S. HRG. 108–453

# PREDATORY LENDING: ARE FEDERAL AGENCIES PROTECTING OLDER AMERICANS FROM FINANCIAL HEARTBREAK?

## HEARING

BEFORE THE

## SPECIAL COMMITTEE ON AGING UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

WASHINGTON, DC

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# PREDATORY LENDING: ARE FEDERAL AGENCIES PROTECTING OLDER AMERICANS FROM FINANCIAL HEARTBREAK?

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**TUESDAY, FEBRUARY 24, 2004**

U.S. SENATE,
SPECIAL COMMITTEE ON AGING,
*Washington, DC.*

The committee met, pursuant to notice, at 10:02 a.m., in room SD–628, Dirksen Senate Office Building, Hon. Larry Craig (chairman of the committee) presiding.

Present: Senators Craig and Stabenow.

## OPENING STATEMENT OF SENATOR LARRY CRAIG, CHAIRMAN

The CHAIRMAN. Good morning, everyone. The Senate Special Committee on Aging will be convened. Our ranking member, Senator Breaux wanted to be here, but he had a conflict in his committee schedule, which is quite typical this hour of the day with many of our colleagues.

Anyway, I want to thank you all for attending the Special Committee on Aging hearing this morning. Four years ago, this Committee held a hearing on equity predators, which treated this type of lending fraud in a very broad context. However, since then, we felt this subject merited further sustained and comprehensive inquiry, particularly in the context of home real estate assets belonging to our nation's seniors. To that end, in the fall of 2002, we commissioned a bipartisan study by the General Accounting Office into the problems presented by this type of fraud. The study was to include the Federal and State efforts in enforcement and education in this area as well as the effectiveness of such efforts, particularly on senior citizens.

This study has taken a year to complete and represents only the initial step in this oversight endeavor. Accordingly, today, we narrow the focus on the ruthless stripping of seniors of their lifelong, hard-earned equity in homeownership by unscrupulous brokers and lenders. Senior citizens seek to live comfortably in their advancing years but also must meet the rising financial costs of medical care and everyday living expenses. To meet these expenses, they often tap into the equity of their homes. In so doing, all too often, through are taken advantage of by those types of predators.

Today, we explore the types of Federal agency efforts as well as State efforts and their effectiveness in addressing the problems under the myriad of laws already in place. We will begin with witnesses from the General Accounting Office and two Federal agencies involved in the noble combat of this kind of fraud.

The CHAIRMAN. Our first witnesses will be David Wood, director of Financial Markets and Community Investment of the General Accounting Office. He will be joined by John Weicher, assistant secretary for Housing, Federal Housing Commissioner at HUD and Howard Beales.

Mr. BEALES. Beales.

The CHAIRMAN. Beales; thank you, Director, FTC's Bureau of Consumer Protection.

Our second panel will be that of Gavin Gee, past-president of the National Association of State Bank Examiners and Lavada DeSalles, member of the Board of Directors, AARP and Ms. Veronica Harding of Philadelphia, PA, a victim of such a predator who has come here today to share her important message.

We thank you all for joining us. We will start with our first panel. Again, to all of you thank you for being here. Mr. Wood, if you would proceed, please.

## STATEMENT OF DAVID WOOD, DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENTS, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON, DC

Mr. WOOD. Thank you, Mr. Chairman. As we note in our report to you and Ranking Member Breaux, predatory home mortgage lending has no precise definition, rather, it refers to a range of unsavory practices. Our report, which you are releasing today, addresses five aspects of this complex issue: first, how elderly homeowners, in particular, may be susceptible to abusive or predatory lenders; second, the actions of Federal agencies to address predatory lending practices; third, an overview of State laws on the subject, with case examples from two States; fourth, how the secondary market for home mortgage loans can affect predatory practices; and fifth, the roles of consumer education, mortgage counseling and disclosure requirements in fighting such practices.

In the interests of time, I will focus my remarks on the first two aspects. A number of factors may make the elderly especially susceptible to predatory or abusive lenders. First, older homeowners on average have more equity in their homes, making them inviting targets to lenders looking to strip equity from unsuspecting borrowers. Second, elderly homeowners often live in older homes and are more likely to need someone to do repairs for them. This makes them particularly vulnerable to lenders and home improvement contractors who collaborate to swindle. Third, physical impairments associated with aging such as declining vision, hearing or mobility can restrict elderly consumers' ability to obtain and compare credit information. Finally, some elderly people lack social and family support systems, potentially increasing their susceptibility to unscrupulous lenders who market loans through home visits.

In response to concerns about predatory lending, Federal agencies have taken a number of actions that generally fall into three categories. First, Federal agencies have conducted or funded education initiatives to increase consumers' financial literacy. Some of this effort is focused on the elderly population; for example, the Department of Justice offers guidance warning about financial crimes against the elderly.

However, Federal consumer protection laws that have been used to address predatory lending generally do not have provisions specific to elderly persons. Accordingly, the other two types of actions by Federal agencies: first, revising regulations or guidance applicable to lending institutions; and second, undertaking enforcement actions against certain lenders are designed to protect all consumers.

We asked eight Federal agencies involved in oversight or law enforcement among mortgage lending institutions to identify actions they have taken to address predatory lending. These eight agencies included the five financial institution regulators, that is, the Federal Reserve, the Office of the Comptroller of the Currency or OCC, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation and the National Credit Union Administration. The others were the Federal Trade Commission, the Department of Justice and HUD.

The five banking regulators reported little evidence of predatory lending activities among the institutions they supervise. Accordingly, only one, the OCC, reported taking a formal enforcement action. The regulators have, however, issued guidance to their institutions about predatory lending and subprime lending in general. Further, the Federal Reserve tightened its regulations implementing the Home-Ownership and Equity Protection Act, the only Federal law specifically directed at predatory lending practices, and revised other regulations to require that lenders provide more data with which to analyze lending patterns.

The Federal Reserve also oversees financial and bank holding companies, some of which own non-bank mortgage lending subsidiaries. Because these companies are engaged in subprime lending, our report recommends that the Congress clarify the Federal Reserve's authority to monitor and examine their lending activities.

Among the remaining three Federal agencies, the Federal Trade Commission has filed about 20 complaints since 1998 against mortgage lenders or brokers. HUD has taken steps to avoid abuses involving mortgages insured by the Federal Housing Administration, or FHA. While abuses such as flipping FHA properties, that is, repeatedly reselling them at escalating prices, are ultimately directed at bilking the lender or insurer, they may also harm innocent homebuyers. Finally, the Department of Justice has taken two major enforcement actions against lenders under the fair lending laws.

Mr. Chairman, that concludes my prepared statement, and I will be happy to respond to any questions you have. Thank you.

[The prepared statement of Mr. Wood follows:]

United States General Accounting Office

GAO

Testimony

Before the Special Committee on Aging, U.S. Senate

For Release on Delivery
Expected at 10:00 a.m. EST
Tuesday, February 24, 2004

# CONSUMER PROTECTION

# Federal and State Agencies Face Challenges in Combating Predatory Lending

Statement of David G. Wood, Director
Financial Markets and Community Investment

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GAO-04-412T

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# Highlights

Highlights of GAO-04-412T, a testimony before the Special Committee on Aging, U.S. Senate

February 24, 2004

## Why GAO Did This Study

While there is no universally accepted definition, the term "predatory lending" is used to characterize a range of practices, including deception, fraud, or manipulation, that a mortgage broker or lender may use to make a loan with terms that are disadvantageous to the borrower. Concerns about predatory lending have increasingly garnered the attention and concern of policymakers, consumer advocates, and participants in the mortgage industry. This statement is based on GAO's report, released at today's hearing, and discusses federal and state efforts to combat predatory lending; factors that may make elderly consumers more susceptible to predatory lending; the roles of consumer education, mortgage counseling, and loan disclosures in preventing predatory lending; and how the secondary mortgage market can affect predatory lending.

## What GAO Recommends

In its report, GAO suggested that Congress consider (1) providing the Federal Reserve Board with the authority to routinely monitor and, as necessary, examine nonbank mortgage lending subsidiaries of financial and bank holding companies to ensure compliance with federal consumer protection laws applicable to predatory lending, and (2) giving the Board specific authority to initiate enforcement actions under those laws against these nonbank mortgage lending subsidiaries.

www.gao.gov/cgi-bin/getrpt?GAO-04-412T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact David G. Wood at 202-512-8678 or woodd@gao.gov.

# CONSUMER PROTECTION

## Federal and State Agencies Face Challenges in Combating Predatory Lending

### What GAO Found

Federal agencies have taken a number of enforcement actions, sometimes jointly, using various federal consumer protection laws to combat predatory lending. The Federal Trade Commission (FTC) has played the most prominent enforcement role, filing 19 complaints and reaching multimillion dollar settlements. The Departments of Justice and Housing and Urban Development have also taken various predatory lending-related enforcement actions. Federal banking regulators report little evidence of predatory lending by the institutions they supervise. However, concerns exist about nonbank mortgage lending companies owned by financial or bank holding companies. While FTC is the primary federal enforcer of consumer protection laws for these entities, it is a law enforcement agency that conducts targeted investigations. In contrast, the Federal Reserve Board is well equipped to routinely monitor and examine these entities and, thus, potentially deter predatory lending activities, but its authority in this regard is less clear.

As of January 2004, 25 states, as well as several localities, had passed laws to address predatory lending, often by restricting the terms or provisions of certain high-cost loans; however, federal banking regulators have preempted some state laws for the institutions they supervise. Also, some states have strengthened their regulation and licensing of mortgage lenders and brokers.

While there are no comprehensive data, federal, state, and consumer advocacy officials report that elderly people have disproportionately been victims of predatory lending. According to these officials and relevant studies, predatory lenders target older consumers in part because they are more likely to have substantial home equity or may live on limited incomes that make them more susceptible to offers for quick access to cash. Older consumers may also have cognitive or physical impairments such as poor eyesight, hearing, or mobility that limit their ability to access competitive sources of credit.

GAO's review of literature and interviews with consumer and federal officials suggest that consumer education, mortgage counselling, and loan disclosures are useful, but may be of limited effectiveness in reducing predatory lending. A variety of factors limit their effectiveness, including the complexity of mortgage transactions, difficulties in reaching target audiences, and counselors' inability to review loan documents.

The secondary market—where mortgage loans and mortgage-backed securities are bought and sold—benefits borrowers by expanding credit, but may facilitate predatory lending by allowing unscrupulous lenders to quickly sell off loans with predatory terms. In part to avoid certain risks, secondary market participants perform varying degrees of "due diligence" to screen out loans with predatory terms, but may be unable to identify all such loans.

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to be here today to discuss federal and state efforts to deter predatory home mortgage lending, especially as it affects the elderly. While there is no universally accepted definition, the term "predatory lending" is used to characterize a range of practices, including charging excessive fees and interest rates, making loans without regard to borrowers' ability to repay, or refinancing loans repeatedly over a short period of time without any economic gain for the borrower. No comprehensive data are available on the extent of these practices, but they appear most likely to occur among subprime mortgages—those made to borrowers with impaired credit or limited incomes. Predatory practices, often targeted at the elderly, minorities, and low-income homeowners, can strip borrowers of home equity built up over decades and cause them to lose their homes.

My statement today is based on the report on predatory lending that you requested and are releasing today.[1] Specifically, my statement discusses (1) federal laws related to predatory lending and federal agencies' efforts to enforce them; (2) actions taken by states to address predatory lending; (3) factors that make elderly consumers susceptible to predatory lending practices; (4) the roles of consumer education, mortgage counseling, and loan disclosure requirements in preventing predatory lending; and (5) how the secondary market for mortgage loans can affect predatory lending. The scope of this work was limited to home mortgage lending and did not include other forms of consumer loans. In preparing the report, we examined federal laws, as well as selected state and local laws, and interviewed officials from federal, state, and local agencies. At GAO's request, federal agencies identified enforcement or other actions they have taken to address predatory lending. We also met with officials from industry and consumer advocacy groups and reviewed relevant literature. We conducted our work in accordance with generally accepted government auditing standards from January 2003 through January 2004.

[1] U.S. General Accounting Office, *Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending*, GAO-04-280 (Washington, D.C.: Jan. 30, 2004).

In summary:

- Federal agencies have addressed predatory lending by enforcing a variety of federal laws, including the Federal Trade Commission Act, the Home Ownership and Equity Protection Act (HOEPA), the Real Estate Settlement Procedures Act (RESPA), and the Truth in Lending Act (TILA). The Federal Trade Commission (FTC) took 19 enforcement actions against predatory home mortgage lenders and brokers between 1983 and 2003—17 of them between 1998 and 2003—to combat alleged deceptive acts or other illegal practices, with some resulting in multimillion dollar settlements. The Department of Justice and the Department of Housing and Urban Development have also taken individual and joint enforcement actions related to abusive lending. While federal banking regulators—the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System (the Board), the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Administration—report little evidence of predatory lending by the depository institutions that they supervise, concerns exist about nonbank mortgage lending companies that are owned by financial or bank holding companies. Our report recommends that Congress consider making statutory changes to provide the Board with clear authority to monitor, examine, and take enforcement actions against nonbank mortgage lending subsidiaries of financial and bank holding companies.

