumer debt delinquency history
- Bankruptcy or foreclosure
- Collection or judgments
- High debt-to-income ratios
- High loan-to-value ratios
- Low credit risk scores

Although the definitions of the subprime grades are neither precise nor completely uniform throughout the industry, the following examples convey the general concept of credit grading:

- A homeowner who filed for bankruptcy two years ago due to mismanagement of credit and was sixty days late on his current mortgage may qualify for a "B-" credit grade;

- A borrower who was laid off and had to accept a lower-paying job, and, as a result, was occasionally thirty days late in making her mortgage payment may qualify for an "A-" credit grade; and

- A widow who has an excellent credit record but has had difficulty in paying outstanding medical and home repair expenses and needs cash for her son's college education may qualify for a "B" credit grade. In this example, the subprime credit grade is based on income compared to total amount of debt, rather than on credit history.

SPECIFIC PRACTICES OFTEN LABELED "PREDATORY"

(Tab 2)

In this section we discuss a number of practices that have been attacked as "predatory."[5] As the Board of Governors of the Federal Reserve System has noted, there are two types of abusive practices in home equity lending—blatant fraud or deception, and the use of practices that are not inherently abusive but can be misused to injure consumers:

> "[A]busive practices in home-equity lending take many forms but principally fall within two categories. One category includes the use of *blatantly fraudulent or deceptive techniques* that may also involve other unlawful acts, including violations of HOEPA [the Home Ownership and Equity Protection Act]. These practices occur even though they are illegal. For example, loan applicants' incomes and ability to make scheduled loan payments may be falsified, consumers' signatures may be forged or obtained on blank documents, or borrowers may be charged fees that are not tied to any service rendered. The other category of abuses involves various techniques used to manipulate borrowers, *coupled with practices that may ordinarily be acceptable but can be used or combined in abusive ways*. . . . [S]ome loan terms that work well for some borrowers in some circumstances may harm borrowers who are not fully aware of the consequences. For example, a consumer may not understand that a loan with affordable monthly payments will not amortize the principal or that the consumer may have to refinance a balloon payment at additional cost."[6]

Fraud and Deception

Predatory lenders who are disregarding existing legal requirements—including, in many cases, prohibitions against fraud and forgery that predate current consumer protections by many centuries—will not be deterred by additional rules. Instead, public policy should focus on more effective and sophisticated enforcement of those existing requirements. Examples of "predatory" practices that are prohibited under current law include the following:

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[5] This list of alleged predatory lending practices is largely drawn from Patricia Sturdevant and William J. Brennan, Jr., *The Double Dirty Dozen Predatory Mortgage Lending Practices* (National Association of Consumer Advocates, Inc. 2000).

[6] Testimony of Gov. Edward M. Gramlich before the Committee on Banking and Financial Services, U.S. House of Representatives (May 24, 2000) (emphasis added).

Misleading Solicitations

Advertising and marketing material may mislead consumers about the true cost or nature of a loan. These marketing practices are already prohibited under the Federal Trade Commission Act and analogous state laws. In many instances, deceptive solicitations also violate the Truth in Lending Act.

Home Improvement Scams

A home improvement contractor may originate a mortgage loan to finance the home improvements and sell the loan to a lender, or steer the homeowner to the lender for financing. The contractor may mislead the consumer about the work to be performed, fail to complete the work as agreed, damage the property, or fail to obtain required permits.

Current law prohibits all of these practices. In addition, under the Federal Trade Commission's "Holder in Due Course Rule," similar state law provisions, and HOEPA (for HOEPA loans), the lender will generally subject to the same claims and defenses that the consumer has against the contractor (up to the amounts that the consumer has paid on the contract). Thus, if the work is not completed in a satisfactory manner, the consumer will not be responsible for full payment.

As a result of this exposure, subprime mortgage lenders use devices such as joint proceeds checks and progress payments to ensure that home improvement contractors perform the work properly. We would recommend that all lenders these practices.

Falsified or Fraudulent Applications; Forgery of Loan Documents; and Inflated Appraisals

An unscrupulous broker or lender may convince an unsophisticated borrower who cannot repay a loan to sign a blank application form. The broker or lender then inserts false information on the form, claiming income sufficient to make the payments, and sells the loan to an investor on the basis of the false information. Alternatively, the "predatory" broker or lender may simply forge the borrower's signature. Another fraudulent practice is for the broker or lender to collude with a corrupt appraiser to deliver an appraisal that exceeds the true value of the property. The investor then purchases the loan on the basis of the inflated appraisal.

All of these practices have two things in common—

- They are illegal under current law; and
- The investor is a victim along with the borrower, since the loan will eventually default and the investor will lose most or all of its investment.

Although legitimate, mainstream lenders maintain extensive procedures to avoid being caught in scams of this type, they are sometimes victimized by fraud by "predatory lenders." We recognize that more can be done—CMC's plan for addressing predatory

lending includes the creation of a nationwide registry that would report on licensing status and disciplinary actions, so that brokers and companies who are caught engaging in fraud in one jurisdiction could not simply relocate to another area.

Incapacitated Homeowners

There have been allegations that predatory lenders make loans to homeowners who are mentally incapacitated. Since the homeowner does not understand the nature of the transaction, the end result is default and foreclosure.

Under long-standing contract law principles, a mortgage loan in which the borrower was incapacitated at the time of signing is unenforceable. Entering into such a transaction may also represent civil or criminal fraud.

As noted, subprime lenders are not in the business of making loans that are likely to default, and major lenders maintain procedures to avoid originating or purchasing loans in which the borrower lacks the legal capacity to enter into a contract.

Acceptable Practices That Are Subject to Abuse

The second type of alleged predatory lending consists of practices that are not illegal or unacceptable but may harm consumers when used in abusive ways.

Mortgage Broker's Fees and Kickbacks (Including Yield Spread Premiums)

A prominent target of critics of "predatory lending" has been the yield-spread premium —compensation paid to the broker through an increase in the interest rate. Yield spread premiums have been the subject of extensive class-action litigation in which plaintiffs have argued that this form of compensation is illegal under the prohibitions in RESPA against kickbacks and fee-splits.

Yield spread premiums can be helpful to consumers. Paying a yield spread premium allows a lender to reduce the cash required to close the loan by financing closing costs through a higher interest rate. A borrower who understands the cost of the loan can choose between paying more of these costs upfront or over the course of a loan.

The appropriate remedy for any abuses of yield spread premiums is not to prohibit a practice that often benefits consumers. It is to provide more effective disclosures and improve the competitive environment so that consumers can make informed choices that serve their interests. If consumers understand their closing costs, including the broker's fees they are to pay, before they commit themselves to a transaction and lenders are allowed to compete in providing ancillary settlement services, the broker's receipt of a yield spread premium is irrelevant to the consumer's shopping decision. Importantly, we note that the Mortgage Bankers Association of America and the National Association of Mortgage Brokers have encouraged the use of a form, developed jointly by those organizations, that explains the broker's role.

Prepayment Penalties

Another practice that is often criticized as "predatory" is the imposition of a prepayment penalty—a fee for paying off the loan before some specified time. In most instances, the penalty is reduced over time until it is finally phased out completely.

Legitimate lenders use prepayment penalties to protect themselves against the risk that the borrower will prepay the loan before the lender has recovered its origination costs. A prepayment penalty is one way for a lender to hedge against that risk as well as other financial risks that can occur from early prepayment of the loan. The benefit of reduced prepayment risk can be passed on to the borrower in the form of lower points or a lower interest rate. If a lender is not allowed to impose a prepayment penalty, then it may not be able to offer a zero- or low-closing-cost loan or it may have to increase its rates to be profitable.

On the other hand, an unscrupulous lender can use a prepayment penalty to lock a consumer into an undesirable loan. The CMC believes that the appropriate remedy for the "predatory" abuse of prepayment penalties is to ensure that borrowers understand that a loan with a prepayment penalty is an option that allows them to reduce their interest rate or upfront costs, not a requirement to obtain the loan. In addition, under the CMC's mortgage reform proposal, no prepayment penalty would be permitted after five years from the date of the loan. However, prepayment penalties would be authorized during this five-year period, notwithstanding state law. Any prepayment penalty permitted would be limited to a maximum of six months' interest on the original principal balance.

Making Unaffordable Loans (Asset-Based Lending)

Another common allegation is that predatory lenders make loans on the basis of the value of the property, disregarding the borrower's ability to pay and in fact anticipating that the borrower will default and the lender will foreclose.

CMC members and other responsible subprime lenders are not in the business of making loans that borrowers cannot repay. Foreclosing on a house is costly, time-consuming, and almost always results in significant losses to the lender. As discussed in greater detail under Tab 3, many subprime loans are now sold into the secondary market, and the rating agencies insist that such loans meet underwriting standards.

For those reasons, the CMC supports, in principle, the existing HOEPA rule against engaging in a pattern or practice of lending without regard to repayment ability. In practice, however, it is difficult to craft specific rules to prevent such "asset-based" lending that reliably apply to all situations. Attempts to specify static rules regarding each borrower's repayment ability are likely to be counterproductive and injure the very borrowers they are intended to protect. For example, one common proposal is to establish a presumption that a borrower with a debt-to-income ratio ("DTI") above a certain cutoff, such as 50%, lacks repayment ability. This rule seems to make sense until a lender encounters a borrower who currently is meeting her obligations with a DTI of 65% and wants a loan that would reduce her DTI to 55%. Moreover, a DTI that indicates

an excessive debt load in a rural area may reflect the average in areas such as New York City or San Francisco with very high housing costs.

In addition, setting a cutoff for DTI at any particular level ignores differences in borrowers' circumstances that affect the debt load they can carry. At one extreme, an individual with a very high income, $1 million/year for example, and few family obligations can easily afford to make high monthly payments and still have enough to meet other living expenses. At the other extreme, a borrower with a low level of income and many dependents may not be able to make mortgage payments that represent a high fraction of his or her income.

Another proposed remedy for asset-based lending is to institute "suitability" rules that create lender liability for making an individual loan if, in hindsight, the lender should have anticipated that the borrower would default. For a mainstream subprime lender that already makes every effort to avoid making loans that go into default, the effect of such a rule will be to increase the costs of foreclosure by requiring the lender to absorb both the losses on the loan itself and the cost of settling the claim that it made an unsuitable loan. These costs will ultimately be passed onto borrowers in the form of higher loan costs or reduced credit availability.

High Points and Fees: Padding Closing Costs; Inflated Appraisal Costs; Padded Recording Fees; Bogus Broker Fees; and Unbundling (Double-Charging for the Same Service)

One of the major sources of criticism of and litigation against the subprime lending industry has been fees paid to mortgage brokers and to other participants in the mortgage process such as appraisers. For example, critics allege that lenders overpay mortgage brokers in comparison to the services the brokers provide or require an expensive appraisal when a "drive-by" evaluation would suffice. Critics also note that the actual amount of these costs (as opposed to an estimate) is not disclosed in advance of settlement, when the borrower still has the opportunity to shop for a better deal or negotiate an improvement in the current one.

Although the CMC agrees that borrowers should not have to pay for services that are not needed or not provided, we believe that a focus on the specific components of the cost of the mortgage is misplaced. Ultimately, the borrower is concerned with total costs (closing costs and interest rate) and not with the relationship among the different providers of settlement servicers or the cost of each individual component of the loan.

The CMC also agrees that present disclosure requirements do not give borrowers accurate and understandable information about the costs of obtaining a loan when they are in a position to use it. In some instances, current requirements may actually have facilitated abuses—as when an unscrupulous lender allegedly misrepresented the TILA-required "amount financed" (which does not reflect loan fees deducted from the proceeds) as if it were the total amount of the loan.

But the CMC believes that it is ineffective to combat excessive loan fees through ever-increasing scrutiny of the practices of settlement service providers and the relationships among them. A more sensible approach—the one taken in the CMC's mortgage reform proposal—would be to eliminate the disincentives in current law that prevent mortgage originators from offering a single, guaranteed price for all settlement services, and then impose a requirement mortgage originators to honor that commitment. Borrowers have no way of knowing what a service such as an appraisal or flood certification "should" cost, yet current law has created an elaborate system of disclosure and monitoring of such costs that is of very little value to most consumers.

Credit Insurance

Consumer advocates often assert that credit insurance products are of little or no benefit to consumers. In fact, while credit insurance is clearly not a good choice for all consumers, lender-provided credit insurance meets a consumer demand that is not met elsewhere in the marketplace. Independent insurance agents are often not interested in providing insurance to subprime borrowers in the relatively small amounts characteristic of a second mortgage loan. In addition, the liberal eligibility standards and convenience of purchasing the insurance are attractive to some subprime customers.

An unscrupulous lender can abuse the credit insurance product by selling it to a consumer who does not want or need it, based on the misrepresentation that insurance is required to obtain a loan. But a recent report on subprime lending shows penetration rates for single-premium credit insurance ranging from 28.3% for first-mortgage loans to 47.9% to second mortgages.[7] These statistics do not support the common assertion that credit insurance is being foisted on unwilling consumers.

Moreover, abusive credit insurance practices are illegal under current law. TILA currently permits a creditor to exclude credit insurance from the finance charge and annual percentage rate only when the lender discloses in writing that it is voluntary and the consumer consents to the purchase by signing or initialing the disclosure form.[8] Misleading consumers about credit insurance would also violate the Federal Trade Commission Act and similar state laws.

Voluntary credit insurance helps to address the an unmet demand for life and disability insurance. About 25% of all U.S. households have no life insurance coverage, and about 40% of single-parent households and households with annual incomes below $35,000 are completely uninsured. About 50% of all households are uninsured. The Department of Housing and Urban Development estimates that 46% of all foreclosures on conventional mortgages are caused by borrower disability and that 33% of Americans will suffer a serious disability between ages 35 and 65.

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[7] *See* Michael E. Staten and Gregory Elliehausen, *The Impact of The Federal Reserve Board's Proposed Revisions to HOEPA on the Number and Characteristics of HOEPA Loans* at 12 (July 24, 2001).

[8] 12 C.F.R. § 226.4(d).

Single-premium credit insurance—in which the cost of the insurance is financed as part of the total cost of the loan—has been particularly controversial. Several CMC members and other large lenders have recently modified their sales policies in response to concerns about the marketing of this product, by, for example, offering a monthly-premium product as an alternative and instituting a liberal cancellation policy. It should be noted, however, that the single-premium product has advantages for some consumers. For example, the consumer does not face cancellation of the policy if he or she misses a single payment—a consideration for some subprime borrowers.

The CMC's mortgage reform proposal, discussed above, includes a number of other protections related to credit insurance. There would be clear and conspicuous disclosure given to the consumer that the insurance is voluntary and that it may be cancelled at any time with a refund of unearned premiums. Monthly-pay insurance could also be sold at or before closing. In both situations, there would be a notice after closing that the borrower may cancel the insurance at any time. Refunds of unearned premiums would be based on the actuarial method, not the less favorable Rule of 78's.

Loan Flipping

Loan flipping is the practice of an unscrupulous broker or lender repeatedly convincing the borrower to refinance in order to get a small amount of cash back. The broker or lender then receives additional points and fees. Consumer advocates often argue that it would be better for the consumer to take out a second, junior loan than to refinance the entire obligation. While that may be true in many instances, there are other situations in which the rate and terms on a new first mortgage are more desirable than the combination of retaining the existing first mortgage and obtaining a new second mortgage.

Loan flipping is another example of a practice that is easy to condemn in theory but difficult to prevent through a single rule that can be applied to all situations. One approach, taken in several state anti-predatory laws, is to require a demonstrated "net benefit" to the borrower before the same lender can refinance a loan. The difficulty in this approach is its subjectivity, which could leave lenders exposed to litigation if they could not demonstrate an adequate net benefit.

The CMC's mortgage reform proposal would limit the financing of closing costs and points on HOEPA loans to 3% of the loan amount for refinancings or equity loans entered into within twelve months of a prior financing. The rationale for this approach is to reduce the lender's incentive to flip HOEPA loans. Borrowers who must bring cash to closing to pay costs over the 3% are less likely to be "flipped" numerous times. At the same time, the CMC believes that 3% should be sufficient to allow for refinances to take advantage of declining interest rates.

Arbitration Clauses

Many consumer credit contracts—including many subprime mortgages—include a provision requiring that disputes be resolved through arbitration rather than through the lengthy process of litigation in the courts. Consumer advocates have asserted that binding arbitration clauses are inherently unfair, and there is no question that such a clause could be abused by erecting insuperable obstacles to a consumer's obtaining relief. But the U.S. Supreme Court has upheld the use of such clauses even when the case involves "claims arising under a statute designed to further important social policies," so long as the consumer can vindicate the rights granted under the law before the arbitrator.[9]

The Supreme Court noted in another case that arbitration benefits consumers in many ways:

> "[A]rbitration's advantages often would seem helpful to individuals, say, complaining about a product, who need a less expensive alternative to litigation. See, *e.g.*, H.R. Rep. No. 97-542, p. 13 (1982) ('The advantages of arbitration are many: it is usually cheaper and faster than litigation; it can have simpler procedural and evidentiary rules; it normally minimizes hostility and is less disruptive of ongoing and future business dealings among the parties; it is often more flexible in regard to scheduling of times and places of hearings and discovery devices . . .').''[10]

In place of long, drawn-out proceedings in which the attorneys' fees often dwarf any nominal amount received by consumers, an arbitration clause offers consumers speedy access to a neutral forum that can resolve their dispute with the damages being paid to the consumer, rather than attorneys. The one group that clearly does not benefit from reasonable arbitration clauses in consumer contracts is the class-action trial bar.

Balloon payments and Negative Amortization

Consumer advocates often characterize two loan structures—*balloon payments* and *negative amortization*—as types of predatory lending. In a balloon payment loan, the monthly payments do not fully amortize the amount of the loan, resulting in a large final payment. In negative amortization, the monthly payments are insufficient to pay the interest that accrues on the loan, and the difference is added to the principal. Balloon payments are restricted and negative amortization is prohibited under HOEPA.

We recognize that both of these structures can be used in an abusive manner. If the broker or lender misleads the borrower about the nature of a balloon loan or the final payment is due in an unreasonably short time, the homeowner may not be able to afford the balloon payment and may either lose the home or be forced to refinance on

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[9] *Green Tree Fin. Corp. v. Randolph,* 531 U.S. 79, 90, 121 S.Ct. 513, 521 (2000).

[10] *Allied-Bruce Terminix Cos. v. Dobson,* 513 U.S. 265, 280, 115 S.Ct. 834, 843 (1995).

unfavorable terms. A borrower who does not understand the nature of negative amortization may face similar negative consequences.

At the same time, both of these loan structures can be helpful to some consumers. Balloon payments can benefit borrowers by allowing them to obtain lower-cost credit than they would otherwise qualify for. A balloon note can be particularly helpful to a borrower who expects to move to a new location within the period of the balloon mortgage. Such a mortgage would be less expensive than a fixed-rate, long-term mortgage loan for the consumer.

Negative amortization, by definition, reduces the monthly payment and may make a loan more affordable to a borrower with significant equity but insufficient income to qualify for a standard loan. Congress has recognized the benefits of one form of negative-amortization loan—the reverse annuity mortgage—by exempting such loans from the general prohibition against negative amortization in HOEPA.

Thus, further blanket restrictions on these loan structures, while protecting some consumers, could prevent others from obtaining loans that fit their financial circumstances.

MORTGAGE LENDING AND SERVICING PROCESS

(Tab 3)

In this section of our testimony, we describe the mortgage origination, funding and servicing process, its participants and the compensation each receives.

Mortgage Origination

Application Processing

In some instances, the borrower seeks out the source of financing, or responds to direct mail or other direct marketing. In others, the borrower is referred by a real estate broker or home improvement contractor. In both prime and subprime lending, there are two major distribution channels for distributing mortgage credit:

- In the *retail* channel, the lender offers mortgage loans directly to borrowers, through a sales force of loan officers. Loan officers are employees of the lender/servicer who counsel the applicant, take and process the application, obtain verification documents, order the appraisal of the property, and prepare the loan for *underwriting* (evaluation).

- In the *wholesale* channel, the lender does not deal directly with the consumer. Instead, the lender and consumer work though an intermediary.

  The types of intermediaries in the wholesale channel include the following:

- A *mortgage broker* is usually an independent contractor that offers loan products from a number of wholesale lenders. The mortgage broker generally does what the loan officer does (described above), i.e., discusses loan options with the borrower, takes an application, and usually processes the loan—obtains a credit report and appraisal, verifies employment and assets, and otherwise prepares the loan for underwriting.

- A *correspondent lender* not only takes the application and processes the loan, but also funds the loan. The correspondent then sells the loan to a wholesale lender, usually under a previous commitment of the wholesaler to purchase a certain amount of loans at an agreed-upon interest rate.

- A *home improvement contractor* may act as, in effect, the originating lender, taking an installment sales contract in payment for the goods and services provided and then discounting (selling) the contract to a lender. In that situation, the application is usually processed and underwritten by a mortgage broker or mortgage banker.

Underwriting

Historically, the next step after taking and processing the application was for the lender to *underwrite* (evaluate and approve or reject) the application. With the advent of credit scoring and automatic underwriting systems, much of the evaluation of an applicant is now accomplished during the application stage, but loans are still subject to final underwriting approval by the lender, including the underwriting of the property to be used as collateral for the loan.

There are a number of factors used to assess risk. Typically, they include:

- Credit-Related Factors
- Mortgage or Consumer Debt Payment History
- Bankruptcies, Foreclosures or Judgments
- Borrowing Capacity Factors
- Debt-to-income ("DTI") requirements (the borrower's debt load, including the proposed loan, compared to his or her income)
- Loan-to-Value ratio (the amount of the proposed loan compared to the appraised value of the property)
- Non-standard Collateral
- Mixed-use commercial/residential properties

Closing

Once the loan has been underwritten and approved, the closing is scheduled. The lender generally has certain conditions to closing which must be met, including assurance that (i) the borrower has clear title to the property (through title insurance), (ii) the borrower has other required insurance on the property, such as flood insurance or property and casualty insurance, and (iii) the borrower has sufficient funds to close the loan. At the closing, the borrower executes the mortgage note evidencing the debt and the mortgage on the property in exchange for the closing proceeds. Funds for points and closing costs, payable by the borrower to the lender, the mortgage broker or correspondent, or third party settlement service providers, are collected either directly from the borrower or from the loan proceeds.

Funding: Holding the Loan In Portfolio or Selling into the Secondary Market

After the loan has been underwritten and closed, the lender will either hold the loan in its portfolio or to sell it in the *secondary market* either in a *securitization* or a whole loan sale. If the loan is held in portfolio, the lender is effectively the investor in

the loan. In a securitization, a pool of loans is used to back an issuance of securities to be traded in the securities market, or an undivided interest in the loans themselves is sold to investors. There are costs to the lender in the execution of both a whole loan sale and an issuance of mortgage-backed securities.

Mortgage-backed securities are first analyzed and rated by an independent bond-rating agency such as S&P or Moody's. The rating agency's evaluation includes computation of the average credit scores of the loans in the pool to be securitized as well as a due diligence review of the lender's procedures. The lender will generally have to promise that proper underwriting procedures were followed. If it fails to keep that promise, the investors will often have the right to force the lender to repurchase the loan in the event of default.

Even when a lender expects to retain a loan in portfolio rather than sell it into the secondary market, prudent risk management dictates that the lender complies with appropriate underwriting criteria to ensure that the borrower can afford to repay the loan.

Investors, whether they be secondary market investors or portfolio lenders will only make a return on their investment if the loans that they fund perform.