- As of January 2004, 25 states, 11 localities, and the District of Columbia have passed their own laws addressing predatory lending, according to a database that tracks state and local legislation.[2] In addition, some states have strengthened the regulation and licensing of mortgage lenders and brokers, and state law enforcement agencies and banking regulators have taken a number of enforcement actions under state consumer protection and banking laws. However, a state law may not apply to all mortgage lenders within the state. The Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Administration have asserted that federal law preempts some state predatory lending laws for the institutions they regulate, stating that federally chartered lending institutions should be required to comply with a single uniform set of national regulations.

[2]Information relating to state and local laws and their provisions is from a database maintained by Butera & Andrews, a Washington, D.C., law firm that tracks predatory lending legislation. These laws only include state and local laws that placed actual restrictions on lending. For example, they do not include local ordinances that consist solely of a resolution that condemns predatory lending.

- While there are no comprehensive data, government officials and consumer advocacy organizations have reported that elderly consumers have been disproportionately targeted and victimized by predatory lenders. Elderly consumers appear to be favored targets for several reasons—for example, because they may have substantial equity in their homes or live on limited incomes that make them susceptible to offers for quick access to cash. Further, some seniors have cognitive or physical impairments such as poor eyesight, hearing, or mobility that may limit their ability to access competitive sources of credit. While most government and private class-action enforcement activities seek to provide redress to large groups of consumers, some private efforts have focused on helping older victims of predatory lending.

- A number of federal, state, nonprofit, and industry-sponsored organizations offer consumer education initiatives designed to deter predatory lending by, among other things, providing information about predatory practices and working to improve consumers' overall financial literacy. Most of these efforts seek to serve the general consumer population, but a few education initiatives have specifically addressed predatory lending and the elderly. GAO's review of literature and interviews with consumer and federal officials suggest that while consumer education, mortgage counseling, and disclosures are useful, they may be of limited effectiveness in reducing predatory lending. For example, consumer education is hampered by the complexity of mortgage transactions and the difficulty of reaching the target audience. Similarly, unreceptive consumers, lack of access to relevant loan documents, and the sheer volume of mortgage originations each year limit the potential impact of universal counseling. And while efforts are under way to improve the federally required disclosures associated with mortgage loans, the complexity of mortgage transactions hinders the effectiveness of disclosures, especially given the lack of financial sophistication among many borrowers who are targeted by predatory lenders.

- The secondary market for mortgage loans—which allows lenders and investors to sell and buy mortgages and mortgage-backed securities—provides lenders with an additional source of liquidity and may benefit borrowers by increasing access to credit and lowering interest rates. But the secondary market may also inadvertently serve to facilitate predatory lending, both by providing a source of funds that enables unscrupulous originators to quickly sell off loans with predatory terms and by reducing incentives for these originators to ensure that borrowers can repay their loans. Secondary market participants use varying degrees of "due diligence"—a review and appraisal of legal and financial information—to avoid purchasing loans with abusive terms, but even the most extensive due diligence may not detect some predatory lending practices. Some states have passed laws making secondary market buyers liable for violations by loan originators, although such laws may have the unintended consequence of reducing the availability of legitimate credit to consumers.

## Background

While there is no uniformly accepted definition of predatory lending, a number of practices are widely acknowledged to be predatory. These include, among other things, charging excessive fees and interest rates, lending without regard to borrowers' ability to repay, refinancing borrowers' loans repeatedly over a short period of time without any economic gain for the borrower (referred to as "loan flipping"), and committing outright fraud or deception—for example, falsifying documents or intentionally misinforming borrowers about the terms of a loan. These types of practices offer lenders that originate predatory loans potentially high returns even if borrowers default, because many of these loans require excessive up-front fees. No comprehensive data are available on the incidence of these practices, but banking regulators, consumer advocates, and industry participants generally agree that predatory loans are most likely to occur in the market for "subprime" loans. The subprime market serves borrowers who have limited incomes or poor or no credit histories, in contrast with the prime market, which encompasses traditional lenders and borrowers with credit histories that put them at low risk of default. Subprime lending is not inherently abusive, and, according to officials at HUD and the Department of the Treasury, the emergence of a subprime mortgage market has enabled a whole class of credit-impaired borrowers to buy homes or access the equity in their homes. Originators of subprime loans most often are mortgage and consumer finance companies but can also be banks, thrifts, and other institutions.

Serious data limitations make the extent of predatory lending difficult to determine. However, there have been a number of major settlements resulting from government enforcement actions or private party lawsuits in the last 5 years that have accused lenders of abusive practices affecting large numbers of borrowers. For example, in October 2002, Household International, a large home mortgage lender, agreed to pay up to $484 million to homeowners to settle states' allegations that it used unfair and deceptive lending practices to make mortgage loans with excessive interest and fees. In addition, the rate of foreclosures of subprime loans has increased substantially since 1990, far exceeding the rate of increase for subprime originations. Some consumer groups and industry observers have attributed this development, at least in part, to an increase in abusive lending, particularly loans made without regard to borrowers' ability to repay. Additionally, groups such as legal services agencies have reported seeing an ever-growing number of consumers, particularly the elderly and minorities, who are in danger of losing their homes as a result of predatory lending practices.

## Federal Agencies Have Taken Enforcement and Other Actions to Address Predatory Lending, but Face Challenges

As shown in figure 1, Congress has passed numerous laws that federal agencies and regulators have used to combat predatory lending. Among the most frequently used laws—HOEPA, the Federal Trade Commission Act, TILA, and RESPA—only HOEPA was specifically designed to address predatory lending. Enacted in 1994, HOEPA places restrictions on certain high-cost loans, including limits on prepayment penalties and balloon payments and prohibitions against negative amortization. However, HOEPA covers only loans that exceed certain rate or fee triggers, and although comprehensive data are lacking, it appears that HOEPA covers only a limited portion of all subprime loans. The Federal Trade Commission Act, enacted in 1914 and amended on numerous occasions, authorizes FTC to prohibit and take action against unfair or deceptive acts or practices in or affecting commerce. TILA and RESPA are designed in part to provide consumers with accurate information about the cost of credit.

Figure 1: Federal Laws and Statutes Used to Address Lending Practices Generally Considered to be Predatory

| Predatory lending practice | Governing federal statute | | | | | Enforcing federal agencies | | | |
|---|---|---|---|---|---|---|---|---|---|
| | TILA | HOEPA[a] | RESPA | FTC Act | Title 18 of U.S. Code | Federal banking regulators | FTC | HUD | DOJ |
| Failure to disclose actual loan costs | ● | ● | ● | | | ● | ● | ● | |
| Prohibited fees and payments | | | ● | | | ● | | ● | |
| Lending without regard to ability to repay | | ● | | | | ● | ● | | |
| Loan flipping | | ● | | | | ● | ● | | |
| Fraud and deception | | | | ● | ● | ● | ● | | ● |
| Prohibited prepayment penalties | | ● | | | | ● | ● | | |
| Prohibited balloon payments | | ● | | | | ● | ● | | |

Source: GAO

[a]HOEPA covers only a limited portion of all subprime loans.

Other federal laws that have been used to address predatory lending practices include criminal fraud statutes that prohibit certain types of fraud sometimes used in abusive lending schemes, such as forgery and false statements. Also, the Fair Housing Act and Equal Credit Opportunity Act—which prohibit discrimination in housing-related transactions and the extension of credit, respectively—have been used in cases against abusive lenders that have targeted certain protected groups.

Using these or other authorities, federal agencies have taken a number of enforcement actions and other steps, such as issuing guidance and revising regulations. Among federal agencies, FTC has a prominent role in combating predatory lending because of its responsibilities in implementing and enforcing certain federal laws among lending institutions that are not depository institutions supervised by federal banking regulators. FTC reported that it has filed 19 complaints—17 since 1998—alleging deceptive or other illegal practices by mortgage lenders or brokers and that some actions have resulted in multimillion dollar settlements. The Department of Justice, which is responsible for enforcing certain federal civil rights laws, has taken two such enforcement actions related to predatory mortgage lending practices and has taken an additional action on behalf of FTC. The Department of Housing and Urban Development has undertaken enforcement activities related to abusive lending that focus primarily on reducing losses to the Federal Housing Administration insurance fund.[3] It has also taken three enforcement actions in abusive mortgage lending cases for violations of the Real Estate Settlement Procedures Act's prohibitions on certain types of fees.

Federal banking regulators have stated that their monitoring and examination activities have uncovered little evidence of predatory lending in federally regulated depository institutions. Four of the five federal banking regulators reported taking no formal enforcement actions involving predatory mortgage lending, while the fifth—the Office of the Comptroller of the Currency—reported that it has taken one formal enforcement action against a bank engaged in abusive mortgage lending. Regulators noted that they have taken informal enforcement actions to address questionable practices raised during the examination process and required their institutions to take corrective actions. The banking regulators have also issued guidance to the institutions they supervise on avoiding direct or indirect involvement in predatory lending. In addition, in 2001 the Board made changes to its regulations implementing HOEPA that, among other things, increase the number of loans HOEPA covers. The Board also made changes to its regulations implementing the Home Mortgage Disclosure Act in 2002 that make it easier to analyze potential patterns of predatory lending.

Federal agencies and banking regulators have coordinated their efforts to address predatory lending on certain occasions through participation in interagency working groups and through joint enforcement actions. For example, FTC, the Department of Justice, and the Department of Housing and Urban Development coordinated to take an enforcement action against Delta Funding Corporation, with each agency investigating and bringing actions for violations of the laws within its jurisdiction.

Issues related to federal oversight and regulation of certain nonbank mortgage lenders may challenge efforts to combat predatory lending. Nonbank mortgage lending companies owned by financial or bank holding companies (i.e., nonbank mortgage lending subsidiaries) account for an estimated 24 percent of subprime loan orginations, according to the Department of Housing and Urban Development, and some have been the

[3]The Department of Housing and Urban Development's Federal Housing Administration mortgage insurance program makes loans more readily available for low- and moderate-income families by providing mortgage insurance to purchase or refinance a home. Lending institutions such as mortgage companies and banks fund the loans.

target of notable federal and state enforcement actions involving allegations of abusive lending.[4] The Board may be better equipped than FTC to monitor and examine these holding company subsidiaries because of its role in overseeing financial and bank holding companies, but the Board does not have clear authority to do so. Our report recommends that Congress consider (1) making appropriate statutory changes that would grant the Board the authority to routinely monitor and, as necessary, examine the nonbank mortgage lending subsidiaries of financial and bank holding companies for compliance with federal consumer protection laws applicable to predatory lending practices and (2) giving the Board specific authority to initiate enforcement actions under those laws against these nonbank mortgage lending subsidiaries. In commenting on our report, the Board stated that while the existing structure has not been a barrier to Federal Reserve oversight, the approach we recommended for consideration by the Congress would likely be useful for catching some abusive practices that might not be caught otherwise. The Board also noted that the approach would present tradeoffs, such as different supervisory schemes being applied to nonbank mortgage lenders based on whether or not they are part of a holding company, and additional costs. However, these nonbank mortgage lenders are already subject to a different supervisory scheme than other lenders. We agree that costs could increase and believe that Congress should consider both the potential costs and benefits of clarifying the Board's authorities.

## Many States Have Passed Laws Addressing Predatory Lending, but Federal Agencies Have Preempted Some Statutes

In response to concerns about the growth of predatory lending and the limitations of existing laws, 25 states, the District of Columbia, and 11 localities have passed their own laws addressing predatory lending practices, according to a database that tracks such laws. Most of these laws regulate and restrict the terms and characteristics of high-cost loans—that is, loans that exceed certain rate or fee thresholds. While some state statutes follow the thresholds for covered loans established in HOEPA, many set lower thresholds in order to cover more loans than the federal statute. The statutes vary, but they generally cover a variety of predatory practices, such as balloon payments and prepayment penalties, and some include restrictions on such things as mandatory arbitration clauses that can restrict borrowers' ability to obtain legal redress through the courts.

[4] These nonbank mortgage lending subsidiaries are owned by the bank or financial holding companies and are not the direct operating subsidiaries of the bank itself.