Servicing

Whether the loan is held in the lender's portfolio or sold in the secondary market, the loan must be serviced, that is, the monthly payments must be collected, payments must be passed through to the investor, and delinquencies, defaults, bankruptcies and foreclosures must be dealt with, as they arise. On first mortgage loans, the servicer must collect funds for tax and insurance escrow accounts and disburse those funds to the taxing authorities and insurance companies, in accordance with state and federal law and the mortgage contracts. Second lien loans generally do not involve escrow accounts.

Except for correspondent lenders, lenders often retain the servicing responsibilities on loans they make and fund. Sometimes they conduct the servicing functions through a contractor in a "subservicing" arrangement. In other cases, they will sell the servicing rights (including the rights to servicing fees) and responsibilities to another servicer.

Compensation

Compensation to Brokers and Correspondent Lenders

The mortgage broker or correspondent may receive its compensation for the borrower, the lender, or both. Compensation by the borrower, if any, is in the form of points or an application fee, an origination fee, or a broker fee.[11] All or part of the application fee may be used to pay for the credit report and appraisal. Compensation paid

[11] Some originators also charge a lock-in fee for locking-in an interest rate for the borrower.

by the lender reflects the difference between the retail rate charged to the borrower and the lender's wholesale rates. When a correspondent lender sells a loan to a wholesaler, the price reflects this compensation and may exceed the amount that the correspondent lender advanced to the borrower. When a mortgage broker brings a loan to a lender, the lender may pay a "yield spread premium" that is equivalent to the difference in value between a loan at the retail rate and one at the wholesale rate.

The points and fees paid to a mortgage broker or loan correspondent cover the costs of processing the application and underwriting a subprime loan. These costs are generally higher than for prime lending, for several reasons:

- First, by definition, a subprime borrower is likely to have issues that must be resolved through manual verification. For example, the borrower's explanations for late payments or for a reduction in income must generally be independently verified—an expensive, hands-on process.

- Second, subprime loans tend to be for somewhat lower amounts than prime loans, thus the cost per loan tends to be proportionally higher.[12] Many processing and underwriting costs are fixed regardless of the size of the loan.

- Third, as "lenders of last resort," subprime lenders receive a much higher proportion of applications from applicants who do not qualify even for subprime loans. Accordingly, subprime lenders have much higher rejection rates than do prime lenders.[13] Brokers and lenders generally do not recover the cost of processing rejected applications through fees charged to rejected applicants and must make up some of those costs through revenues from approved loans. Thus, the cost of processing loan applications that are eventually denied raises per-loan processing and underwriting costs on approved subprime loans.

As noted, in the wholesale loan market, the mortgage broker or correspondent lender bears many of these processing and underwriting costs. The broker or correspondent also has advertising and marketing costs that would otherwise be borne by a retail lender. Either the borrower or the lender, or both, must compensate the broker or lender for these expenses.

Compensation to Lenders/Servicers

Lenders who originate loans through a retail channel receive compensation from borrowers in the form of am application fee, a lock-in fee if applicable, and points and fees paid at closing. In addition, if a lender sells the loan in the secondary market, it will

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[12] According to the same study, 1998 HMDA data show that subprime lenders had an 11.25% share of the total mortgage market in terms of number of loans, but only 8% of the dollar volume.

[13] The study of 1998 HMDA data showed denial rates for subprime lenders of 50.0% in purchase loans, 59.5% in refinances, and 69.1% in home improvement lending. Comparable figures for prime lenders were 11.8% in purchase-mortgage lending, 13.6% in refinances, and 33.2% in home improvement lending.

receive some compensation on the execution of that sale, whether in a whole loan sale or a securitization.

The compensation a lender receives from the borrower through fees and through a secondary market sale often do not fully cover, or cover only by a small margin, the costs of originating and, if applicable, transferring the loan. Thus, the lenders' profits come principally from its servicing earnings, and there is a great incentive for the servicer to do everything it can to keep the borrower paying the loan on time. Defaults interrupt the servicer's income until the borrower resumes making payments. A foreclosure not only stops the income, but it results in the added costs of prosecuting the foreclosure. Not all of these costs are entirely reimbursed by the investor. In fact, foreclosures are costly, time-consuming, and almost always result in large losses to the lender/servicer.

Servicing income is also the principal component of earners for subprime lenders/servicers. The upfront fees are higher because originating a subprime loan is more costly. Upfront fees are also higher because lender/servicers need to defray the higher origination costs to compensate for the shorter period over which these loans will be serviced. Subprime loans refinance more quickly because borrowers, as they become qualified for prime loans, refinance into a prime loan product. Moreover, subprime loans have higher default rate and are more expensive to service. Those additional costs need to be built into the price charged to consumers. Nonetheless, subprime servicers have the same very high incentive to do everything they can to keep the borrower paying the loan. Conversely, they have no incentive whatsoever to get the borrower into a loan that he or she cannot afford to repay. Nor do they have an incentive to get the borrower into a loan with a very high interest rate that is more likely to refinance more quickly. In either case, the servicing income on that loan comes to an end.

Compensation to Investors (Portfolio Lenders or Secondary Market Investors)

Investors earn the interest paid on the loan by the borrower over the life of the loan, minus the fraction of a percent that is paid to lender/servicers that service the loan. Like lender/servicers, mortgage market participants that fund loans, whether they are portfolio lenders or secondary market investors, do not have an economic incentive to fund loans at above market interest rates because those loans will refinance more quickly. (Of course, consumers have the choice of agreeing to a lower market interest rate if they agree to a prepayment penalty.)

Like lender/servicers, investors earn money when consumers are provided loans they can afford to repay over time.

July 27, 2001

The Honorable Paul Sarbanes
Chairman
Senate Committee on Banking, Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Sarbanes:

On behalf of its more than 19,000 members, I am pleased to submit the testimony of the Appraisal Institute to the Senate Banking, Housing and Urban Affairs Committee on the issue of Predatory Mortgage Lending: The Problem, Impact and Responses. Today and throughout its nearly 70-year history, the Appraisal Institute is the leading organization for professional real estate appraisers. Through its extensive educational programs, the Appraisal Institute's members are skilled in the latest methods of real estate valuation for commercial and residential properties. Reflecting their unbiased and objective approach to real property appraisal and analysis, members of the Appraisal Institute adhere to a strictly enforced Code of Professional Ethics and Standards of Professional Appraisal Practice. Appraisal Institute members hold the prestigious MAI, SRPA and SRA designations.

While the vast majority of appraisers perform their assignments ethically and properly, some have been party to faulty or fraudulent mortgage transactions. When an appraiser is involved in a premeditated property-flipping scheme, or has unwittingly been part of a fraudulent transaction, the Appraisal Institute is concerned for the victims and the economic consequences. This testimony will call your attention to a number of deficiencies within the real estate appraisal regulatory structure that allow bad actors to be involved in mortgage fraud, both in the conventional mortgage market and in the government-assisted market.

Current Appraisal Regulatory Structure

The Savings and Loan crisis of the 1980s led Congress, in August 1989, to enact the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, better known as FIRREA or the "Savings and Loan Bailout Bill." Title XI of FIRREA, the "Real Estate Appraisal Reform Amendments," was targeted at solving appraisal-related problems. In general, Title XI required federally regulated financial institutions to use state-certified or

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licensed appraisers to perform appraisals in connection with federally related transactions. Of prime importance in this testimony is the fact that FIRREA requires the independence of an appraiser in a mortgage transaction, which will be discussed in more detail later in this testimony.

Title XI created a unique, complementary, yet complicated relationship between the states, the private sector, and the Federal government. Title XI recognized that the states were in the best administrative position to certify and license real estate appraisers and to supervise their appraisal-related activities. At the same time, Title XI authorized the private sector — a private not-for-profit organization, The Appraisal Foundation (and its two independent boards, the Appraiser Qualifications Board and the Appraisal Standards Board) — to establish uniform minimum appraiser qualifications and uniform standards of practice, which would be enforced by the states.

Title XI then created the Appraisal Subcommittee (ASC) of the Federal Financial Institutions Examination Council to oversee the activities of the states and The Appraisal Foundation. State certified and licensed appraisers fund the ASC operations and a portion of the Title XI-related functions of The Appraisal Foundation through a $25 annual fee assessed by the states. This fee is passed through to the ASC, which has amassed a sizable reserve of funds.

Title XI also authorized the Federal financial institutions regulatory agencies — the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Office of Thrift Supervision, and National Credit Union Administration — to adopt regulations regarding real estate appraisals made in connection with federally related transactions, including: when appraisals are required, who must perform the appraisals and the manner in which appraisals must be performed.

The Appraisal Foundation

The Appraisal Foundation is a private, not-for-profit corporation charged by Title XI with the responsibility of establishing, improving and promoting minimum uniform appraisal standards and appraiser qualifications criteria. The Foundation serves as the parent organization for two independent boards established to accomplish this mission: the Appraisal Standards Board (the ASB) and the Appraiser Qualifications Board (the AQB). These boards respectively promulgate and maintain the Uniform Standards of Professional Appraisal Practice (USPAP) and the Appraiser Qualifications Criteria. The Foundation is directed by a board of trustees, which appoints members to and provides financial support for the AQB and the ASB.

The work of The Appraisal Foundation is important to the appraisal profession, the financial and real estate industries, and to the consumer public. The Foundation's work benefits the appraisal profession by standardizing the appraisal process and thus increasing the quality of appraisals, and by addressing issues critical to the advancement of professional valuation.

The AQB establishes minimum criteria for state certification of appraisers, and the ASB sets forth the rules for developing an appraisal and reporting its results. FIRREA requires that real estate appraisals used in conjunction with federally related transactions be performed in accordance with USPAP. These standards contain the recognized standards of practice for real estate, personal property and business appraisal. More than 80,000 state-certified and licensed appraisers are currently required to adhere to USPAP, the authority of which extends beyond FIRREA in states that made licensing mandatory for all appraisers. In those states, all appraisers are subject to USPAP. Since 1992, the Office of Management and Budget (OMB) has required federal land acquisition and direct lending agencies to use appraisals in conformance with these standards.

State Appraiser Regulatory Agencies

All state-certified appraisers must meet the AQB criteria, as imposed by the state appraiser regulatory agencies. In addition, state appraiser certification and licensing laws require certified and licensed appraisers to conform to USPAP when performing appraisals in connection with federally related transactions. USPAP is then used as the basis for enforcement actions.

Each state or territory has an appraiser regulatory agency, which is responsible for certifying and licensing real estate appraisers and supervising their appraisal-related activities, as required by federal law. Each appraiser regulatory agency is charged with licensing and certification requirements as well as oversight and enforcement over appraisers. These agencies are a part of the state regulatory structure, funded by the state legislature and appraiser licensing and certification fees, and are often found in the state departments of commerce or licensure and certification.

Regulatory Deficiencies

The regulatory structure for real estate appraisers is unique and very complex. It involves numerous boards and agencies at the state and federal level, all acting together to license, certify and provide oversight and enforcement of existing standards requirements and federal and state laws. Because the system is so complicated, it is ripe for loopholes and deficiencies.

The Appraisal Institute continually looks for these deficiencies and attempts to correct them through discussions and activities with the organizations within the current framework. The Appraisal Institute Government Relations Committee has also reviewed current laws and regulations over the past year and has compiled a list of deficiencies with these laws and regulations, that may contribute to appraisers' involvement in mortgage fraud. What follows is a listing of each of these deficiencies, as well as our recommendations on how to address the issues involved.

Revisiting the de minimis appraisal requirement

FIRREA requires that real estate appraisals used in conjunction with federally related transactions be performed by licensed or certified appraisers in accordance with USPAP.

However, over the years the federal agencies and Congress have modified the law to exempt nearly 90 percent of all transactions in the residential mortgage market from being appraised by licensed and certified appraisers. Whereas originally contemplated, all transactions greater than $15,000 would be required to be appraised by a licensed and certified appraiser, now a transaction must be greater than $250,000 to require the use of a licensed and certified appraiser is required.