Some states have also increased the regulation of and licensing requirements for mortgage lenders and brokers, in part to address concerns that some unscrupulous lenders and brokers have been responsible for lending abuses and that these entities have not been adequately regulated. For example, some states have added educational requirements that lenders and brokers must meet in order to obtain a license. In recent years, state law enforcement agencies and banking regulators have also taken a number of actions against mortgage lenders involving predatory lending. For example, an official from Washington State's Department of Financial Institutions reported that the department had taken several enforcement actions to address predatory lending, including one that resulted in a lender being ordered to return more than $700,000 to 120 Washington borrowers for allegedly deceiving them and charging prohibited fees.

Three federal banking regulators—the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision—have issued opinions stating that federal laws preempt some state predatory lending laws for the institutions that they regulate. The regulators note that such preemption creates a more uniform regulatory framework, relieves lending institutions of the burden of complying with a hodgepodge of state and federal laws, and avoids state laws that may restrict legitimate lending activities. State officials and consumer advocates that oppose preemption argue that federal laws do not effectively protect consumers against predatory lending practices and that federal regulators do not devote sufficient resources toward enforcement of consumer protection laws for the institutions they oversee. In response, federal banking regulators have noted that federally supervised institutions are highly regulated and subject to comprehensive supervision. The regulators also said they found little to no evidence of predatory lending by the institutions they regulate.

## Predatory Lenders May Target Elderly Consumers

Consistent observational and anecdotal evidence, along with some limited data, indicates that, for a variety of reasons, elderly homeowners are disproportionately the targets of predatory lending. Because older homeowners, on average, have more equity in their homes than younger homeowners, abusive lenders could be expected to target these borrowers in order to "strip" the equity from their homes. According to federal officials and consumer groups we contacted, abusive lenders often try to convince elderly borrowers to repeatedly refinance their loans, adding more costs each time—an abuse known as loan flipping. In addition, some brokers and lenders aggressively market home equity loans as a source of cash, particularly for older homeowners who may have limited incomes but require funds for major home repairs or medical expenses. The financial losses older people can suffer as a result of abusive loans can result in the loss of independence and security and a significant decline in their quality of life.

A number of factors may make the elderly particularly susceptible to predatory lending practices. For example:

- Diseases and physical impairments associated with aging—such as declining vision, hearing, or mobility—can restrict elderly consumers' ability to access financial information and compare credit terms. In such situations, potential borrowers may be susceptible to the first lender to offer what seems to be a good deal, especially if the lender is willing to visit them at home or provide transportation to the closing.

- Some older people may also have diminished cognitive capacity, which can impair their ability to comprehend and make informed judgments on financial issues. According to a report sponsored by the National Academy of Sciences, elderly people may be more likely to have conditions or disabilities that make them easy targets for financial abuse and they may have diminished capacity to evaluate proposed courses of action.[5] Representatives of legal aid organizations have said that they frequently represent elderly clients in predatory lending cases involving lenders that have taken advantage of a borrower's confusion and, in some cases, dementia.

- Several advocacy groups have noted that some elderly people lack social and family support systems, potentially increasing their susceptibility to unscrupulous lenders who may market loans by making home visits or offering other personal contact.

- Elderly homeowners often live in older homes and are more likely to need someone to do repairs for them. Federal officials, legal aid services, and consumer groups have reported that home repair scams targeting elderly homeowners are particularly common. For example, a joint report on predatory lending by the Department of Housing and Urban Development and the Department of the Treasury noted that

[5]Richard J. Bonnie and Robert B. Wallace, eds., "Elder Mistreatment: Abuse, Neglect, and Exploitation in an Aging America," Panel to Review Risk and Prevalence of Elder Abuse and Neglect, National Research Council (Washington, D.C.: National Academies Press, 2003), 393.

predatory brokers and home improvement contractors have collaborated to swindle older consumers.[6] A contractor may come to a homeowner's door, pressure the homeowner into accepting a home improvement contract, and arrange for financing of the work with a high-cost loan. The contractor then does shoddy work or does not finish the agreed-on repairs, leaving the borrower to pay off the expensive loan.

Federal agencies, states, nonprofits, and trade organizations have conducted and funded financial education for consumers as a means of improving consumers' financial literacy and, in some cases, raising consumers' awareness of predatory lending practices. Because the elderly may be more susceptible to predatory lending, government agencies and consumer advocacy organizations have focused some of their education efforts on this population. For example, the Department of Justice offers on its Web site the guide "Financial Crimes Against the Elderly," which includes references to predatory lending. The Department of Health and Human Services' Administration on Aging provides grants to state and nonprofit agencies for programs aimed at preventing elder abuse, including predatory lending practices targeting older consumers. AARP, which represents Americans age 50 and over, sponsors a number of financial education efforts, including a borrower's kit that contains tips for avoiding predatory lending.

However, federal consumer protection and fair lending laws that have been used to address predatory lending do not generally have provisions specific to elderly persons. For example, age is not a protected class under the Fair Housing Act, which prohibits discrimination in housing-related transactions. In addition, the Home Mortgage Disclosure Act (HMDA)—which requires certain financial institutions to collect, report, and disclose data on loan applications and originations—does not require lenders to report information about the age of the applicant or borrower. An exception is the Equal Credit Opportunity Act, which prohibits unlawful discrimination on the basis of age in connection with any aspect of a credit transaction.

Little comprehensive data exist on the ages of consumers involved in federal and state enforcement actions and private class-action lawsuits

[6] HUD-Treasury Task Force on Predatory Lending, *Curbing Predatory Home Mortgage Lending: A Joint Report* (June 2000).

involving predatory lending. Such actions generally seek to provide redress to large groups of consumers, but a few cases have involved allegations of predatory lending targeting elderly borrowers. For example, FTC, six states, AARP, and private plaintiffs settled a case with First Alliance Mortgage Company in March 2002 for more than $60 million. The company was accused of using misrepresentation and unfair and deceptive practices to lure senior citizens and those with poor credit histories into entering into abusive loans; an estimated 28 percent of the 8,712 borrowers represented in the class-action suit were elderly.

Some nonprofit groups—such as the AARP Foundation Litigation, the National Consumer Law Center, and the South Brooklyn Legal Services' Foreclosure Prevention Project—provide legal services that focus, in part, on helping elderly victims of predatory lending. The AARP Foundation Litigation, which conducts litigation to benefit Americans 50 years and older, has been party to 7 lawsuits since 1998 involving allegations of predatory lending against more than 50,000 elderly borrowers. Six of these suits have been settled, and the other is pending.

## The Usefulness of Consumer Education, Counseling, and Disclosures in Deterring Predatory Lending May Be Limited

While representatives of the mortgage lending industry and consumer groups have noted that financial education may make some consumers less susceptible to abusive lending practices, GAO's review of literature and interviews with consumer and federal officials suggest that consumer education by itself has limits as a tool for deterring predatory lending. First, mortgage loans are complex financial transactions, and many different factors—including the interest rate, fees, provisions of the loan, and situation of the borrower—determine whether a loan is in a borrower's best interest. Even an excellent campaign of consumer education is unlikely to provide less sophisticated consumers with enough information for them to determine whether a loan contains abusive terms. Second, predatory lenders and brokers tend to use aggressive marketing tactics that are designed to confuse consumers. Broad-based campaigns to make consumers aware of predatory lending may not be sufficient to prevent many consumers—particularly those who may be uneducated or unsophisticated in financial matters—from succumbing to such tactics. Finally, the consumers who are often the targets of predatory lenders are also some of the hardest to reach with educational information.

Prepurchase mortgage counseling—which can offer a "third party" review of a prospective mortgage loan—may help borrowers avoid predatory loans, in part by alerting consumers to predatory loan terms and practices. The Department of Housing and Urban Development supports a network of approximately 1,700 approved counseling agencies across the country and in some cases provides funding for their activities. While beneficial, the role of mortgage counseling in preventing predatory lending is likely to be limited. Borrowers do not always attend such counseling, and when they do, counselors may not have access to all of the loan documents needed to review the full final terms and provisions before closing. In addition, counseling may be ineffective against lenders and brokers engaging in fraudulent practices, such as falsifying applications or loan documents, that cannot be detected during a prepurchase review of mortgage loan documents.

Finally, disclosures made during the mortgage loan process, while important, may be of limited usefulness in reducing the incidence of predatory lending practices. Certain federal laws, including TILA and RESPA, have requirements covering the content, form, and timing of the information that must be disclosed to borrowers. However, industry and consumer advocacy groups have publicly expressed dissatisfaction with the current disclosure system. In July 2002, the Department of Housing and Urban Development issued proposed rules intended to streamline the disclosure process and make disclosures more understandable and timely, and debate over the proposed rules has been contentious.[7] Although improving loan disclosures would undoubtedly have benefits, once again the inherent complexity of loan transactions may limit any impact on the incidence of predatory lending practices. Moreover, even a relatively clear and transparent system of disclosures may be of limited use to borrowers who lack sophistication about financial matters, are not highly educated, or suffer physical or mental infirmities. Finally, as with mortgage counseling, revised disclosures would not necessarily help protect consumers against lenders and brokers who engage in outright fraud or who mislead borrowers about the terms of loans in the disclosure documents themselves.

[7]67 Fed. Reg. 49134 (July 29, 2002).

## The Secondary Market May Benefit Consumers but Can Also Facilitate Predatory Lending

The existence of a secondary market for subprime loans has benefited consumers by increasing the sources of funds available to subprime lenders, potentially lowering interest rates and origination costs for subprime loans. However, the secondary market may also inadvertently facilitate predatory lending by providing a source of funds for unscrupulous originators, allowing them to quickly sell off loans with predatory terms. Further, the existence of a secondary market may reduce the incentive for originating lenders—who generally make their profits from high origination fees—to ensure that borrowers can repay.

Purchasers of mortgage loans undertake a process of due diligence designed to avoid legal, financial, and reputational risk. However, the degree of due diligence purchasers undertake varies. Officials of Fannie Mae and Freddie Mac—which are estimated to account for a relatively small portion of the secondary market for subprime loans—told us that their organizations undertake a series of measures aimed at avoiding the purchase of loans with abusive characteristics that may have harmed borrowers. In contrast, according to some market participants, the due diligence of other secondary market purchasers of residential mortgages may be more narrowly focused on the creditworthiness of the loans and on their compliance with federal, state, and local laws. However, even the most stringent efforts cannot uncover some predatory loans. For example, due diligence may be unable to uncover fraud that occurred during the loan underwriting or approval process, some excessive or unwarranted fees, or loan flipping.

Under some state and local legislation, purchasers of mortgages or mortgage-backed securities on the secondary market may be held liable for violations committed by the originating lenders—referred to as "assignee liability" provisions. Assignee liability is intended to discourage secondary market participants from purchasing loans that may have predatory features and to provide an additional source of redress for victims of abusive lenders, but some argue that it can also discourage legitimate lending activity. Secondary market purchasers that are unwilling to assume the potential risks associated with assignee liability provisions have stopped purchasing, or announced their intention to stop purchasing, mortgages originated in areas covered by such provisions. Assignee liability provisions of the Georgia Fair Lending Act were blamed for causing several participants in the mortgage lending industry to withdraw from the market, and the provisions were subsequently repealed.

Mr. Chairman, this concludes my prepared statement. I would be happy to answer any questions at this time.

## Contacts and Acknowledgements

For further information on this testimony, please contact David G. Wood at (202) 512-8678, or Harry Medina at (415) 904-2000. Individuals making key contributions to this testimony included Jason Bromberg, Randall C. Fasnacht, Jr., Elizabeth Olivarez, and Paul Thompson.

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The CHAIRMAN. Mr. Wood, thank you very much for that statement.

We have been joined by another of our colleagues and a member of this Committee, Senator Stabenow. So, Secretary Weicher, before we go to you, I am going to ask if the Senator has any opening comments, and then we will proceed.

## OPENING STATEMENT OF SENATOR DEBBIE STABENOW

Senator STABENOW. Thank you. I first welcome our panelists and want to particularly thank you for this hearing. This is a very important topic. I sit on the Banking, Housing and Urban Affairs Committee and since coming to the Senate 3 years ago have spent a great deal of time on this issue, and recognize, in fact, it was one of the first issues brought to me after becoming a member of that Committee from the people of Michigan.

I would appreciate if I could put a statement, my prepared opening remarks into the record.

The CHAIRMAN. Certainly.

Senator STABENOW. I would just add that I think there are a number of things that we can do together, and one of the positive steps that has already been taken is that in the Fair Credit Reporting Act, which we passed overwhelmingly last fall, a title of mine that I cosponsored along with Senator Enzi in the Committee is on financial literacy, and we specifically placed that in the new law to focus on a coordinated effort on financial education, specifically to help address some of the issues of predatory lending.

I realize it is a larger issue. It is complicated. There is a lot that needs to be done on the enforcement end, but we also know that good consumer information, consumers being able to ask the right questions and being able to get good answers before they make decisions is a part of the whole issue.

So, I am hopeful that this section, this new title of the act, will be enforced quickly, and we will be able to use that as part of the way we begin to address this very serious issue. Thank you.

[The prepared statement of Senator Debbie Stabenow follows:]

### PREPARED STATEMENT OF SENATOR DEBBIE STABENOW

Thank you, Senator Craig, for convening this hearing on predatory lending. Americans have a right to expect their national legislators to be concerned about and take action to thwart abusive lending practices.

We know that home ownership provides basic financial security for Americans at all income levels. Homeowners hold an asset that most often increases in value, that provides stability in uncertain times; and that can be bequeathed to heirs. We also know that most mortgage lenders and brokers are upstanding businesspeople. But there are some unscrupulous lenders who prey upon naive consumers and take advantage of their limited financial understanding, ultimately jeopardizing consumers' basic financial security.

Sadly, predatory lending is a practice that disproportionately targets older adults. Victims of this type of financial abuse often find themselves paying much higher interest rates, losing their equity through unnecessary and repeated refinancings. Many even end up losing their homes.

Members of Congress have heard horror stories from victims of predatory lendings as well as potential solutions from different representatives of the lending industry. As a member of the Banking and Housing Committee, I have pushed for greater financial education, enhanced enforcement of existing anti-predatory laws, and strong new protections against unethical yet technically legal practices. I will continue to do so.

Thank you again, Senator Craig, for holding this important hearing. I look forward to hearing testimony from these knowledgeable witnesses and to working toward ending the unfair practice of predatory lending.

The CHAIRMAN. Senator, thank you for your leadership in this area. We hope you will take this study over to the Committee along with the record that I think we can build here that will advance these issues for you.

Thank you very much. Now, let us turn to John Weicher, assistant secretary for Housing. Welcome before the Committee, John.

## STATEMENT OF JOHN C. WEICHER, ASSISTANT SECRETARY OF HOUSING/FEDERAL HOUSING COMMISSIONER, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, WASHINGTON, DC

Mr. WEICHER. Thank you, Mr. Chairman and thank you, Senator Stabenow for the opportunity to testify this morning on the efforts of the Department of Housing and Urban Development to combat predatory lending and protect senior citizens and, indeed, all Americans against unfair and deceptive lending practices.

Meeting the housing needs of senior citizens while protecting them from predatory lending practices is a high priority at the Department. I would like to submit my prepared statement for the record and just discuss a few aspects of our efforts with you this morning.

The CHAIRMAN. All full statements will become a part of the record. Thank you.

Mr. WEICHER. HUD's authority to address predatory lending essentially extends only to FHA loans and FHA lenders, so I would like to start by describing our mortgage insurance activity.

Our typical homebuyer is a young, first-time homebuyer, often a minority household. In fiscal year 2003, FHA insured 600,000 home purchase mortgages. Of these 80 percent were to first-time homebuyers, and 40 percent were to minority households. About 1 percent of FHA's home purchase borrowers are elderly.

But FHA does have one important insurance program that specifically serves the elderly. This is the home equity conversion mortgage program. HECMs are also known as reverse mortgages. They let elderly homeowners convert the equity into their homes into income that can be used to pay for living expenses. FHA accounts for about 95 percent of the reverse mortgage market.

The HECM program started as a demonstration in 1990. We now have insured 90,000 loans overall. In each of the last 2 years, we have set records. We endorsed over 13,000 loans in 2002 and then set another record in 2003 with over 18,000 loans. Three-quarters of the borrowers are aged 70 or over. There are even some borrowers older than 90. We recognize that seniors with considerable equity in their homes can be prime targets for predatory lending. FHA-insured HECMs give seniors an alternative. We require that seniors considering a HECM loan receive counseling, and we have worked hard to ensure that the counseling they receive is of high quality.

During the housing counseling session, the senior learns how a HECM works, how much he or she would receive through a HECM, how much the transaction will cost, what are the financial alternatives and what are the tax and estate consequences, among other things.

One of HUD's major partners in our effort to educate seniors about reverse mortgages is the AARP Foundation. The foundation sponsors the reverse mortgage education project, which has been the leading consumer voice in the reverse mortgage market for over a decade, providing in-depth, objective consumer information and promoting high quality independent consumer counseling on reverse mortgages and other alternatives.

During 2003, the project doubled the size of its counseling network, and this year, the project has received a 150 percent increase in funding from HUD, from $750,000 in 2003 to $1.9 million this year. HUD funds AARP through our Housing Counseling Grant Program. Housing counseling funds have doubled in this administration, from $20 million to $40 million, and President Bush is proposing to increase our Housing Counseling Grant Program to $45 million in this year's budget, another 12.5 percent increase.

We know that housing counseling works. Families who receive counseling are better able to select the best mortgage for their needs and better able to manage their finances so they can remain in their homes. Housing counseling has proven to be an extremely important activity to educate consumers on how to avoid abusive lending practices.

In my formal statement, I discuss other HUD activities to combat predatory lending, including new regulations, some addressing the HECM program specifically and others addressing all of our borrowers, and also vigorous enforcement of FHA procedural violations by lenders and others. They protect all FHA homebuyers, elderly and non-elderly alike.

In the interests of time, I will skip over these at this point, but I would like to mention that HUD works closely with State and local governments to carry out enforcement actions against business partners engaged in predatory lending. We also work with coalitions of community groups to help FHA-insured borrowers who have been victimized by predatory practices.

We have tripled our enforcement staff over the last year. On a national level, HUD's Inspector General continues to work closely with law enforcement in many States, notably New York, New Jersey, Pennsylvania, Illinois and Arizona, to target unscrupulous lenders and better combat abusive lending practices.

HUD also works closely with the FTC to prosecute lenders who engage in illegal practices. Some of these cases are described in both my prepared testimony and the statement of Mr. Beales and also in the GAO report.

I hope this discussion of our efforts and accomplishments has made clear that the Department is aggressively policing program participants and imposing significant sanctions on business partners found to be violating our procedures or otherwise engaged in abusive or deceptive behavior. The administration remains firmly committed to protecting seniors and all consumers against predatory lending practices.

We are happy to have this opportunity to discuss our activities and look forward to working with you to strengthen consumer protections against predatory lending.

[The prepared statement of Mr. Weicher follows:]

# STATEMENT OF JOHN C. WEICHER
## Assistant Secretary for Housing –Federal Housing Commissioner
## U.S. Department of Housing and Urban Development

**BEFORE THE**
**UNITED STATES SENATE**
**SPECIAL COMMITTEE ON AGING**

**February 24, 2004**

Good morning, Chairman Craig, Ranking Member Breaux and distinguished Members of the Special Committee. Thank you for the opportunity to testify on the efforts of the Department of Housing and Urban Development to combat predatory lending and protect senior citizens and indeed all Americans against unfair and deceptive practices. Meeting the housing needs of senior citizens while protecting them from predatory lending practices is a high priority at the Department.

I would like to provide you with an overview of HUD's initiatives and describe what HUD, particularly through the Federal Housing Administration (FHA) is currently doing to address this problem.

FHA has made significant efforts through consumer education, enforcement actions and regulatory reforms to combat abusive and deceptive lending practices. Before I discuss the full range of these efforts across all our insurance programs, I would like to describe FHA's mortgage insurance activity to the Committee, to place our efforts in context. FHA insures mortgages for homebuyers who do not qualify for conventional mortgage loans. Our typical borrower is a young, first-time homebuyer, often a minority household. In FY 2003, FHA insured 600,000 home purchase mortgages. Of these, 80 percent were to first-time homebuyers, and 40 percent of those were to minority households.

Of special interest to this committee, about one percent of FHA's borrowers are elderly (65 or over) and another one percent are between the ages of 60 to 64. About 20 percent of FHA-insured elderly homebuyers purchase manufactured homes, compared to less than two percent of young homebuyers. Over 4.4 percent of FHA borrowers who bought manufactured homes were 60 and over.

Home Equity Conversion Mortgages

FHA does have one important insurance program that specifically serves the elderly. This is the Home Equity Conversion Mortgage Program. At HUD, we refer it as HECM for short. The HECM program, commonly referred to by consumers as a reverse mortgage program, is designed to enable elderly homeowners to convert the equity in their homes into income that can be used to pay for home improvements, medical costs, living expenses, or other expenses. FHA accounts for about 95% of the reverse mortgage market.

The HECM program started as a demonstration program in 1990 and was seen as a true innovation in the mortgage industry, a way of helping elderly people who were house rich but cash poor. The program became permanent in 1993. In the last two years –2002 and 2003 – the program has been growing at a rapid rate. We set records in both of these years. We endorsed over 13,000 loans in 2002 and then set another record in 2003 with over 18,000 loans.

According to demographic data on new borrowers in the HECM program over the last three years, 50 percent are between 70 and 79. Another 25 percent are 80 or over, so three quarters of the borrowers are 70 or over. There are even some borrowers older than 90: they comprise 3.2 percent of the total.

Housing Counseling

We recognize that seniors with considerable equity in their homes can be prime targets for predatory lending. We require that seniors considering a HECM loan receive counseling, and we have worked hard to ensure that the counseling they receive before applying is of high quality.

HUD believes that our frontline of protection against predatory lending is an informed consumer. Housing counseling has proven to be an extremely important activity to educate consumers on how to avoid abusive lending practices. Housing counseling agencies help educate borrowers, so they have the financial literacy they need to protect themselves. Counselors assist individuals with making intelligent decisions, helping unwary borrowers avoid inflated appraisals, unreasonably high interest rates, unaffordable repayment terms, and other conditions with can result in a loss of equity, increased debt, default, and even foreclosure.

During the housing counseling session the senior learns how a HECM works, how much equity he or she would receive through a HECM, how much the transaction will cost, what are the financial alternatives to a HECM and what are the tax and estate consequences, among other things.

One of HUD's major partners in our effort to educate seniors about reverse mortagages is the AARP Foundation. The AARP Foundation sponsors the Reverse Mortgage Education Project which is designed to help older homeowners make informed decisions about converting the equity in their homes into cash - without having to sell their homes, or make monthly loan repayments. This project has been the leading consumer voice in the reverse mortgage market for over a decade, providing in-depth, objective consumer information, and promoting high-quality, independent consumer counseling on reverse mortgages and other alternatives.

During 2003, the Reverse Mortgage Education Project doubled the size of its counseling network, handled 10,000 consumer inquiries and counseled 3,400 households. The Project recently received a 150% increase in funding from HUD – from $750,000 in 2003 to $1.9 million in 2004. The increase will enable the project to add more counselors and nearly triple the number of households it counsels. It will also pay for upgrading the project's online reverse mortgage calculators, developing a formal counseling quality assurance program, and strengthening the project's client screening and appointment scheduling systems.

HUD's funds AARP through its Housing Counseling Grant Program. This grant program funds housing counseling agencies across the country. In FY 2003, HUD awarded $37.6 million in grants, $2.7 million being awarded specifically to combat predatory lending. These grants will assist more than 430,000 people to either become first-time homeowners or remain homeowners after their purchase. The grants were awarded to 17 national and regional organizations and approximately 350 state and local housing counseling agencies. President Bush is proposing to increase HUD's Housing Counseling grant program to $45 million next year - another 12.5 percent increase. We know that housing counseling works. Families who receive counseling are better able to select the best mortgage for their needs and better able to manage their finances so they can remain in their homes.

<u>HECM Regulatory Changes</u>

In addition to pursuing our housing counseling efforts, HUD has undertaken several regulatory reforms in recent years to protect seniors participating in the HECM Program from predatory practices. These rules include:

- A final rule that would implement statutory changes to the HECM Program under Section 201 of the American Homeownership and Economic Opportunity Act of 2000. This legislation authorized FHA to offer mortgage insurance for the refinancing of existing HECM loans and established a set of consumer safeguards for these HECM refinancing transaction. The statute requires an anti-churning disclosure to inform the borrower of the total cost of the refinancing and the new principal limit. The Department submitted this rule to OMB on February 3.

- A final rule was published in 1999 requiring that seniors receive a full disclosure of all costs, including estate planning, financial advice and other services that are related to the mortgage, but are not required to obtain a HECM loan. This rule was designed to protect senior homeowners in the HECM program from becoming liable for payment of excessive fees for third party services that may have little or no value and are not necessary.

Combating Predatory Lending

In addition to the reforms that HUD has pursued in the HECM program, the Department has developed new requirements specifically targeting lending practices to protect all FHA borrowers and set an example for the rest of the housing industry. These reforms benefit all of FHA's homebuyers, including the elderly.

In particular, there are several new, more stringent procedures for participating in FHA insured programs that have been implemented as final rules. They include:

- An Anti-Flipping Rule that was made effective in June 2003. This rule prohibits FHA insurance on a property resold within 90 days of the previous sale and also prohibits sale of a property by anyone other than the owner of record.