Higher Risk

The Appraisal Institute believes this has resulted in higher risk for fraudulent activity and abuse of consumers, and in the end, an increased risk to the safety and soundness of financial institutions. Unqualified individuals are now performing a large portion of the real estate valuation work throughout the country in the form of "evaluations," or "broker price opinions" (BPOs), or through "competitive market analysis" (CMA) reports. In many cases, evaluations are done by staff of organizations that have a vested interested in a real estate transaction. This negates the benefit of having an independent third party involved in the real estate transaction.

We contend that these "evaluations," estimating the value of real property are actually "appraisals" and therefore must be performed by appraisers who adhere to industry standards. Presently, there are more than 80,000 state licensed and certified real estate appraisers throughout the country available to perform appraisal assignments for federally insured financial institutions. These individuals perform appraisals in accordance with USPAP and are subject to state enforcement actions for failure to comply with these industry standards. An active state enforcement system is a necessary tool to help ensure qualified appraisal practitioners are involved in mortgage transactions. Omission of a licensing or certification requirement for properties under $250,000 by federal agencies creates a disruptive gap in the enforcement of appraisal standards. When an individual performing an "evaluation" is not accountable and loses nothing by delivering a poor appraisal, you are putting out a welcome mat for fraud.

Only one federal financial regulator, the National Credit Union Administration (NCUA), has not raised its appraisal threshold to $250,000. However, the NCUA is currently in the process of considering a Final Rule (generally called the Regulatory Flexibility Rule) that would raise the threshold to $250,000. The Appraisal Institute called for a withdrawal of this proposal in May 2001.

A recent clarification to USPAP, in our opinion, allows qualified and independent appraisers to offer a range of services to lending institutions, effectively eliminating the need to increase the appraisal threshold. One of the results of this will be that a lending institution, instead of seeking a service from a real estate sales person not adhering to professional valuation standards or trained in valuation theory, will be able to consult an appraiser for an "appraiser price opinion" (APO) where the appraiser will adhere to appraisal standards and act responsible to the state appraiser regulatory agency.

HUD Recommendation

The report published in June 2000 by the Department of Housing and Urban Development and Treasury Department on "Curbing Predatory Home Mortgage Lending" recognized the need to address this problem. The Task Force that helped write the report recommended the following: "Under FIRREA, a licensed or certified appraiser must appraise properties with a value of above $250,000. Since many of the abuses occurring with the recent cases of predatory lending and loan flipping involve high-cost loans and fraudulent appraisals, it would be beneficial to introduce qualified appraisers into the Home Ownership and Equity Protection Act (HOEPA) arena. With this, the requirement for a licensed or certified appraiser should be extended to a property that is intended to secure a HOEPA loan."

Because of these reasons, the Appraisal Institute recommends that Congress conduct oversight hearings on FIRREA and the appraisal threshold, particularly now that the legislation has been fully implemented for 10 years. We also encourage Congress to review the NCUA plan to increase their appraisal threshold from $100,000 to $250,000. For too long, federal agencies have deviated from Congress' original intent to have appraisals performed by licensed and certified appraisers, and it is time to revisit these policies.

Client pressure

The Appraisal Institute has placed a great deal of attention on an issue commonly referred to as "client pressure," namely, the actions of a lender, broker or realty agent to pressure an appraiser to appraise a property at a predetermined value. Many appraisers have become increasingly concerned about this pressure, so much so that in January the Appraisal Institute requested Congress to conduct an investigation into the phenomenon because we have seen evidence that it can contribute to mortgage fraud. The Appraisal Institute is aware of cases of client pressure where an appraiser acting under duress has inflated the value of a home in order for a loan to be made that is greater than the actual value of the house. In these circumstances, a homeowner will enter the home with a negative equity position, which later can lead to an assortment of problems, including default. These "higher" values also serve to exacerbate and extend the obvious risks by becoming "comps" for future mortgage transactions. Such a cycle of ever escalating values adds unnecessary risk to our mortgage finance system.

In a letter to the Senate Banking Committee and the House Financial Services Committee, the Appraisal Institute pointed out that there are cases where mortgage creditors, lenders, brokers and realty agents apply undue influence on an appraiser to artificially "make the value" on a property being appraised. The letter also stated that appraisers believe they have nowhere to turn when productive communication between client and appraiser devolves into threats to withhold future work and other coercive tactics.

Following the letter to Congress, the Appraisal Institute continued to study the issue, reaching out to appraisal clients to discuss these complaints. Federal regulators and

congressional investigative committees were also contacted. From March to May this year, the Appraisal Institute met with banking community trade associations to discuss how our organizations could work together to address the issue of client pressure on appraisers.

The meetings were the first step in an effort to solve the problem of client pressure internally, without new legislation or regulation. The banking trade associations have stated that the overwhelming majority of their members comply with all relevant regulations, but indicated support for working with the Appraisal Institute to develop a "best practices statement" on acceptable and proper communications and practices between a financial institution or client and an appraiser. The groups agreed to publish educational materials in their respective membership publications.

Through the course of these activities some general conclusions have been reached about the client pressure issue:

- Client pressure is a problem experienced most often by residential real estate appraisers, although commercial appraisers have reported cases as well.
- A client has the right to communicate with the appraiser. However, there are lines that, if crossed by the client, make that communication illegal, unethical or fraudulent.
- Communication between a client and an appraiser should be encouraged. However, blackballing, ostracism and defamation of an appraiser who fails to meet a predetermined value of a client should be prohibited.
- It is the appraiser's responsibility to report client pressure to the appropriate agency when it occurs.
- Appraisers fear retaliation from clients if they report instances of pressure when there are no systems in place guaranteeing anonymity.
- Government agencies have reporting mechanisms to accept complaints against clients pressuring appraisers.
- When an appraiser reports an instance of client pressure, it must be in writing and the parties must be named with the circumstances clearly explained.

FIRREA requires the independence of an appraiser in a mortgage transaction. However, our members say that lenders, brokers and realty agents often pressure them to meet predetermined values to help finalize a mortgage transaction. If an appraiser fails to meet the predetermined value, he or she may not receive future work from that lender and can face ostracism from others in the marketplace. Appraisers can report instances of this type of pressure to state banking regulators or to any of the five federal financial regulators when it involves officials within a lending institution, such as a loan officer. However, the appraiser must report the instance in writing and it must be addressed to the correct regulatory agency. Because of the myriad of federal and state regulators, determining which agency to report the instance of client pressure can be a daunting task.

The Appraisal Institute understands that this pressure can come not only from loan officers or bank officials but also from other parties involved in the transaction, such as a mortgage broker, realty agent or even a consumer. The client pressure problem does not

always necessarily come from the "lender" who orders the report or connected with the underwriting of the loan, but rather someone connected with the "production side" of the lending process, e.g. mortgage brokers, mortgage bankers and realty agents. These parties are not regulated the same way as banks, thrifts and other financial institutions. Their production staff has incentives to produce deals. In many cases they are the underwriter of the loan as well. For these reasons, regulations could be amended to require separate individuals with different reporting structures handle the production and underwriting functions. In the end, it is important that someone who has no incentives on loan volume order the appraisal.

Unfortunately, there are no mechanisms in place for appraisers to report instances of client pressure when it comes from a broker, a realty agent or even buyers and sellers. One single location should be established to receive these types of complaints. In addition, a reporting mechanism should be established to accept complaints against brokers and realty agents.

The Appraisal Institute supports the intent of a legislative provision contained in H.R. 2513 introduced by Rep. Janice Schakowksy, D-Ill., which is meant to address pressure from lenders and mortgage brokers. It states: "No creditor or mortgage broker may compensate, directly or indirectly, coerce, or intimidate an appraiser for the purpose of influencing the independent judgment of the appraiser with respect to the value of real estate that is to be covered by a conforming home loan or is being offered as security according to an application for a conforming home loan." While this provision attempts to address client pressure, it does not assure the appraiser that other realty agents or mortgage brokers will not blacklist them. It is this risk that will keep most appraisers silent.

Recognizing the need for industry consensus, and realizing that a federal prohibition of client pressure will likely not halt its occurrences, the Appraisal Institute has reached out to mortgage banking, mortgage broker and other banking associations to plan a coordinated response to this challenge. The Appraisal Institute hopes to have a best practices statement completed in the fall of 2001. Nevertheless, it would be beneficial for Congress to review the extent of this activity through hearings or through consideration of the Schakowsky client pressure provision in H.R. 2513.

Greater uniformity among state appraisal licensure standards

As indicated earlier in the testimony, there is no requirement that all appraisers performing appraisal work be state-licensed or certified. Approximately one half of the states have a mandatory licensing requirement for appraisers, while the remainder have "voluntary" licensing. Optional licensing is a serious flaw within our profession's regulatory structure. This is evident in facts uncovered through testimony given by the Federal Bureau of Investigation at a hearing on predatory lending held by Senator Barbara Mikulski, D-Md., in Baltimore in March 2000. While Maryland ranks fifth in the nation in mortgage fraud, New York, California, Florida and Illinois have larger problems in this area. It is interesting that these five states, those with the most egregious

property flipping problems, are all "appraiser-licensing-optional," or non-mandatory states.

The Appraisal Institute believes that licensing of all real estate appraisers doing business in the state must be mandatory. This will put all real estate appraisers doing business in a state under USPAP standards and make them liable to state appraiser regulatory agencies. These state regulatory agencies should be encouraged to adopt uniform licensure requirements to help address the problem of unqualified appraisers performing appraisals. Greater uniformity among the states would solidify standards within the profession and decrease the probability of unqualified individuals performing appraisals, and hence, potentially damaging consumers.

Model state appraiser laws
Currently, the Appraisal Subcommittee has a reserve fund with the U.S. Treasury with almost $5 million in funds that are sitting idle. The Appraisal Institute, in reviewing how that money might be used for greater benefit, recommends that the ASC use a portion of those funds to conduct a study to foster the development of model state laws for registration, licensing and regulation of appraisers. Such a study could be conducted using the knowledge and expertise of the appraisal professional organizations or The Appraisal Foundation. Currently, there is no model legislation available to the 50 state appraiser regulatory agencies.

Financial regulatory communication
H.R. 1408, sponsored by Rep. Mike Rogers, R-Mich., is meant to encourage communication between state and federal regulators, so as to prevent fraudulent financial services professionals from exiting one field and entering another. The Financial Services Committee passed an amendment in June 2001 to include the Appraisal Subcommittee to become a part of a network of information sharing to facilitate greater communication among investigative bodies. In doing so, it would require the ASC to be a liaison to the network of financial regulators to share information available through its National Registry of real estate appraisers. The Appraisal Institute encourages Congress to pass this legislation.

Automated valuation models
The real estate industry recognizes that human error or bias even under the best of circumstances may influence the appraisal of properties using traditional approaches. The sales comparison approach is the most commonly used technique in the appraisal of residential real estate. It is based on the principle of substitution. A property is worth approximately the same as a similar property offering analogous benefits and amenities (i.e., a comparable utility). The sequence proceeds methodically, with the appraiser identifying the subject property and finding comparable properties in the same or similar neighborhoods from which to draw a comparison.

Automated valuation models (AVMs), or computer-generated databases that arrive at estimates of value, can greatly reduce the time to complete a value estimate. AVMs may also be used to ascertain trends in the market before these trends are readily discernible

by traditional fee appraisers and may be used to review fee-based appraisers. AVMs come in a variety of forms. They have prevailed in the academic literature for some time, but only recently have the benefits of such models gained the attention of practicing appraisers.

The two major participants in the secondary markets, Fannie Mae and Freddie Mac, are strongly encouraging the development and use of automation in appraisal services. The increased popularity of AVMs is evident by the number of firms providing such services. Unfortunately, many of these firms' models are constructed with incomplete data, tax data, or data based on some unreliable market index, calling the accuracy of the value result into question. This directly impacts the mortgage fraud issue in that if AVM-generated values, and the data within the AVMs are flawed, it raises the possibility of widespread and even catastrophic losses in the residential mortgage market.