- An Appraiser Qualifications Rule for Placement on FHA Single Family Appraiser Roster that was made effective in June 2003. This rule establishes stronger professional credentials for FHA-approved appraisers.

- A rule establishing Section 203(k) Consultant Placement and Removal Procedures that was made effective in September 2002. The rule establishes placement and removal procedures for HUD's roster of 203(k) consultants to better ensure the consultants meet HUD requirements. The 203(k) program insures mortgages for home purchases that include the costs of repairs as well as the purchase price.

- A rule allowing Electronic Submission of Audited Financial Statements that was made effective in September 2002. This rule allows HUD to accept electronic submissions of lenders' financial audits to identify and remove noncompliant lenders more quickly.

- A rule establishing Placement and Removal Procedures for HUD's Nonprofit Organization Roster that was made effective in July 2002. This rule better insures that nonprofits meet HUD requirements.

There are also proposed rules we have published:

- A proposed rule Limiting Nonprofit Organization Participation in FHA Single Family Activities was just published on February 13. This rule proposes ways to reduce defaults.

by nonprofits and create more reasonable conditions for their participation in FHA programs. It would require nonprofits that obtain FHA financing for10 or more properties in a fiscal year to prepay at least 80 percent of that total number of mortgages within two years after the fiscal year they were originated.

- A proposed Rule Regarding Lender Accountability for Appraisals that was published in January 2003. This rule provides that lenders and appraisers are held strictly accountable for the quality of appraisals on properties securing FHA insured mortgages. It proposes that lenders who submit appraisals to HUD that do not meet FHA requirements are subject to the imposition of sanctions by the Mortgagee Review Board. The final rule is expected to be published in the second quarter of this calendar year.

- A proposed rule on the FHA Fee Panel Inspector Roster that was published in October 2002. This rule creates the FHA Fee Panel Inspector Roster for inspecting new construction projects.

Monitoring and Enforcement

In addition to establishing more stringent procedures for participating in FHA insured programs, the Department is taking aggressive action concerning business partners that demonstrate poor performance and abusive lending practices.

HUD has created the Credit Watch Program by which we track quarterly the default rates for the 25,000 lender offices that originate FHA loans and terminates those operations where the default rate exceeds twice that of the local jurisdiction. Credit Watch protects the integrity of the FHA insurance funds and sanctions those lenders who demonstrate imprudent or possible abusive lending practices. The default rates of these lenders are published on the Web and thereby serve as a source of information by which other lenders and interested parties can judge a lender's performance.

Since Credit Watch started in May 1999, we terminated 205 lender branches and sent out another 19 sanction letters through December 2003. That is about one percent of FHA lender offices.

FHA also produces Neighborhood Watch, a web-based software application, for HUD oversight of lenders and lender self-monitoring. Neighborhood Watch complements the Credit Watch Termination initiative by providing FHA approved lenders with statistical views of their performance. As a self-policing tool it has enabled lenders to monitor their performance in comparison to other lenders, take corrective actions within their own organizations, and/or sever relationships with poorly-performing business partners.

When FHA staff finds evidence of widespread abuse of HUD's program requirements, lenders are referred to the Mortgagee Review Board. (MRB) for action. I chair the MRB and other senior HUD officials serve on the Board. Board cases generally involve the most serious findings. The MRB is authorized to impose a range of administrative sanctions from a letter of reprimand to withdrawal of a mortagee's FHA approval. The MRB may also impose civil money penalties.

FHA monitors the activities of lenders down to the branch level. Based on these reviews, over the past three years, the MRB took action against 137 lenders, withdrew FHA approval of 36 of them, and assessed $9.59 million in civil money penalties. Also, 8,980 indemnification agreements were executed for a potential total savings of about $209 million. When we find loans that are improperly originated or underwritten, we require indemnification- if the loan goes bad, the lender pays, not our insurance fund. We made over 1,100 referrals to the OIG for further investigations. We have debarred 407 individuals and entities from participating in FHA's Single-Family Programs.

FHA has also created a new risk management tool to target appraisers for review, known as "Appraiser Watch." Appraiser Watch uses traditional risk factors – such as loan volume, loan performance, and loan type – to compare appraisers across peer groups and identify appraisers for review. With Appraiser Watch, FHA can better identify appraisers who either knowingly or unintentionally put homeowners at risk for losing their homes to foreclosure because of inflated valuations and sometimes the poor condition of the property.

Through Appraiser Watch, FHA has identified over 100 poorly performing appraisers each year and removed them from the FHA Appraiser Roster. The review versus removal rate under this new system is about one percent. Appraiser Watch is a major improvement over the appraiser monitoring system we inherited. Under that former appraiser monitoring system, FHA field staff reviewed more than 30,000 appraisals annually from October 1997 through September 2001, but identified only 20 poorly performing appraisers each year.

Interagency Enforcement Activities

HUD works closely with state and local governments to carry out enforcements actions against business partners engaged in predatory lending. On a national level, HUD's Office of Inspector General continues to work closely with law enforcement in many states, notably in New York, New Jersey, Pennsylvania, Illinois and Arizona, to target unscrupulous lenders and better combat abusive lending practices. In many of these areas HUD is working with coalitions of community groups to provide relief to FHA-insured borrowers who have been victimized by predatory practices.

HUD has tripled its RESPA investigative staff from ten full time staff to thirty full time, and has increased funding for investigation and enforcement of fair housing and RESPA violations, with a new $1.5 million investigation contract and an additional $500,000 for Fair Housing investigations. Recent RESPA violation settlements have led to more than $1.5 million in donations by lenders to HUD-approved counseling services.

HUD also works closely with the Department of Justice, federal financial regulators and the Federal Trade Commission to distinguish between predatory practices of some lenders and others whose practices are fairly serving the mortgage credit needs of those not qualified for prime loans. In November 2003, HUD and the FTC jointly filed a case against and reached settlement with a mortgage loan servicing company charged with violations of the FTC Act, RESPA, and other laws.

Public Education

HUD is committed to increasing awareness in the public about predatory lending. HUD has developed literature about predatory lending and distributes this information at homeownership fairs and other public forums. HUD's website also includes information on the subject.

In addition, HUD has partnered with other organizations in public education campaigns about predatory lending. In early 2004, HUD will launch a national advertising campaign to warn against the dangers of predatory lending. The $1 million campaign consists of print, radio, and television ads. The ads are being produced under a contract with the National Fair Housing Alliance and the Ad Council. HUD is also a member of the Interagency Task Force on Fair Lending. HUD worked with the task force in drafting a new brochure that alerts consumers to potential borrower pitfalls, including high cost loans and provides tips for getting the best financial deal possible.

Loss Mitigation

HUD also addresses predatory lending through its Loss Mitigation Program, which is often able to help a victim of predatory lending who has defaulted on the mortgage and faces possible foreclosure. Under this program, lenders have options that may help homeowners stay in their homes or may mitigate the financial consequences of the default if the homeowner does not have the resources to make that possible. FHA regulations require that lenders explore all available loss mitigation options prior to proceeding to foreclosure. The success of this program is clear. In the last two years, the number of loss mitigation cases resolved by the borrower retaining homeownership is nearly as large as the number of cases resolved through foreclosure.

The Baltimore Predatory Lending Task Force

In early 2000 the Department initiated a wide-ranging inquiry into the impact of predatory lending on loans insured by the FHA. The Department established a "Flipping and Predatory Lending Task Force" in Baltimore City to study predatory lending activity at a community level over a long term. At the time substantial number so delinquent and potentially predatory loans were originated in Baltimore by multiple entities (of 595 case files reviewed, 100 were determined to have predatory characteristics involving many different lenders, investors, appraisers, closing agents, and straw buyers).

Today, predatory lending in Baltimore is on the decline. Forty-eight criminals have been indicted and jailed. A HELP program, funded in part by a $1 million grant from HUD, has been established to provide victim's assistance. Property flipping of FHA loans has been eliminated, and homeownership counseling has helped home purchasers avoid the pitfalls of predatory lending practices. These accomplishments have been realized thanks to coordination with the Department of Justice, the State of Maryland, the Baltimore City Government and local community groups.

Conclusion

I hope this discussion of our efforts and accomplishments has made clear that the Administration and the Department are aggressively policing its participants and imposing significant sanctions on business partners found to be violating procedures or otherwise engaged in abusive or deceptive behavior. The Administration and the Department remain firmly committed to protecting seniors and all consumers against predatory lending practices. We are happy to have this opportunity to discuss our activities, and look forward to working with you to strengthen consumer protections against predatory lending.

This concludes my statement, Mr. Chairman. I thank the Committee for the opportunity to meet with you today to discuss this important issue.

The CHAIRMAN. Mr. Secretary, thank you very much. Now, let us turn to Howard Beales, director, FTC'S Bureau of Consumer Protection. Director Beales, welcome.

**STATEMENT OF HOWARD BEALES, DIRECTOR, BUREAU OF CONSUMER PROTECTION, U.S. FEDERAL TRADE COMMISSION, WASHINGTON, DC**

Mr. BEALES. Thank you very much, Mr. Chairman and Senator Stabenow.

I appreciate the opportunity to appear before you today on behalf of the Commission to discuss our efforts to combat unfair and deceptive practices in the subprime mortgage lending industry.

The damage that dishonest and unscrupulous lenders can cause to consumers of all ages, loss of one's life savings or even one's home, is potentially catastrophic. The Commission has maintained a vigorous enforcement program, achieving notable successes in halting illegal practices and returning hundreds of millions of dollars to defrauded borrowers. At the same time, the agency has been careful to avoid discouraging honest subprime lenders from making credit available to consumers.

My testimony today will discuss the subprime lending market and the Commission's enforcement and education efforts. In recent years, the subprime mortgage lending market has grown dramatically as part of a trend in this country toward greater availability of credit to credit-impaired consumers. This development has been fueled by the use of risk-based pricing, through which creditors fine-tune the terms of a loan offer to a consumer's specific credit history.

No longer are credit-impaired consumers shut out from the credit market. Instead, they are offered credit, albeit on terms less favorable than those offered to consumers with stronger credit histories. The expansion of credit availability that risk-based pricing makes possible greatly benefits consumers, providing more choices at more reasonable rates. Subprime borrowers can now obtain needed credit when previously they did not qualify at all.

Of course, subprime loan terms are less favorable than those available to prime borrowers, but higher rates are appropriate when commensurate with the risks involved. For the subprime market to operate effectively, it is critical that it be free of illegal practices. As this market has emerged, however, some lenders and loan servicers deceived or defrauded consumers. The Commission, working with its Federal and State partners, has used its law enforcement tools successfully to stop such illegal conduct.

The Commission has jurisdiction over lenders and servicers other than banks, savings and loan institutions and Federal credit unions. Our primary enforcement tool is the FTC act, which broadly prohibits unfair or deceptive practices. In recent years, we have settled or prosecuted cases against 20 subprime mortgage companies of various sizes and located in different parts of the country. Several of these cases have resulted in large monetary judgments.

Let me highlight three of the Commission's most recent enforcement efforts. In September 2002, we reached a settlement with the Associates and its successor, Citigroup. At one time, the Associates was the largest subprime lender in the United States. The Commission alleged that it lured consumers into high rate loans by deceiving them about their true costs and by deceptively packing single premium credit insurance into the loan.

At the time, the $215 million settlement was the largest redress order in FTC history, by far. In another recent settlement with First Alliance Mortgage Company, the FTC and others, including six States, private plaintiffs and the AARP alleged that the company promised consumers loans with no up front fees. In reality, the companies charged exorbitant origination fees, typically 10 percent but sometimes 20 percent of the amount of the loan.

Most recently, last November, the Commission and the Department of Housing and Urban Development announced a settlement with Fairbanks Capital Corporation, one of the country's largest third-party subprime loan servicers. Among other things, the Commission charged that Fairbanks did not post payments until after the payment deadline had expired and then imposed late fees and other charges as a result.

The Commission also alleged that Fairbanks charged borrowers for homeowners' insurance even when they already had insurance in place. FTC redress funds for these three settlements alone amount to $345 million, a remarkable achievement on behalf of aggrieved borrowers. Enforcement is important, but the first line of defense against fraud and deception is educated consumers who shop for the best deal. The Commission has implemented extensive programs to educate consumers about financial literacy generally and subprime borrowing specifically.

In October 2003, the Interagency Task Force on Fair Lending, of which the Commission is a part, published a brochure called Putting Your Home on the Loan Line is Risky Business. This brochure discussed the risks of home equity loans and makes recommendations to help borrowers avoid those risks. Also, earlier this month, when we mailed over 800,000 redress checks to borrowers in the Associates case, we included a bookmark containing tips on shopping for a home equity loan.