AVMs will most certainly change the work of appraisers. Routine assignments, such as refinancing or home equity loans in which there is little doubt that the property will carry the debt, may require less of an appraiser's services and expertise. In many ways, use of AVMs is analogous to driving an automobile. The biggest and most expensive automobile in the world is of little or no value without fuel. The fuel required to run AVMs is data, and appraisers are the best sources to provide data. Opportunities for the use of AVMs exist in other areas of the real estate industry. Brokers might employ AVMs to conduct competitive market analysis, while homeowners and prospective homebuyers might use AVMs to search for specifically priced property.

AVMs are generally less expensive than the services of a traditional fee appraiser but cannot be used on every property. They require an abundance of accurate data on the sales of a significant number of similar types of properties. AVM technology cannot replace the experience and expertise a professional real estate appraiser provides to buyers, sellers, lenders and investors. Studies have shown that having an appraiser involved in the AVM process increases the degree of accuracy. The Appraisal Institute believes Congress should carefully monitor the use of AVMs in the residential marketplace to avoid misuse.

Federal Housing Administration Reforms

The Department of Housing and Urban Development, through the Federal Housing Administration, as well as the Veterans Administration, provides government-assisted mortgage insurance in an effort to increase homeownership in low-to moderate-income neighborhoods and in the veteran community. FHA is the larger of the two programs, so it is more appropriate to discuss programmatic reforms in FHA rather than the VA. That is not to say the VA program does not deserve our attention or that it does not have flaws, for the Appraisal Institute is aware of a number of deficiencies within the VA appraisal program. Rather, the FHA program is simply larger and thereby represents greater challenges.

To be eligible for placement on the FHA Roster of Appraisers, and thus be eligible for selection by a lender to appraise a property that will be security for FHA insured mortgage financing, an appraiser must:

- be state-licensed or certified in accordance with the minimum licensing criteria established by the AQB of the Appraisal Foundation;
- not be listed on the General Services Administration's Suspension and Debarment List, HUD's Limited Denial of Participation List or HUD's Credit Alert Interactive Voice Response System; and
- pass a HUD/FHA examination on appraisal methods and reporting.

The examination focuses on applied knowledge of the HUD Valuation Handbook, 4150.2. The examination consists of 50 questions in a computer-based multiple-choice format and is essentially an open-book examination.

The Appraisal Institute continually monitors the operation of the FHA Roster of Appraisers and fields comments and complaints about its operation. Our members report that there are a number of deficiencies with the operation of the Roster, which will be explained below.

Lender select v. fee panel

In 1994, HUD moved from what was generally referred to as the "Fee Panel of Appraisers" to the system called the "Roster" or "Lender Select of Appraisers." Rather than having the appraisal (and appraiser) randomly ordered by FHA, the authority to order appraisals now resides with the originating lender. This change also granted full responsibility over the accuracy and integrity of the appraisal to the originating lender.

Since this modification, Appraisal Institute members report that instances of client pressure have increased greatly. This, our members say, comes as a direct result of granting the appraisal ordering authority to the lender. For example, under the previous Fee Panel system, when an appraisal was ordered, FHA would randomly select from an approved panel of appraisers. The appraiser would perform the appraisal and send it to FHA and the originating lender. The appraiser was insulated from most forms of outside pressure to hit a predetermined value.

Under Lender Select, the appraisal is ordered by the lender who keeps a roster of approved appraisers that it can tap to perform the appraisal. The assignment is then given out to the appraiser the lender chooses. The Lender Select system has handed significant power to a lender to coerce an appraiser to meet a predetermined value or deliver a report designed to facilitate the approval of the transaction. Appraisers working in FHA-generated mortgage transactions collect appraisal fees for their services. These fees range from $275 to $500 per appraisal. If an appraiser fails to meet or conform to the lender's desires, the appraiser mysteriously stops receiving work from that lender. This creates a system whereby there are incentives for appraisers to conform to the wishes of lenders.

Unfortunately, this has tended to dissuade appraisers with the highest education and experience requirements from performing FHA appraisals. A recent survey of Appraisal Institute members indicates that fewer members are performing FHA appraisals. Of Appraisal Institute members that report performing fewer appraisals for FHA, 44 percent claim that client pressure is the culprit, which was far and away the greatest complaint. Then, who is performing work for the FHA? Too often, it is the least qualified and least experienced appraisers in the profession.

The Appraisal Institute is aware of individuals who were forced to leave the profession as a result of pressure being exerted through the Lender Select program. One appraiser in Louisiana followed HUD guidelines and would not succumb to client pressure. Unfortunately for him, he became known in the industry as an appraiser who could cause a problem for the client. Once the Fee Panel was changed to Lender Select, he could not secure a sufficient number of assignments to justify remaining in the real estate appraisal profession.

If HUD is to be seen as a leader in the housing industry, the Appraisal Institute believes the agency should have the most qualified appraisers performing appraisal work. With this, FHA should consider modifying its Fee Panel appraisal ordering system. The Fee Panel that existed prior to 1994 was not perfect. Largely, complaints against the Fee Panel revolved around the difficulty in being accepted on the Fee Panel or that the Fee Panel acted like a "club" of appraisers. Some of these allegations were true. If HUD were to revert back to the Fee Panel, it should allow new appraisers to be accepted on the Panel and be removed when it is shown the appraiser acts improperly.

Greater accountability of lenders over quality of appraisals
Alternatively, there are some modifications that can be made to the Lender Select program to help it run more effectively. Under Lender Select, FHA gave responsibility to lenders over the quality of appraisals being performed. Yet, FHA has sanctioned very few lenders that have failed to oversee their appraisers responsibly. Enforcement activity and penalties for lenders should be increased. In addition, Congress should clarify the authority of HUD to terminate mortgage origination approval for poorly performing mortgagees. This clarification is made within S. 1195, sponsored by Sen. Sarbanes, and the Appraisal Institute supports its passage.

Requiring mortgage reductions
HUD recently stated that it would demand lenders reduce mortgages to appropriate levels when it found loans that exceeded 120 percent of fair market value. Unfortunately, lenders have refused to voluntarily make these mortgage reductions. Meanwhile, the FHA apparently has no authority to force them to do so. To make matters worse, if those inflated mortgages end up in default and foreclosure, FHA must make good on the entire mortgage amount through the insurance fund.

The Appraisal Institute believes this system needs to be changed. Currently, lenders have no incentive to be more diligent in checking values on lending, and secondary market purchasers have no incentive to do more due diligence with regard to the loans they are

purchasing. Legislative authority should be granted to FHA to induce such mortgage reductions.

Increase standards for acceptance on the appraisal roster
HUD should have only the most qualified and experienced appraisers performing appraisals on its behalf. Given this, the test for acceptance on the appraiser roster should be modified to allow for the most qualified and experienced appraisers to be accepted on the roster.

The qualifications criteria should be clarified to ensure that only those appraisers meeting AQB criteria be accepted on the Roster. A recent loophole within the FHA guidelines allowed numerous individuals on the FHA Appraiser Roster who did not meet AQB criteria and additional FHA-specific training. We understand the FHA is working to address this problem by removing those appraisers; however, it is likely that many of these individuals will be "grandfathered" onto the current Roster. Meanwhile, the Appraisal Institute has great concern over what kind of damage may have already been done by those individuals who clearly were not qualified to perform FHA appraisal work, not to mention what damage will occur if these unqualified individuals are permitted to continue preparing FHA appraisals. Congress should actively monitor this problem until a solution guaranteeing greater safety and soundness has been found.

More resources for review appraisals
HUD is required to review 10 percent of the appraisals performed for the agency. Yet, the agency has rarely been able to perform a 10 percent review. This is mostly due to the lack of resources available to HUD, which has gone through considerable downsizing over the last few years. The Appraisal Institute believes more resources should be granted to the FHA Real Estate Assessment Center so that FHA can perform a greater number of appraisal reviews. In addition, current fees paid for FHA reviews are below market for review work. The Appraisal Institute believes the FHA should raise the fees paid for review appraisals to encourage more qualified appraisers to perform review appraisal work.

There are a number of other reforms that can take place within FHA; however, most of them are geared towards greater enforcement of existing laws and modifying currently accepted programs and practices. The Appraisal Institute is committed to help HUD solve the appraisal-related problems having an impact on mortgage fraud, and we hope these efforts bear positive results. We will be happy to apprise the Committee of our progress along these lines.

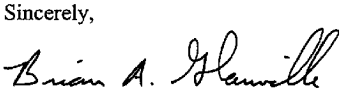
Conclusion

Predatory mortgage lending and mortgage fraud are very serious issues, damaging the lives of many people. They are also very complicated issues that will require great diligence in exposing fraudulent participants in the marketplace and developing proactive solutions.

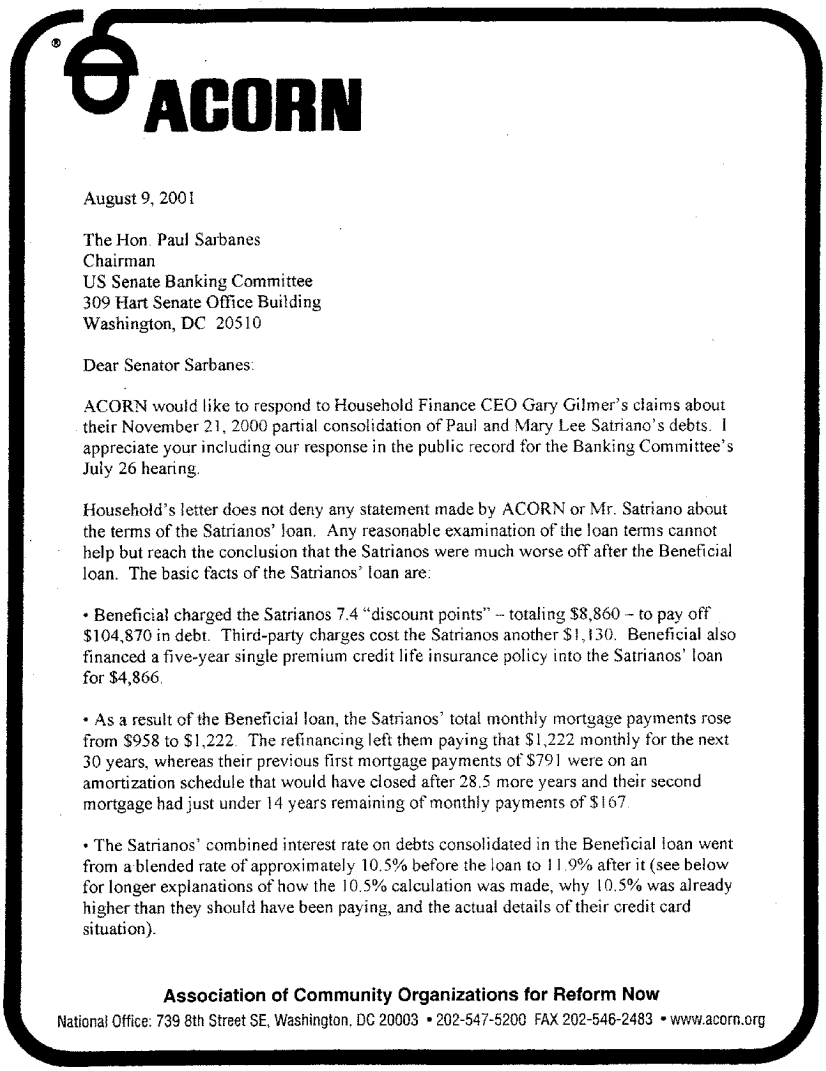
The appraisal-related issues that are contributing to mortgage fraud are extremely complicated as well. The Appraisal Institute hopes that this testimony provides you with some background information on our concerns. In addition, the Appraisal Institute urges Congress to take up our recommendations to begin investigating these deficiencies and help craft solutions.

We look forward to working with you in developing these solutions, and thank you for this opportunity to testify. If you should have any questions, please contact Don Kelly, Vice President of Public Affairs, at 202-298-5583 or dkelly@appraisalinstitute.org.

Sincerely,



Brian A. Glanville
President



ACORN

August 9, 2001

The Hon. Paul Sarbanes
Chairman
US Senate Banking Committee
309 Hart Senate Office Building
Washington, DC 20510

Dear Senator Sarbanes:

ACORN would like to respond to Household Finance CEO Gary Gilmer's claims about their November 21, 2000 partial consolidation of Paul and Mary Lee Satriano's debts. I appreciate your including our response in the public record for the Banking Committee's July 26 hearing.

Household's letter does not deny any statement made by ACORN or Mr. Satriano about the terms of the Satrianos' loan. Any reasonable examination of the loan terms cannot help but reach the conclusion that the Satrianos were much worse off after the Beneficial loan. The basic facts of the Satrianos' loan are:

• Beneficial charged the Satrianos 7.4 "discount points" – totaling $8,860 – to pay off $104,870 in debt. Third-party charges cost the Satrianos another $1,130. Beneficial also financed a five-year single premium credit life insurance policy into the Satrianos' loan for $4,866.

• As a result of the Beneficial loan, the Satrianos' total monthly mortgage payments rose from $958 to $1,222. The refinancing left them paying that $1,222 monthly for the next 30 years, whereas their previous first mortgage payments of $791 were on an amortization schedule that would have closed after 28.5 more years and their second mortgage had just under 14 years remaining of monthly payments of $167.

• The Satrianos' combined interest rate on debts consolidated in the Beneficial loan went from a blended rate of approximately 10.5% before the loan to 11.9% after it (see below for longer explanations of how the 10.5% calculation was made, why 10.5% was already higher than they should have been paying, and the actual details of their credit card situation).

Association of Community Organizations for Reform Now
National Office: 739 8th Street SE, Washington, DC 20003 • 202-547-5200 FAX 202-546-2483 • www.acorn.org

• Beneficial set a five-year prepayment penalty on the Satrianos' loan for nearly $6,000.

• Immediately prior to the Beneficial loan, the Satrianos owed $103,635 against their house. After the Beneficial loan, the Satrianos had $119,726 in debt secured against their home, which was appraised at $106,000. Assuming that appraisal is correct, the Satrianos' loan-to-value ratio jumped from 97.8% to 112.9%, preventing them from refinancing for several years at least.

• The new loan consolidated only $1,191 in credit card debt along with the Satrianos' two prior mortgages, plus the Satrianos received a cash-out of $44.

• Beneficial included a mandatory arbitration clause in the Satrianos' loan.

The above list sets out the predatory characteristics of the Satrianos' loan, and Mr. Gilmer's letter does not dispute any of these key facts. Instead, much of his letter is devoted to responding to Mr. Satriano's assertion that Beneficial engaged in deceptive practices during the course of the transaction, and the rest purports to find some other benefits to the refinancing.

It seems to us that one thing this response does is underline the argument that relying on current law protections against fraud does not, and cannot, protect borrowers from abusive loans. The lender can, as they have in this case, simply assert that they did fully disclose the terms of the loan, and (though we find Mr. Satriano to be overwhelmingly more credible, and will outline additional evidence as to why), the matter comes to resemble a question of he said / we said.

We think the essential point is that the loan Beneficial made to the Satrianos did the family real harm. In order to prevent such abusive loans, we need to focus, as your legislation would, Mr. Chairman, on making grossly abusive loan terms themselves illegal. Borrowers lose and predatory lenders win when consumer protections against predatory lending are limited to prohibitions against fraud and do not focus on abusive loan terms.

At the same time, it is not surprising that deception is required in order to sell loans like the one sold to the Satrianos, and we would also like to respond in detail to Mr. Gilmer's defense of the company's procedures, and to his attempts to argue that the loan provided some benefits.

- Mr. Gilmer suggests that Beneficial informed the Satrianos far ahead of closing about the terms of their loan because they had several phone calls with them about the loan. The

paper the company actually provided before closing seriously undermines their claim to have presented clear information in advance. The 'offer sheet' describing the loan attached at the end of this letter (and attached to Mr. Satriano's written testimony) was faxed to Mr. Satriano at 11:28 am on November 21, 2000 – the same day the loan closed. He had not received any paper from the company before this date.

The loan 'offer sheet' lists $106,000 as the maximum amount of the loan. In fact, the actual loan amount was $119,726. The loan offer sheet makes no mention of points and fees, or of credit insurance. In fact, as we have said, there were close to $15,000 in points, fees, and credit insurance included in the loan. Also, the offer sheet lists seven credit cards being paid off on the loan with a total of $2,234 in balances, but the loan only paid off $1,191 of the debts. Even on a piece of paper labeled 'Amortization Schedule' that is marked 5:45 pm on November 21 (Mr. Satriano says that their appointment for the closing was at 5:30), the loan amount is listed as being $106,000.[1] This paper is also attached to our letter.

- Later, Mr. Gilmer claims that the Satrianos were "provided with detailed disclosures and given several days to review them." It appears that Mr. Gilmore is in fact referring to the legally required documents which Mr. Satriano was presented with at the closing, and to the three days after closing, during which, as required by law, he could have filled out a form to cancel, or rescind, the loan.

- Mr. Gilmer is highly selective in describing the interest rates on the Satrianos' previous debts, leaving the false impression that Beneficial lowered their overall interest rate. The following loans were consolidated into the Beneficial loan: a $91,099 first mortgage with Bank One at about a 9.99% interest rate (see below on why the Satrianos might have qualified for a better rate), a $12,536 second mortgage with The Money Store at 13.99%, and $1,191 in credit card debts. Assuming the credit card debts were at an average interest rate of 20%, the blended interest rate on that $104,826 of debt was 10.5%. After consolidating with Beneficial, the Satrianos' interest rate on $119,726 was 11.9%.

- Mr. Gilmer argues that the Satriano's loan benefited the family because one of their earlier loans had a balloon payment which would have forced them to refinance. The Satrianos' previous first mortgage with Bank One did indeed have a balloon payment that would have come due in another thirteen years. We are not defenders of balloon payments, however, the balloon payment provides no meaningful defense of the

[1] There are numerous other inaccuracies in this disclosure as well. Their loan's annual percentage rate was actually 13.0%, and the 11.52% rate listed is lower than the interest rate, which is impossible by definition. The biweekly payment of $541 is substantially lower than the biweekly payments of $611 that were subsequently required of the Satrianos.

Beneficial loan. The family was not facing the balloon payment immediately, and what they needed was a better loan, not the worse one they got. The Satrianos were in a perfectly good position to refinance into a decent, non-balloon loan some time well before the balloon payment came due (especially because their second loan would have been fully paid off before the balloon came due).

- Mr. Gilmer also argues that the loan benefited the Satrianos because it offered them a shorter repayment period; in fact, the Satrianos are now scheduled to repay the loan over 30 years. The suggestion that the loan has a shorter term is linked to Household's EZ Pay Plus plan, which they did offer the Satrianos with this loan.

Household markets the EZ Pay Plus plan, or "biweekly direct debit," where borrowers pay every two weeks, as a special benefit which will allow borrowers to reduce the loan term, and pay a lower effective interest rate. In fact, borrowers always, in any loan, have the option of paying more in order to pay off the loan sooner, so there is no special feature here. In addition, Household promotes this system in a confusing and deceptive way, suggesting that paying every two weeks is just like splitting a monthly payment in two, and making it in two parts, so that borrowers can shorten the term of the loan without paying any more. Actually, of course, borrowers only shorten the term of the loan by paying more, because paying every two weeks results in some months with three payments.

As a result of exactly this confusion, the Satrianos actually withdrew from the EZ Pay Plus plan shortly after taking out the loan – a point on which Mr. Gilmer's letter is unclear. Mr. Satriano initially understood that his monthly payment would simply be split in two, and paid in two equal installments each month. When he realized that in fact the plan payments were half of the monthly payment, but due every two weeks, he withdrew from the program, because he could not afford to pay at this faster rate. This initial misunderstanding – fostered by Household's presentation of this plan – was one element in convincing him to accept higher monthly payments on the loan in the first place. He thought the higher payments were because they would be paying off the loan sooner.

As a final point with regard to the EZ Pay Plus plan, Household actually charges borrowers an extra $5 every two weeks for having their payment deducted from their account directly – a payment system which actually saves the lender money.

- Mr. Gilmer also refers to the benefits to the Satrianos of the "pay rewards" program. This feature lowers the interest rate for borrowers who are not late on any of their mortgage payments after the third, fourth, and fifth years of their mortgages. While it might be reasonable to expect that a borrower who has paid off their mortgage on time

every month for five years might qualify for very close to an 'A' rate, Beneficial lowers qualifying borrowers from an extremely inflated rate to a slightly lower but still greatly inflated rate. The program is structured to lower the interest rate by .25% (and in the future, according to Household's July 23rd announcement, by .5%, although we assume that this change would not have applied to the Satrianos' loan) after each of the third, fourth, and fifth years, meaning after five years of perfect on-time repayment, the Satrianos would have had their interest rate lowered from 11.9% to 11.15% (or to 10.4% had it received reductions of .5%). Of course, the Satrianos no longer qualify for the future reductions as they missed their first payment last month, in significant part because Beneficial's consolidation of their debts damaged their financial situation.

- Mr. Gilmore also tries to justify the rate and fees on the Satrianos' loan by arguing that they belong to the highest risk class of borrowers or, to use another term, that they have a 'D' credit rating.[2] In fact, at the time of the refinancing, the Satrianos had very good credit, and ACORN Housing Corporation counselors believe that AHC could have gotten them into an 'A' loan. We have attached the Satrianos' credit report, which we will now run through in detail.

As of November 2000, the Satrianos had the following history on mortgage payments:

• First mortgage with Norwest – all payments on-time from March 1998 until March 1999 when refinanced with Bank One

• First mortgage with Bank One – all payments on-time from March 1999 until November 2000 when refinanced with Beneficial

• Second Mortgage with Money Store – all payments on-time from June 1999 until November 2000 when refinanced with Beneficial

The following non-mortgage debts were in Paul's name:

• Car loan with Beneficial – all payments on-time from April 2000

• Providian Financial credit card – all payments on-time from March 1996

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[2] We assume Household's claim that "[b]orrowers scoring in Mr. Satriano's range are 23 times more likely to default than the average U.S. borrower" is an indication that they are following the same study cited by Charles Calomiris in his July 26th testimony to the Senate Banking Committee at http://www.aei.org/ct/ctcalo010726.htm: "According to Frank Raiter of Standard & Poor's, the probability of default (over the lifetime of the mortgage, which is typically three to five years) for the highest risk class of subprime mortgage borrowers is roughly 23%...."

• Cross Country Bank credit card – all payments on-time from Jan. 1999

• First Premier credit card – all payments on-time from September 1999

• Another First Premier card – all payments on-time from December 1999

• Norwest Financial – all payments on-time from May 1998

The following non-mortgage debts were in Mary Lee's name:

• Providian credit card – all payments on-time from June 1999

• MBNA credit card – all payments on-time from November 1999

• Bankfirst credit card – all payments on-time from August 1996

• Capital One credit card – all payments on-time from Sept. 1997

• First National Credit Card – all payments on-time from April 2000

• Lane Bryant – all payments on-time from June 1999

• Roamans – all payments on-time from April 2000

As of November 2000, the Satrianos had the following five marks against their credit record:

• An account with AVCO Finance, on which they fell behind in June 1994 and did not get caught up and paid off until May 1995

• A charge-off of $800 with Norwest Financial in August 1997

• A $68 cable bill collection from March 1998

• A state tax lien filed in October 1996 and satisfied in May 1998

• A loan with Wells Fargo Financial that had five consecutive 30-day-lates from November 1999 until March 2000

When the Satrianos saw their credit report for the first time with an ACORN Housing Corporation loan counselor, they saw that two of the five negative marks were mistakes.