We recognize that the American population is aging, and issues facing older consumers are therefore a priority for the agency. A recent study found that the population of subprime borrowers tends to be older than the population of prime borrowers. Therefore, while older Americans may have benefited more from the expansion of the subprime market, they may have also suffered more from illegal lending practices.

At the FTC, we are committed to preserving the increased access to credit that the subprime market has made possible while illegal practices that deceive or defraud consumers. Through our enforcement and consumer education, we continue to work to protect consumers of all ages.

Thank you and I would be happy to answer questions.

[The prepared statement of Mr. Beales follows:]

# PREPARED STATEMENT OF

# THE FEDERAL TRADE COMMISSION

on

# EFFORTS TO COMBAT
# UNFAIR AND DECEPTIVE SUBPRIME LENDING

Before the

# SENATE SPECIAL COMMITTEE ON AGING

Washington, D.C.

February 24, 2004

## I. INTRODUCTION

Mr. Chairman and members of the Committee: I am Howard Beales, Director of the Bureau of Consumer Protection of the Federal Trade Commission.[1] I appreciate the opportunity to appear before you today on behalf of the Commission to discuss the Commission's efforts to combat unfair, deceptive, and other illegal practices in the subprime mortgage lending industry, among all consumers, including the elderly. The damage to consumers that dishonest and unscrupulous lenders can cause – loss of their life savings or even their homes – is potentially catastrophic. The Commission has maintained a vigorous enforcement program, achieving notable successes in halting illegal practices and returning hundreds of millions of dollars to defrauded borrowers. At the same time, the agency has been careful to avoid discouraging honest subprime lenders from making credit available to consumers.

The testimony today will discuss the Commission's authority to act against illegal subprime lending practices; the operation of the subprime lending market, including the considerable benefits that access to credit can provide subprime borrowers; and the Commission's enforcement and consumer education efforts.

## II. THE COMMISSION'S LEGAL AUTHORITY

The Commission has jurisdiction over lenders in or affecting interstate commerce, other than banks, savings and loan institutions, and federal credit unions.[2] As part of its consumer protection mandate, the Commission enforces Section 5 of the Federal Trade Commission Act

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[1] The views expressed in this statement represent the views of the Commission. My oral presentation and responses to any questions you have are my own, however, and do not necessarily reflect the Commission's views or the views of any individual Commissioner.

[2] 15 U.S.C. § 45(a).

("FTC Act"), which broadly prohibits unfair or deceptive acts or practices.[3] That section has provided the basis for most of the Commission's enforcement activity in this area. The Commission also enforces a number of laws that address specific aspects of mortgage lending and servicing practices, including the Home Ownership and Equity Protection Act[4] and a number of consumer credit statutes.[5]

## III. THE SUBPRIME LENDING MARKET

Subprime lending (also commonly referred to as "B/C" or "nonconforming" credit) refers to the extension of credit to persons who are considered to be higher-risk borrowers, usually due to their impaired credit histories. In recent years, subprime mortgage lending has grown dramatically. In 2003, subprime lenders originated $332 billion in mortgage loans,[6] compared to $125 billion in 1997.[7] Thus, the widespread availability of mortgage credit to subprime borrowers is a relatively new development.

The dramatic rise in subprime mortgage lending is part of a broader trend in this country of increasing availability of credit to populations that in the past could not qualify for it.[8]

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[3] *See* 15 U.S.C. § 45(a).

[4] 15 U.S.C. § 1639. HOEPA, which is part of the Truth in Lending Act ("TILA"), provides additional protections for consumers who enter into certain non-purchase money, high-cost loans secured by their homes.

[5] *See* the TILA, 15 U.S.C. § 1601 *et seq.*, which requires disclosures and establishes certain substantive requirements in connection with consumer credit transactions; the Equal Credit Opportunity Act, 15 U.S.C. § 1691 *et seq.*, which prohibits discrimination against applicants for credit on the basis of age, race, sex, or other prohibited factors; the Fair Credit Reporting Act, 15 U.S.C. § 1681 *et seq.*; and the Fair Debt Collection Practices Act, 15 U.S.C. § 1692 *et seq.*

[6] *See* "Top 25 B & C Lenders in 2003," *Inside B & C Lending*, Feb. 9, 2004, at 2.

[7] *See* "Top 25 B & C Lenders in 1999," *Inside B & C Lending*, Feb. 14, 2000, at 2.

[8] *See, e.g.*, "An Overview of Consumer Data and Credit Reporting," *Federal Reserve Bulletin*, February 2003, at 70; Fred H. Cate, Robert E. Litan, Michael Staten, and Peter Wallison, "Financial Privacy, Consumer Prosperity, and the Public Good: Maintaining the Balance," AEI-Brookings Joint

Businesses increasingly use credit data to undertake risk-based pricing of credit and other products. Creditors' decision making has moved away from simple approval or denial and towards using credit data in a more finely-calibrated evaluation of what loan terms to offer.[9] Consumers with excellent credit histories are offered products with optimal terms. Those with poorer credit histories, who in the past might have been turned down for credit, may now qualify, albeit on less favorable terms commensurate with the risk. The expansion of credit availability, which has been facilitated by our national credit reporting system,[10] brings substantial benefits to consumers, including more choices for more consumers at more reasonable rates.

The growth in subprime mortgage lending has brought similar benefits. Subprime loans have provided access to mortgage loans, and thus home purchases, in communities that have been underserved in the past. Of course, subprime loan terms are less favorable than those available to prime borrowers, but higher rates are appropriate when commensurate with the

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Center for Regulatory Studies, March 2003, *passim*.

[9] *Id. See also* Fred H. Cate, Robert E. Litan, Michael Staten, and Peter Wallison, "Financial Privacy, Consumer Prosperity, and the Public Good: Maintaining the Balance," AEI-Brookings Joint Center for Regulatory Studies, March 2003, at 12; "An Overview of Consumer Data and Credit Reporting," *Federal Reserve Bulletin*, February 2003, at 70 ("[consumer report] data and the credit-scoring models derived from them have substantially improved the overall quality of credit decisions and have reduced the costs of such decision-making"), *citing* Gates, Perry and Zorn, "Automated Underwriting in Mortgage Lending: Good News for the Underserved?" *Housing Policy Debate*, vol. 13, issue 2, 2002, pp. 369-91; and Barron and Staten, "The Value of Comprehensive Credit Reports: Lessons from the U.S. Experience," Credit Research Center, Georgetown University, 2002.

[10] As the Commission testified last year, "[t]he development of a national consumer reporting system, with its sophisticated risk models and automated underwriting, has contributed greatly to making credit more widely, inexpensively, and rapidly available." Prepared Statement of the Federal Trade Commission on the Fair Credit Reporting Act, before the Senate Committee on Banking, Housing and Urban Affairs, July 10, 2003.

greater credit risks involved. Empirical evidence suggests that subprime loans are different from prime loans in terms of the variety, complexity, and level of risks they pose.[11]

## IV. THE COMMISSION'S ENFORCEMENT ACTIVITIES

For the subprime market to operate efficiently for the benefit of consumers, it is critical that it be free of deception and other illegal practices. As the market has grown, however, some lenders and loan servicers have engaged in illegal practices to the detriment of borrowers. The Commission, working with its federal and state law enforcement partners, particularly, the State Attorneys General, has been active in bringing enforcement actions against such conduct. In recent years, the agency has settled or prosecuted cases against twenty companies in the subprime mortgage lending industry, involving numerous illegal practices by companies of various sizes, as well as companies operating in various regions of the country.[12] Several of these cases have resulted in large monetary judgments, including a record-setting $215 million consumer redress order against Citigroup and The Associates.[13]

I would like to highlight a few of our recent enforcement efforts.

**Citigroup/The Associates**

In a landmark case concluded in September 2002, the Commission charged that two of Citigroup Inc.'s subsidiaries, Associates First Capital Corporation and Associates Corporation of North America ("The Associates"), engaged in systematic and widespread deception and other

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[11] *See* Office of the Comptroller of the Currency, "Working Paper: Economic Issues in Predatory Lending," July 30, 2003 at 11.

[12] *See infra* pp. 4-8 and note 23.

[13] The Commission also has acted to halt illegal practices in connection with subprime personal loans (that is, loans not secured by real estate). *See, e.g.*, *Stewart Finance Co., Inc*, No. 1:03-CV-2648 (N.D. Ga. 2003) (charging Stewart Finance and its affiliates with violating federal lending laws in the making of personal loans to consumers).

illegal lending practices.[14] The Commission's complaint alleged that the defendants – at one time the largest subprime lenders in the U.S. – lured consumers into high-cost loans through false and misleading statements and half-truths about loan costs, packed single-premium credit insurance into loans, and violated numerous federal laws, including the TILA, the Fair Credit Reporting Act, and the Fair Debt Collection Practices Act. The defendants paid $215 million for consumer redress to resolve the charges, in addition to a concurrent $25 million class action settlement.

**First Alliance Mortgage Co.**

In another major case focusing on loan origination practices, the FTC and others, including six states, private plaintiffs, and the AARP, reached a major settlement with mortgage lender First Alliance Mortgage Co. in March 2002.[15] The complaint alleged that the defendants' loan officers in their sales presentations made blatantly deceptive claims about monetary and other loan terms. Most disturbingly, the defendants allegedly promised consumers that the loans contained no upfront fees, when in fact they imposed exorbitant origination fees, typically 10 percent and as much as 20 percent of the loan. The settlement required the defendants to pay an amount equal to virtually the entirety of the corporate assets, as well as a $20 million payment from the individual who founded and ran the company. Recently, the Commission announced that the redress fund will ultimately total about $65 million for nearly 20,000 borrowers.[16]

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[14] *The Associates*, No. 1:01-CV-00606 (N.D. Ga. 2001).

[15] *First Alliance Mortgage Co.*, No. SA CV 00-964 (C.D. Cal. 2000).

[16] http://www.ftc.gov/opa/2004/02/first.htm. Injured borrowers have already been sent partial redress and will be receiving a second check in the near future.

**Mercantile Mortgage Co. and Mark Diamond**

In July 2002, the Commission, the Department of Housing and Urban Development ("HUD"), and the State of Illinois jointly settled a case against a regional subprime lender, Mercantile Mortgage Company, Inc., charging violations of the FTC Act, TILA, HOEPA, and the Real Estate Settlement Procedures Act.[17] The Commission alleged that the company's employees, and one mortgage broker who was acting as its agent in soliciting and closing loans on its behalf, misrepresented key loan terms to borrowers. As a result, many borrowers did not realize that their loans required large "balloon" payments at the end of their terms. The settlement required the company to make a $250,000 payment for consumer redress and create a program to offer refinanced loans on favorable terms to certain borrowers with balloon loans.

At the same time, the Commission and the State of Illinois jointly sued the mortgage broker involved and ultimately reached a settlement providing for an additional $270,000 in consumer redress.[18] Last month, we sent redress checks to the consumers the broker solicited in an average amount of $1,000.

**Fairbanks Capital Corp.**

In November 2003, the Commission, along with HUD, announced a settlement with Fairbanks Capital Corp. and its parent company.[19] Fairbanks is one of the country's largest third-party subprime loan servicers – it does not originate any loans, but collects and processes payments on behalf of the holders of the mortgage notes. The Commission alleged that Fairbanks received consumers' payments that were made on time, but failed to post them until

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[17] *Mercantile Mortgage Co.*, No. 02-5079 (N.D. Ill. 2002).

[18] *Mark Diamond*, No. 02-5078 (N.D. Ill. 2002).

[19] *See Fairbanks Capital Corp.*, No. 03-12219 (D. Mass. 2003).

after the payment deadline had expired, and then imposed late fees and other charges as a result. It also challenged Fairbanks' alleged practice of charging for homeowners' insurance even though the borrowers already had insurance in place. The Commission further alleged that Fairbanks charged numerous fees to those borrowers whom it deemed were in default that were not authorized by the mortgage contract or by state law, or that were based on services that Fairbanks never performed. And, the complaint charged Fairbanks with violating federal laws in using dishonest or abusive tactics to collect debts, and in reporting consumer payment information to credit bureaus that it knew was inaccurate.

Through the settlement, Fairbanks will pay $40 million in consumer redress.[20] Fairbanks also agreed to halt the alleged illegal practices and implement significant changes to its business practices to prevent future violations.[21] Consumers have no choice about who services their loans, because loans are routinely transferred from servicer to servicer, and consumers cannot simply take their business elsewhere if they are mistreated. For that reason, it is essential that servicers comply with their legal obligations.