On the Norwest Financial account, the charge-off that was listed never actually took place. On the Wells Fargo account, they had never been late in making any of those payments. Since AHC assisted the Satrianos in reporting those mistakes to the credit bureaus, their credit report has been corrected on the Wells Fargo account to show all on-time payments and on the Norwest Financial account to delete the charge-off.

It is also worth noting that four of the five negative marks that would have been on the Satrianos' credit record in November 2000 when they received the Beneficial loan at 11.9% interest (and all three of the marks which are accurate) were also on their record when they qualified in March 1999 for a 9.99% first mortgage from Bank One. Indeed, you could easily make a strong case that the Bank One interest rate should have been lower than 9.99% and that the Money Store second mortgage should have been below 13.99%.

So here is the real picture of the Satrianos' credit history at the time of their refinancing with Beneficial: perfect payments on their mortgages; perfect payments on all of their credit cards except one, which was paid off five and a half years before; a state tax lien that was paid off two and a half years before; and a $68 cable bill that went into collection over two and a half years before. If the Satrianos had come in and talked with an AHC counselor last November, we could have worked through one of our bank partners to refinance the Satrianos' two mortgages into an 'A' rate that would have substantially lowered their mortgage payments, freeing up more than enough money each month to quickly pay down their credit card debts.

- Finally, Mr. Gilmer's letter is inaccurate even on minor points. He refers to the $8,860 in fees charged as buy-down points, when this flies in the face of Household's standard practice of charging over 7 points on first loans. The company's settlement statement forms do not list any fees to the lender; the 'points' are the fees.

Mr. Gilmer refers to the Satrianos' loan-to-value ratio as being 100%. Actually, after refinancing the Satrianos' LTV ratio became 113%.

- Mr. Satriano's testimony clearly acknowledges that $1,191 of his credit card debt was paid off, but, unlike Household's letter, properly places that fact in the context of the whole loan. He had responded to Beneficial's solicitation, which offered $35,000 in cash, in the hopes of paying off all of his credit card debts, which totaled nearly $7,000. In the end, he paid $10,000 in fees, had his house refinanced at a higher rate, and still did not get all the $7,000 paid off.

Once again, Mr. Gilmer's letter reveals the same pattern of deceit which characterizes the company's loans.

Thank you again for your leadership of the Banking Committee's investigation of predatory lending abuses that are destroying homeownership opportunities.

Sincerely,

Maude Hurd
National President, ACORN

Attachments

cc: members of the Senate Banking Committee

STATEMENT OF RICHARD STALLINGS

PRESIDENT, NATIONAL NEIGHBORHOOD HOUSING NETWORK

JULY 27, 2001

Mr. Chairman and Members of the Committee on Banking, Housing, and Urban Affairs, I appreciate the opportunity to submit testimony to the Committee on Banking, Housing and Urban Affairs on behalf of the National Neighborhood Housing Network (NNHN).

First I would like to thank Senator Sarbanes for holding hearings on predatory lending—an issue that is of great concern to all of NNHN's members. The purpose of my testimony is to raise awareness of the growing presence of predatory lenders in low income urban and rural communities and to encourage Congress to take action to curtail their activity. I also want to clarify the differences between subprime and predatory lending and discuss the importance of making sure that low- and moderate-income consumers have access to home mortgage credit and other forms of financing through responsible lenders.

National Neighborhood Housing Network

As the president of NNHN, I represent a network of 120 community-based organizations including my own, Pocatello Neighborhood Housing Services in Pocatello, Idaho. NNHN is a nonprofit organization that advocates for better neighborhoods and housing for low to moderate income Americans. The NNHN organization is made up of 120 NeighborWorks® organizations (NWO's) who use Neighborhood Reinvestment Corporation's funds to leverage private dollars to create new homeowners, revitalize distressed communities, and build single family and multifamily housing for low- to moderate-income families. NWO's are nonprofit organizations dedicated to helping families buy and maintain homes. We are committed to assisting low- and moderate-income Americans recognize the dream of becoming homeowners and living in safe and stable neighborhoods.

Owning a home can lead to not only stability and security for individuals and families but can also contribute to the greater stability and security of communities as the tax base is strengthened, the business environment stabilizes and wealth in the community grows. However, the full benefit of home ownership accrues to communities only if these homes become secure investments with the potential for asset accumulation for the homeowner. Our mission, as affordable housing providers, is to ensure that communities receive the full benefits of home ownership and we do this by creating strong, educated consumers as well as default-resistant owners.

Subprime Versus Predatory Lending

There is a distinct difference between subprime lending and predatory lending. Whereas subprime lending takes a borrower's potential risk into account and provides manageable lending rates, predatory lending includes tactics which purposefully damage a borrower's equity and credit, enabling the lender to take advantage of the borrower. These tactics include inflated points and fees, and encouraging loans that rely on home equity rather than the borrower's income and ability to pay. These tactics often end in borrowers? losing their homes.

In my own community I have witnessed the damage that predatory lenders can have. In fact, I have seen an increase in the presence of predatory lenders over the last 5 years. In part these lenders have moved in to fill the vacuum left by conventional lenders who have moved out of the area. Unfortunately, we are usually contacted by homeowners after they have fallen prey to predatory lending schemes and we can do little to rectify the situation.

Predatory loans can have any number of abusive or deceptive characteristics and frequently these loans include one or more of the following features:

- carry excessive interest rates, fees and closing costs, which are often hidden in fine print;
- impose onerous conditions and terms of repayment, such as penalties for paying off the loan early or large balloon payments at the end of the loan term;
- involve mortgage loans to homeowners without verification of income or regard to whether they can afford to pay the loan back; and
- are marketed through deceitful or unfair practices, such as last minute changes to loan terms or inadequate disclosure of the loan terms.

Let me stress that it is not just the presence of these loan features that qualifies a loan as a predatory loan—but also the manner in which the financing is marketed and targeted specifically to vulnerable consumers.

Once locked into a predatory loan, a homeowner may be forced to borrow still more money to stay afloat, and all too often may be forced to give up the home to

foreclosure. Predatory lending is believed to be a major factor in the dramatic 300 percent increase in home mortgage foreclosures since 1980. Predatory lenders will make loans to homeowners with little or no attention to the borrowers ability to repay, but instead focus on the amount of equity they have in the home and how that can be drained. If left unchecked, these practices will cost American homeowners billions of dollars in home equity over the next several years.

A recent study completed by the Neighborhood Reinvestment Corporation and the NeighborWorks® Campaign for Home Ownership 2002 documents a significant increase in subprime lending in the Boston metropolitan area. This study, *Analyzing Trends in Subprime Originations: A Case Study of the Boston Metro Area,* analyzed Home Mortgage Disclosure (HMDA) data from eight counties in the Boston metropolitan area from 1994 to 1998. The study found that loan originations by subprime lenders grew by 435 percent as compared to the growth of all conventional loan originations by 119 percent. The growth of subprime lending was much more significant for properties located in low-income and minority neighborhoods than for properties in other parts of the city. The study revealed that the market share of subprime lenders is significantly higher in low income largely minority communities where they accounted for 13 percent of the overall originations which is more than three times their share for the entire metropolitan area. The study also found that subprime lending activity in minority and low-income communities is especially concentrated in the refinancing market where much of the predatory lending practices are put to use.

The National Training and Information Center (NTIC) in Chicago recently conducted a similar study looking at the increase of subprime lending and the number of foreclosures in Chicago. According to the NTIC study, high interest rate lenders made more than 50,000 loans in 1997 in the Chicago area which is 15 times greater than the number of loans they made in 1991. In addition, the number of foreclosures tied to these predatory loans rose dramatically. In 1993 subprime lenders were responsible for 1.4 percent of all foreclosures in the city and in 1998 they were responsible for 36 percent of the years foreclosures.

NTIC's study also describes the effects that predatory lending practices have on neighborhoods. By looking at a 36 block area in the Chicago Lawn neighborhood, NTIC was able to demonstrate that predatory lending activity was directly responsible for the increase in foreclosures and vacant buildings in the area. Specifically NTIC found that 40 of the 72 foreclosures were initiated by subprime lenders. In addition, NTIC found that an additional 22 abandoned properties in the target area were foreclosures submitted by subprime lenders.

Promoting Responsible Subprime Lending

I do want to stress that NNHN supports the increased flow of mortgage credit into low income and minority communities. The NNHN network is made up of organizations that are committed to working with low and moderate income individuals who for a variety of reasons, including poor or nonexisting credit histories or unstable employment backgrounds, are unable to secure conventional mortgage financing. As responsible subprime lenders, NWO's work to provide these consumers with a range of financial services and products to enable them to become homeowners. We do this both as direct lenders as well as by working with conventional lenders.

Responsible subprime lending entails working with a consumer to come up with a loan product at a price and with terms that appropriately compensate the lender for any risk taken on, inclusion of reasonable return for the lender, and understandable by and appropriate for the borrower. Our concern is that the credit and other financing tools be made available to low- and moderate-income individuals in a responsible manner and that these consumers become educated and empowered through the process of becoming a homeowner.

NNHN supports curtailing the practices of predatory lenders through legislation and we believe this legislation must:

- prohibit points and fees from being financed as part of a homeowner's loan
- prohibit equity stripping where lenders make loans based on the equity a homeowner already has in the home as opposed to the borrower's ability to repay the loan
- prohibit abusive lending practices such as "flipping" the repeated refinancing of a home so the lender can collect upfront fees and eat away at the equity in the home or "insurance packing," when unnecessary and overpriced insurance is financed as part of the financing package often without properly informing the consumer.

NNHN also feels that consumer education is a critical component to any strategy aimed at eliminating predatory lending practices and curtailing unnecessary fore-

closures. Such education needs to focus on building the financial literacy skills of consumers and homeowners to empower them to make sound borrowing decisions.

Predatory Lending In Maryland

As you know, predatory lending is a nationwide problem. I would like to give you some examples of predatory lending in your home State of Maryland, Mr. Chairman, and describe to you the responses by the NNHN members there. As I have mentioned, those homeowners who have become victims of predatory lending often come to the NeighborWorks® Organizations when it is already too late. We have, however, been able to prevent many homeowners from ever falling prey by educating them beforehand and being available to them for advice following the education.

The first example in Maryland that I wish to share is the Salisbury Neighborhood Housing Services, Inc. There is one particularly sad story of an elderly woman who went to the organization after being on the verge of losing her home. In 1993, she had purchased a home in the Westside neighborhood using owner financing from her landlord. Her landlord, a local attorney, sold her the house for $30,000 and set up a balloon payment.

The house was in disrepair when he sold it to her and because of the monthly payment she could not afford to fix up the house. When she was cited by the city for the condition of her house, the landlord agreed to refinance the home for her and to add funds to the original loan amount to fund the cost of some of the repairs. He charged her additional fees and closing costs and added them into the loan amount. Under the pretense of helping her he then refinanced the loan yet again through the Ford Consumer Finance Company in 1995. By the time she went to Salisbury Neighborhood Housing Services, she owed $55,000 on her house, and the contractor's estimate to bring the house up to code was $53,000. In 1997, less than 2 years from the time she took out the loan with Ford, she signed a Deed in Lieu of foreclosure and lost her home.