**Capital City Mortgage Corp.**

In January 1998, the Commission filed suit in federal court against Capital City Mortgage Corporation, a Washington, DC-area mortgage company, alleging numerous violations of federal laws both in its origination and servicing of subprime mortgage loans. For example, the complaint alleges that the defendant assessed unauthorized fees on borrowers' accounts,

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[20] The FTC/HUD consent decree is being coordinated with a proposed class action settlement in which the company will make additional refunds to consumers. Both the FTC redress settlement and the proposed class action settlement, *Alanna L. Curry, et al. v. Fairbanks Capital Corp.*, No. 03-10845 (D. Mass. 2003), are pending court approval.

[21] The Commission charged Fairbanks' former CEO with similar law violations, and he agreed to a settlement with the FTC and HUD requiring $400,000 for consumer redress.

misrepresented the amount of money needed to pay off the loan, and foreclosed on borrowers who were in compliance with their loan terms.[22] This case is scheduled for trial next month.

**Other FTC Enforcement Efforts**

In addition to the cases described above, the Commission has brought fourteen other actions alleging law violations by companies in the subprime mortgage industry.[23] As part of this effort, the Commission has developed cooperative relationships with its sister federal enforcement agencies, as well as states and others, to coordinate enforcement. Working together allows us to leverage our resources to obtain increased remedial and deterrent effects of our actions. The many settlements that the FTC has obtained from subprime lenders provide a deterrent to others who might consider engaging in this type of conduct.

The Commission and other agencies routinely share information about potential targets and enforcement techniques. In 2003, for example, the FTC and the American Association of Residential Mortgage Regulators co-sponsored two enforcement summits that brought together representatives of federal and state agencies working in this area to share information and ideas. Activities such as these increase the effectiveness of our law enforcement.

**V. CONSUMER EDUCATION**

Of course, educated consumers are the first line of defense against fraud and deception. This is especially true for subprime borrowers, given the complexity of the loan transaction and

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[22] *Capital City Mortgage Corp.*, No. 1:98-CV-00237 (D.D.C. 1998).

[23] *Action Loan Co.*, No. 3:00CV-511-H (W.D. Ky. 2000); *First Plus Financial Group, Inc.*, No. 99-23121 (F.T.C. 2000); *NuWest, Inc.*, C00-1197 (W.D. Wash. 2000); *Delta Funding Corp.*, No. 00-1872 (E.D.N.Y. 2000); *Barry Cooper Properties*, No. 99-07782 (C.D. Cal. 1999); *Capitol Mortgage Corp.*, No. 2:99CV580 (D. Utah 1999); *CLS Financial Services, Inc.*, No. 99-CV-1215 (W.D. Wash. 1999); *Granite Mortgage, LLC*, No. 99-CV-289 (E.D. Ky. 1999); *Interstate Resource Corp.*, No. 1:99-CV-5988 (S.D.N.Y. 1999); *LAP Financial Serv., Inc.*, No. 3:99-CV-496 (W.D. Ky. 1999); *Wasatch Credit Corp.*, No. 99-CV-579 (D. Utah 1999); *Fleet Fin., Inc.*, No. C3899 (F.T.C. 1999); *Nationwide Mortgage Corp.*, No. 85-0976 (D.D.C. 1985); *R.A. Walker and Assoc.*. No. 83-2462 (D.D.C. 1983).

many borrowers' limited experience in obtaining mortgages.

The Commission has implemented extensive programs to educate consumers about financial literacy generally, and subprime borrowing specifically. In October 2003, for example, the Interagency Task Force on Fair Lending (of which the Commission is a part) published a brochure, entitled "Putting Your Home on the Loan Line is Risky Business,"[24] that alerts consumers to the risks of home equity loans and makes recommendations to help borrowers avoid those risks. The Commission also has included education materials on mortgage loans in numerous consumer redress distributions. For example, this month we mailed over 800,000 consumer redress checks to claimants in our case against The Associates that included a bookmark containing tips for shopping for a home equity loan.[25]

## VI. SUBPRIME LENDING AND OLDER CONSUMERS

A recent study found that the population of subprime borrowers tends to be older than the population of prime borrowers;[26] more than a quarter of subprime borrowers are 55 years of age or older, compared to only 14% of prime borrowers.[27] Therefore, while older Americans may have benefitted more from the expansion of the subprime market, they also may have suffered more injury from deceptive practices in the market. The Commission is not aware of any evidence that subprime lenders are engaging in illegal practices that specifically target the

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[24] Available at http://www.ftc.gov/bcp/conline/pubs/credit/risky.htm.

[25] To further the goal of preventing abusive lending, the FTC is conducting a research program designed to learn more about how consumers search for mortgages, what consumers understand about mortgage agreements, and how changes in the disclosure process might improve consumers' ability to avoid deception. *See* Notice of Proposed Information Collection Activity, 68 Fed. Reg. 19,825 (Apr. 22, 2003).

[26] Marsha J. Courchane, Brian J. Surette, and Peter M. Zorn, "Subprime Borrowers: Mortgage Transitions and Outcomes," *Journal of Real Estate Finance and Economics* (forthcoming 2004).

[27] *Id.*

elderly. In our experience, the illegal practices cut across demographic groups. Nevertheless, these illegal practices can be particularly devastating to seniors.

The Commission has taken an active role in educating older consumers about abusive lending practices (as well as other consumer issues). We recognize that the American population is aging, and issues facing older consumers are therefore a priority for the agency. In recent years, the FTC has developed a series of publications, launched dedicated Web pages, and worked with numerous federal agencies and private sector partners to develop and disseminate plain-language education materials in English and Spanish aimed at, or of particular relevance to, older consumers. For example, among our numerous free publications are ones entitled "Getting Credit When You're Over 62"[28] and "Reverse Mortgages."[29]

The Commission has been working to protect older Americans from illegal lending practices by educating them and using enforcement actions to halt law violations and return money to the victims. We will continue our vigorous efforts.

**VII. CONCLUSION**

The Commission believes that it is very important to preserve the benefits that increased access to credit bring, while preventing illegal practices from flourishing in the marketplace. Through our enforcement and consumer education, the Commission continues to work to protect consumers of all ages.

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[28] Available at http://www.ftc.gov/bcp/conline/pubs/credit/over62.htm.

[29] Available at http://www.ftc.gov/bcp/conline/pubs/alerts/revralrt.htm.

The CHAIRMAN. Director, thank you very much for that statement.

We will now turn to questioning.

Mr. Wood, in the efforts of the General Accounting Office, did you find a central data base for information containing government investigations, enforcement actions and other efforts to combat predatory lending?

Mr. WOOD. There is no central data base of enforcement actions that we are aware of.

The CHAIRMAN. As a result, your report was a matter of, if you will, fanning out and investigating all of those areas where Government has that authority.

Mr. WOOD. Right, we contacted each agency separately.

The CHAIRMAN. Given GAO's recommendation and what the State of Georgia experienced, has the agency done any serious investigation of the possible adverse effects upon subprime lending markets among providers and consumers?

Mr. WOOD. I am not sure I understand your question with respect to the Georgia law.

The CHAIRMAN. In looking at that law——

Mr. WOOD. Yes

The CHAIRMAN [continuing.] I guess what I am saying have you investigated the possible adverse effects upon a subprime lending market, both for providers and consumers?

Mr. WOOD. We provide some information in our report about the Georgia law and what happened there and the changes that occurred. I do not know that we have a section specifically on the impact, and we certainly did not assess any impacts on our own.

The CHAIRMAN. You did no assessment there.

Mr. WOOD. That is correct.

The CHAIRMAN. OK; that is fine.

How closely have the Federal regulatory agencies coordinated their campaign in educating the public in general and seniors in particular about predatory lending, especially in matters of real estate? Obviously, we have heard an effort now going on at the FTC and others.

Mr. WOOD. Right.

The CHAIRMAN. Has there been an overall coordinated effort, in your analysis?

Mr. WOOD. There has not been a single overall coordinated effort. Each of the agencies is doing different things. However, there are certain mechanisms that provide for coordination. There is an Interagency Fair Lending Task Force that established a working group on predatory lending specifically, and just recently, that group published a brochure. I think it is called Putting Your Home on the Line is Risky Business.

The CHAIRMAN. Just mentioned, yes.

Mr. WOOD. That came out of a cooperative effort among the agencies.

The CHAIRMAN. Good, good. Well, thank you very much.

Secretary Weicher, what is HUD's view on the newly created Financial Literacy and Education Commission chaired by the Secretary of the Treasury?

Mr. WEICHER. Well, we are certainly active participants in that commission, Mr. Chairman, and I am Acting Secretary Jackson's alternate on that Commission, and I attended the first meeting a month ago at his request, and the Commission has established subcommittees to address issues of publicizing and making information public, a Website, an 800 number, and those committees are starting to meet.

We are also very active as members of the Interagency Task Force on Fair Lending that Mr. Beales mentioned and that Mr. Wood mentioned. So we are participating in both of those efforts.

The CHAIRMAN. OK; what is HUD's view of the recommendation that GAO has made regarding the monitoring of the subprime lending market by the Board of Governors of the Federal Reserve?

Mr. WEICHER. Well, we have not taken a position on that, but we certainly think that the subprime market, as Mr. Beales said and I think the GAO report says, embraces more than predatory lending. The important procedure is to attack predatory lending without limiting the ability of borrowers to obtain mortgages which are not predatory but which reflect the risks that they are imposing on lenders.

The CHAIRMAN. OK; Director Beales, you have cited examples of enforcement. Does the FTC have an estimate of how much predatory lending in the real estate markets is costing the citizens of this country today?

Mr. BEALES. We do not. We do not have any reliable basis on which to estimate either the total or the total for any age group.

The CHAIRMAN. In the kind of investigative work you have done and those settlements that you have arrived at, how long did it take to put that kind of effort together and bring it to completion?

Mr. BEALES. It varies by case. Some of them are more straightforward than others. Stewart Financial was probably 4 or 5 months before we filed, something like that. Other cases, like the Associates, were much more complicated cases; probably took a year or more to put together before we were ready to file a complaint.

The CHAIRMAN. So they vary, of course, as you have said, depending on the character of the case.

Mr. BEALES. Depending on the character, yes, and depending on how clear—what we typically see in our enforcement actions is misrepresentations about the terms of the loan.

The CHAIRMAN. Yes.

Mr. BEALES. Sometimes, those are clear. There are scripts that tell people to misrepresent, and those are relatively straightforward cases. Other times, we have to talk to consumers; we have to figure out what kinds of representations were actually made. We have to build the evidentiary record sort of consumer by consumer of what was actually happening and what the salesman was actually selling. Those are more complicated, and, you know, they just take longer to build our case.

The CHAIRMAN. You mentioned that in the subprime market, that group tended to be an older group of people. Is it possible to obtain reliable data on what percentage of seniors make up settlements spoken to in your testimony?

Mr. BEALES. No, we have not collected that information as part of the settlements. We are typically asking for a lot of information that we need in order to administer the redress program, and we try to make it as simple as possible and ask for as little as possible that we do not absolutely need in order to administer the programs.

The CHAIRMAN. Sure; well, thank you very much. Let me turn to my colleague, Senator Stabenow, please.

Senator STABENOW. Thank you, Mr. Chairman. Thank you again to each of you.

I would first indicate that my personal conversations with people in Michigan and the hearings that I have had back home in Michigan have persuaded me that this is a very serious issue and that even though there may not be specific information that this is targeted to seniors, certainly in the information that I receive from people in my State, it is very clear that it appears that seniors are very highly targeted, I think particularly because they may have a home that is paid for or a great deal of equity built up in their homes, and I have had numerous examples brought to my attention of people who need a new furnace or a new roof on the home who have been talked into loans that ended up with extremely high points and fees and interest rates, getting very little out of the loan. In a couple of cases where the home was entirely paid for, and they were into totally refinancing their homes again in order to be able to meet certain needs in terms of home improvements and so on, really outrageous situations.

One case, there was a situation where a gentleman was following seniors home from church on Sunday morning, getting to know them, building a rapport with them and then asking them, gee did they need any home improvements; did they need a new furnace? Could he help them with anything? Then, talking them into, again, situations and loans that took away their life savings or took away their homes. So I think it is a very, very serious issue.

Having said that, I also believe a majority of lenders are reputable and that we are talking about a few bad actors, but they are definitely out there. I am very pleased to see that the Commission is up and running, the Financial Literacy Commission; again, as the sponsor of the provisions requiring a Website and a 1–800 number and so on, I am very pleased to see things are moving as quickly as they are.

One of the things that we found in looking at the financial education piece is that there are a lot of good things going on, FTC or HUD or Federal Reserve or all kinds of different agencies, but it was very difficult from a consumer's standpoint to find out what is going on and to be able to access that. So I think that is a very important part of addressing this, Mr. Chairman, is to be user-friendly for people so that they can find out information.