Another example, which worked out somewhat better, comes from the Neighborhood Housing Services of Baltimore, Inc. A couple of years ago over 100 families became victims of predatory lending in the neighborhood of East Baltimore, near Patterson Park. The Neighborhood Housing Services of Baltimore first heard about these problems of loan flipping and fraudulent loan documents from an individual case of a woman who went to them for help. The NHS discerned problems with the documents immediately, and quickly learned of the other families plagued by the same lender. The NHS worked in collaboration with other East Baltimore nonprofit organizations and a local attorney to file a class action suit against the lender. The case never went to court; the lender is currently settling with the plaintiffs. One of the aspects of the settlement, which has already taken effect, is the reduction of principal balances on some of loans. The NHS is currently working with many of the families to provide loan packaging and rehabilitation. The city has also contributed some funds to assist these families.

In both of these cases, predatory lenders have caused irreparable damage to homeowners and their credit histories.

Mr. Chairman, on behalf of the National Neighborhood Housing Network, I applaud your past efforts in addressing this problem that is destroying families and neighborhoods. This country has made great strides in increasing homeownership nationwide and your commitment to this issue ensures that this is not in vain. The Government's own funds are at stake when Federal Housing Administration (FHA) mortgages and Neighborhood Reinvestment Corporation loans fall prey to unregulated lenders.

These hearings are a wonderful opportunity to find out exactly what is happening in our communities. We hope that with the overwhelming, indisputable evidence that you find here, you will reintroduce the important legislation that you proposed last year, S. 2415 Predatory Lending Consumer Protection Act of 2000. As stated, the bill will "amend the Home Ownership and Equity Protection Act of 1994 and other sections of the Truth in Lending Act to protect consumers against predatory practices in connection with high cost mortgage transactions [and] to strengthen the civil remedies available to consumers under existing law."

I would like to invite you and your colleagues to visit the NeighborWorks® Organizations in Maryland and nationwide. I know you are already familiar with our work, and I hope that we will be able to work together in the future to achieve our mutual goals of curtailing predatory lending practices and strengthening the availability of responsible credit to all low- and moderate-income individuals.

I wish to thank the Committee again for this opportunity to submit testimony regarding predatory lending.

STATEMENT OF MARIAN B. TASCO

COUNCILWOMAN, NINTH DISTRICT, CITY OF PHILADELPHIA, PENNSYLVANIA

JULY 26, 2001

I want to thank Chairman Sarbanes and the Members of the Banking, Housing, and Urban Affairs Committee for this opportunity to submit my remarks on predatory lending. My name is Marian Tasco and I represent the Ninth Councilmanic District in the City Council of Philadelphia. I am the sponsor of the landmark legislation passed by the Philadelphia City Council to stop the epidemic of predatory lending currently ravaging Philadelphia's neighborhoods.

I know that you have already heard testimony from Leroy Williams, a homeowner victimized by predatory lending in Philadelphia and from his attorney, Irv Ackelsberg, the managing attorney from Community Legal Services who has been leading the legal assault against predatory lending not only in Philadelphia but also around the State and the Nation. I do not intend to repeat what they have already eloquently presented to your Committee concerning the devastating effects of predatory lending both in our city and throughout the country.

Instead I want to share with the Committee the story of how we in Philadelphia came to pass the Nation's strongest antipredatory lending laws and how the predatory lending industry, along with the legitimate financial institutions in Pennsylvania, thwarted our efforts by convincing the State Legislature and Governor to completely preempt municipalities in Pennsylvania from regulating lending practices within their borders.

The legislation passed by a unanimous Philadelphia City Council on April 5, 2001 closely mirrors Senator Sarbanes's pending legislation. Under our legislation we set the thresholds for covered loans at 4.5 percent over the applicable Treasure rate for first lien mortgages and 6.5 percent over the applicable Treasury rate for junior mortgages. Threshold loans are not prohibited *per se* under the Ordinance, unless they are issued without the consumer first receiving home loan counseling or if they are issued without regard to the consumer's ability to repay. Our definition of high-cost loan closely mirrors the triggers of Senate Bill 2415. While we lacked the legal authority to directly prohibit the making of high-cost loans, our legislation seeks to discourage the making of high-cost loans by bringing economic sanctions upon any high-cost lender or its affiliate which seeks to do business with the city.

We often hear that it is difficult to define predatory lending, but the Philadelphia Ordinance makes definite progress in itemizing the characteristics of predatory loans. We can take direction from the Supreme Court on this one. As with obscenity, a definition may be elusive, but we know it when we see it; and we are beginning to see it more than we would like. We defined a predatory loan as any threshold or high-cost loan with any one of thirteen characteristics. The list roughly approximates the same terms as are contained in Senate Bill 2415 except that under the Philadelphia Ordinance home loan counseling is mandatory for all threshold loans and no loans are allowed to have prepayment penalties.

The Philadelphia Ordinance adopts a dual approach to the stopping predatory lending practices. For those persons over which the city of Philadelphia has the home rule authority to exercise its regulatory police powers, the ordinance prohibits those persons from issuing, arranging, or assisting others in making predatory loans, making any threshold loan without home loan counseling and directly paying home improvement loan proceeds to home repair contractors. The Philadelphia Ordinance also requires home repair contractors to provide a warning notice to all customers and requires all lenders and brokers to file a certification of compliance with the new law for recording with the mortgage instrument.

In addition to the regulatory approach, we also sought to use Philadelphia's substantial financial power as a market participant to bring economic sanctions to bear on the predatory lenders preying upon our residents and their affiliates. Toward that end the Philadelphia Ordinance cuts off the ability of high-cost or predatory lenders or their affiliates to enter into city contracts, removes city deposits from any depository financial institution engaged directly or through affiliates in predatory or high-cost lending practices, prohibits the bundling of city administered Federal CDBG funds with any loans originated by a high-cost or predatory lender or its affiliate and divests city pension funds from any securities issued by a high-cost or predatory lender or its affiliate, including predatory loan backed mortgage securities.

The process to draft Philadelphia's antipredatory lending began several years ago. I first became aware of this predatory lending issue in the winter of 1999 through a segment on "Good Morning America." We had had some earlier problems in my Councilmanic District. The segment told the lamentable story of a homeowner who had obtained a loan for housing improvements. The loan had so many complicated

terms and costs which the homeowner had not expected and could not pay, she lost her home in foreclosure. During hearings on Philadelphia's Community Development Block Grant application for fiscal year 2001, several representatives from home and loan counseling agencies testified as to how the practices had entered into the Philadelphia market and was creating havoc for our residential homeowners. The witnesses indicated that some protections and safeguards had to be put in place immediately. Northwest Counseling Services set up a variety of community meetings to discuss the issue. Congressman Bob Brady and I made the rounds of the sessions to alert consumers to possible pitfalls in the home mortgage process, and this is still a much-needed message.

Out of the same Community Development Block Grant hearing, I began a conversation with ACORN, which expressed an interest and willingness to participate in drafting a piece of legislation based on their case files, both locally and nationally. In the fall of 2000, I supported the establishment of a local predatory lending task force under the direction of Michelle Lewis of Northwest Counseling Services. Jeff Ordower, the local organizer for ACORN took the issue to the editorial board of the Philadelphia Daily News. I am most grateful to both of these organizations in their leadership for their involvement and commitment to this project and for keeping it on the front burner.

I also called together an *ad hoc* task force composed of leading housing counseling agencies, ACORN, the Urban League, and the city's Office of Housing and Community Development, to draft comprehensive municipal legislation based upon the following understandings:

- Philadelphia is experiencing an epidemic of foreclosures and equity stripping in its minority and distressed neighborhoods resulting from a dramatic rise in predatory lending practices.
- Most but not all of the predatory loans resulted from direct solicitations of homeowners from home repair contractors, mortgage brokers or mortgage lenders.
- Most but not all of the predatory loans were taken out by existing homeowners wishing to cash in on their home's equity.
- Legal advocates for the victims of predatory lending have insufficient resources to address this growing epidemic because existing Federal and State statutes are inadequate in providing effective means to stop this epidemic.
- Philadelphia has the largest network of housing counseling agencies which can be trained to provide antipredatory lending counseling to every borrower at risk of predatory lending practices.
- While the city has limited power to regulate the financial services and lending industry due to Federal and State statutory preemptions it has unlimited power to regulate home repair contractors and mortgage brokers, which are the prime forces behind the predatory lending epidemic in the city.
- The city has unlimited market powers to determine with whom it chooses to contract, deposit funds, invest its pension fund or bundle its governmental financial assistance. While the city has no direct business relationships with most predatory lenders or brokers, the city does have such relationships with affiliates of these entities. By leveraging the desire of these affiliates to maintain their lucrative relationships with the city, the city can exercise enormous pressure on their affiliated predatory and high-cost lenders to cease their practices within the city.

I have always maintained that the cooperation of the lending community is crucial to the ultimate success of any legislative effort to stamp out the abusive and harmful practice of predatory lending. Throughout the process of drafting the legislation we met numerous times with organizations representing the financial lending industry, many of which testified before this Committee. We held a special public meeting solely designed to solicit their input which was attended by over 100 lenders, brokers, and home repair contractors.

At every meeting I called upon the industry to propose constructive legislative proposals which would benefit the homeowners of Philadelphia. Unfortunately, for the most part we received proposals designed to gut our legislation or to enact special exemptions to remove one or another of the financial institutions from the regulatory or economic sanctions portions of the bill.

The greatest disappointment for me was the complete unwillingness of the banking community to engage in a constructive dialogue on the legislation. Rather than sit down to design a bill that would allow legitimate lending activities to flourish and discourage only those which are abusive and deceptive, the bankers locked arms with the predatory lenders for a total defeat of our legislation. Swarms of lobbyists descended on City Hall disseminating falsehoods about the scope and impact of the legislation. Fortunately, we were able to mount an immediate and effective response to each deceptive claim. It turned out that our greatest weapon against the bankers

lobby, surprisingly, was not the strength of our arguments as much as the weakness of theirs. Even Councilmen sympathetic to the bankers' messages concluded that their opposition to the legislation lacked any credibility. The bankers could not articulate why they were opposed to legislation which exempted them from coverage and which regulated a practice which banks do not engage in.

In the end, our legislation passed by a unanimous vote of 16 to 0, with Republicans joining Democrats in a clear and unmistakable message to the financial industry: You have utterly failed to police yourselves and through your failure to act you have given a green light to the unscrupulous predators to strip the wealth from the hard working citizens of our city. The only proper and credible response to this crisis was swift and decisive Government action.

Only weeks after our legislative victory, the financial industry launched a two-pronged assault on the Philadelphia Ordinance. The American Financial Services Association, which in its testimony before this Committee called the massive explosion of predatory lending "[a] system which has been extremely successful in delivering consumer credit to America's working families," brought suit against the city seeking to enjoin the implementation of the Ordinance on the grounds that the State legislative scheme regulating mortgage lenders and brokers preempts the Ordinance by implication and that the city exceeded its powers under its home rule charter. Perhaps fearing that their arguments of an implied State preemption would not carry the day, the predatory lending industry, led by Household Finance, and the Pennsylvania Bankers Association drafted State legislation containing the broadest preemption language ever proposed in Harrisburg. The legislation, Senate Bill 377, was practically secretly passed by overwhelmingly majorities in the Republican controlled House and Senate on the second day after it was introduced, without any opportunity for hearings or floor debate.

The preemption language of Senate Bill 377 is so wide sweeping that it not only prohibits Philadelphia and all municipalities from regulating predatory lending practices, but also attempts to prevent any local community from determining whether or not to enter into contracts, deposit funds or invest pension funds based upon the lending practices of the private business or an affiliate. To make matters worse, the legislation prohibits municipalities from even passing any resolutions concerning lending practices.

Mr. Chairman, Senate Bill 377 is the poster child for the need for strong and effective Federal legislation to stop predatory lending. Not only has our State legislature stripped the home rule powers which Philadelphia sought to invoke to stop the scourge of predatory lending in our midst, but they have given the predators the green light to continue robbing Philadelphia's home owners of their hard earned wealth. Congress is our last and best hope for a legislative solution that will bring real and immediate relief to the past and future victims of predatory lending not only in our city, but also throughout the country.

I applaud your efforts to pass meaningful legislation and pledge our support to you.