My questions really go to the enforcement end, and I also would add though, first, that I want to thank Freddie Mac, who has been involved in a program called Don't Borrow Trouble, which we brought to Detroit, a very successful consumer education program and Fannie Mae and many others who have been involved as well in these efforts.

But there has been a lot of discussion about whether or not we should pass a Federal law. In the absence of a Federal definition of predatory lending from a statutory standpoint, we are seeing communities, city councils, passing ordinances. We are seeing States passing laws to address the legitimate needs and concerns in their States. The question is whether or not we ought to be addressing this and, if so, how to make sure that we are providing adequate consumer protections as well as addressing the question of a national definition.

I am wondering, Mr. Wood, if you looked at all at this issue from the standpoint of not just individual enforcement, and I would ask each of the other panelists as well to address this, but not just individual enforcement within existing regulations but whether or not there is a need for a national definition or set of definitions around which we would then enforce on predatory lending.

Mr. WOOD. As we always do, we look for areas in which we can make a useful recommendation. One of the things in this area that we looked at clearly was, "Is there a gap in the current Federal laws in some area?" The one that we identified is the one that we raised in our matter for consideration. The difficulty, I guess, in coming up with a single definition, and this is one of the things that we wrestled with early, is how do you strike that balance in crafting a law that does not eliminate or cutoff credit to people who otherwise would not have it while at the same time preventing the most egregious abuses. We do not have an answer for exactly where that balance should be.

Senator STABENOW. Thank you. I share that ambivalence or concern about how we strike that balance, but—yes, Mr. Weicher?

Mr. WEICHER. Senator Stabenow, as I think both of my colleagues mentioned, there is no generally accepted definition of predatory lending. What we have done at HUD is to establish regulations that address individual practices which we consider to be abusive, unfair, deceptive, and to establish a regulation prohibiting that particular practice. The body of those regulations becomes, in our judgment, a comprehensive attack on predatory lending.

In my prepared statement, I mention a number of regulations. One, in particular, is an anti-flipping rule, whereby we will not insure a mortgage if the home has been sold twice within a 90-day period unless there is evidence that this is a reasonable transaction and not a flip and that for transactions that occur between 90 days and 270 days, whether insurance is automatic depends on how much the price has increased over that period of time.

This has been a particular problem in some of the larger cities. We have a particular problem in Baltimore, which has been brought under control——

Senator STABENOW. Right.

Mr. WEICHER. By a variety of local efforts, and our anti-flipping rule contributes to fighting that problem in a number of larger cities. That is an example of the approach we have been taking, and we think it has been successful.

Senator STABENOW. Are you indicating, then, that you think that is enough in terms of giving you the authority and the definitions that you need, or if you had a preference, would you prefer to see a more standardized definition?

Mr. WEICHER. As I said, we deal essentially with FHA, almost exclusively with FHA-insured loans and FHA lenders, and we believe that we have authority to address the problems that we see in the FHA-insured market. We have not felt that we needed to come to you with a request for additional legislative authority nor have we felt it necessary to develop a definition of predatory lending in general when we think we can target the individual practices that we see and go at them specifically.

Senator STABENOW. Thank you.

Yes, Mr. Beales?

Mr. BEALES. Senator, what we have seen in our enforcement experience is really more of a problem of the claims that are made than of the loans themselves or the practices themselves. They may be perfectly legitimate kinds of loan approaches in the right circumstances, but if consumers do not know what they are getting into, that is the source of the problem.

For example, in the case we did jointly with HUD that involved Mercantile Mortgage, there were loans with balloon payments. Now, that is a fairly common instrument and perfectly appropriate, but the borrowers were told no balloon payment. That is a problem. But it is a problem of deception rather than of the particular practices, and we feel like we have the authority to go after those practices wherever we find them.

Senator STABENOW. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Thank you very much, Senator.

Let me also echo what the Senator did, and I think it is appropriate to be said that while the vast majority of our lenders out there are reputable, highly professional, skilled people who educate their consumers, we are after those who are not, obviously, and the phenomenal destruction that they raise against an individual or a couple when a life savings is oftentimes eliminated by that.

It appears from the GAO effort and others that accumulating the data, grasping it or being able to bring it together in a way that is definable for our use is still a problem as it relates to age groups and those areas where there may be vulnerable communities of people that are being preyed upon. We will continue to make that effort, gentlemen.

We appreciate all the efforts that you have made and the work that is now underway; and we will stay current on this issue with you and monitor it. As I have said in my opening statement, we believe that this will is one of many that we will be having over time as we review this and watch its process. Thank you very much. We appreciate it.

The CHAIRMAN. Now, let me invite our second panel forward.

Well, again, we thank our second panel for being with us. Let me start with Mr. Gavin Gee, who is the past-president of the National Association of State Bank Examiners and director of the Idaho Department of Finance. Gavin, welcome before the Committee.

## STATEMENT OF GAVIN GEE, DIRECTOR, IDAHO DEPARTMENT OF FINANCE, BOISE, ID

Mr. GEE. Thank you, Mr. Chairman. My name is Gavin Gee. I am the director of the Department of Finance for the State of Idaho and appear here today on behalf of the Conference of State Bank Supervisors. We thank you for this opportunity to testify on the States' efforts to protect senior citizens and other consumers from fraudulent and predatory lending practices.

Through CSBS, State regulators of banks and non-bank lenders meet to share information and share solutions to problems such as predatory lending. Predatory lending is a complex issue, and I want to begin my statement by distinguishing between predatory and subprime lending. Subprime lending is not necessarily predatory lending. As described in the prior panel, subprime lending products are loans that are priced according to risks associated with a particular borrower, and the availability of subprime mortgage loans in particular has made homeownership a reality for thousands of low and moderate income families.

Predatory lending can be hard to define, but it is all too obvious when we see the harm it does to our most vulnerable citizens. Over the past several years, the States have learned a great deal about where the problems lie and how best to address them. We have learned that a single set of rules and remedies is not necessarily appropriate for every lender or for every group of borrowers.

Our challenge and yours is to prevent abuses without reducing the availability of credit or stifling innovation in new lending products such as reverse mortgages, which have been a boon to many older Americans when appropriately marketed and underwritten.

As you seek to understand the options for State and Federal Government action on this problem, I ask that you consider this point: Federal preemption of State consumer protection laws can, for all intents and purposes, deny consumers the real protection that State laws would give them. The explosion of the mortgage industry created a new class of lenders for nonprime borrowers, and in some cases, these lenders have engaged in predatory and fraudulent practices.

Many States sought remedies through enforcement of existing laws, new legislation and financial education efforts. Our efforts have reached thousands of borrowers and potential borrowers, punished and discouraged predatory lenders and brought a national spotlight to this program and this problem. I would mention that the States have the largest enforcement action on record to date against a particular predatory lender.

Even small States like Idaho have their share of predatory lenders. Idaho has found its existing laws sufficient to take action against predatory lenders, and we have not seen a need to enact separate anti-predatory lending legislation. A priority for my agency under this law has been to establish a program of routine examinations of mortgage brokers and mortgage lenders. Routine examinations allow our examiners to identify and address violations of consumer protection laws before these violations harm large shares of the population.

Education is also a key element of our consumer protection mission. We are actively involved in the Idaho Financial Literacy Coalition, which provides educational resources and instructions to educators, youth leaders, the elderly and others who are in need of assistance or at financial risk.

Over the past 3 years, our Department has processed 617 complaints related to non-depository lenders and 247 complaints relating to national banks or their operating subsidiaries. In the same period, we returned over $3.5 million to Idaho consumers as a result of resolved consumer complaints against mortgage brokers, mortgage lenders and finance companies and charged an additional $216,000 in fines and penalties.

Under regulations recently issued by the Comptroller of the Currency, we would not have been able to take these actions if these businesses were operating subsidiaries of national banks. The OCC began by exempting national banks from specific State laws against predatory lending and has in recent weeks vastly expanded that exemption. The OCC now claims that national banks and their thousands of nonbank operating subsidiaries are exempt from virtually all State consumer protections and licensing requirements in the area of mortgage lending.

The OCC has also said that the States have no authority to enforce a vast number of laws affecting national banks and their State-chartered subsidiaries, including consumer protections and laws against unfair and deceptive practices. Taking the States out of enforcement for a large and growing segment of the industry can have serious consequences. The Comptroller's recent regulations would displace much of the investigative and enforcement network States have created for responding to consumer complaints; many related to the operating subsidiaries and affiliates of national banks.

This network has been working, with millions even hundreds of millions of dollars, being returned to mistreated consumers. This issue of preemption is a critical obstruction to our work against the threat predatory lenders pose to senior citizens. Over the past 3 years, our small agency conducted 618 routine examinations of nondepository lending institutions doing business in Idaho. These examinations are the ones that will be left undone if Idaho's mortgage brokers, mortgage lenders and finance companies continue to surrender their State licenses to us under the claim of OCC preemption.

With limited resources at both State and Federal levels, we should be talking about sharing responsibilities, not preempting valuable resources. Most consumers shopping for a mortgage do not understand that different sets of laws apply to different lenders. As in most States, Idaho borrowers call our Department if they have a problem with their bank, their mortgage broker or finance company.

For the elderly, a local contact is critical, and consumers rightly expect that their State officials can go to bat for them when they have been wronged. We want to be able to respond to these calls effectively. If you lose the States as a laboratory for consumer protections and other innovations, you lose two great attributes of our Federalist system: the ability to find out what does and does not work and the ability to tailor the response to the problem.

Predatory lending is an insidious practice that turns the American dream into the American nightmare. It steals not only the victims' money and homes but their confidence in our financial system. We at the State level are the first line of defense against these unscrupulous businesses. A long-term solution to predatory lending requires three elements: consumer education, clear and consistent laws and effective enforcement. For the States, enforcement is becoming the weakest link. Federal preemption continues to hinder our enforcement efforts and has created incentives for businesses to seek the regulatory structure that guarantees the fewest consumer protections. This hurts the citizens of Idaho; this hurts the citizens of the United States.

We stand ready to work with the Congress and with our Federal counterparts on a coordinated stand against predatory lending. Our experience should create a valuable foundation for solutions as we go forward.

That concludes my testimony, Mr. Chairman. I would be happy to answer any questions the Committee may have.

[The prepared statement of Mr. Gee follows:]

Testimony of

GAVIN M. GEE

DIRECTOR OF FINANCE

for the

STATE OF IDAHO

on behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

Before the

SPECIAL COMMITTEE ON AGING

UNITED STATES SENATE

February 24, 2004

Good morning, Chairman Craig, Senator Breaux and members of the Committee. I am Gavin Gee, Director of Finance for the State of Idaho, and I appear today on behalf of the Conference of State Bank Supervisors (CSBS). Thank you for the opportunity to testify on the states' efforts to protect senior citizens and other consumers from fraudulent and predatory lending practices.

CSBS is the professional association of state officials who charter, regulate and supervise the nation's nearly 6,400 state-chartered commercial and savings banks and more than 400 state-licensed foreign banking offices nationwide. Through CSBS, state regulators of banks and nonbank lenders meet to exchange information and share solutions to problems such as predatory lending.

We are also, by and large, the same state officials who license, examine, and handle consumer complaints and enforcement actions against other financial services providers who extend consumer loans and mortgages.

**Predatory Lending**

Predatory lending is a complex issue, and I want to begin my statement by distinguishing between *predatory* and *subprime* lending. The United States economy depends on the free flow of credit from responsible lenders to worthy borrowers. The average American household has more credit options than consumers in any other country, and certainly more credit options than it had ten years ago. A major reason for this is the ability of lenders to manage risk through pricing. The emergence of "subprime" lending products has made credit available to traditionally underserved markets. These products are loans that are priced, through their interest rate and other terms, consistent with the risks associated with a particular borrower. In particular, the availability of subprime mortgage loans has made homeownership a reality for thousands of low-and moderate-income families. Subprime lending is not necessarily predatory lending.

Predatory lending can be hard to define, and one of its most frustrating aspects is that we too often recognize it by its effects. Predatory lending is all too obvious when we see the harm it does to our most vulnerable citizens, particularly the elderly, the unbanked and those who are isolated by barriers of language or economic status. Our challenge at the state level has been to develop laws and regulations that identify, prohibit and punish activities we know will lead to borrowers destroying their credit ratings, losing their homes, or filing for bankruptcy. At the same time, these laws cannot have the effect of driving creditors away from our states. We recognize that enacting laws is only part of the equation; the most significant components are our continuing effort to educate all types of borrowers and give them the tools they need to make wise credit decisions and strong enforcement of laws to detect and weed out bad actors and bad practices.

The states, individually and together, have been working hard on the issue of predatory lending for many years now. Over this time, we have learned a great deal about what works and what doesn't, about where the problems lie and how best to address them. We have learned that a single set of rules and remedies is not always appropriate for every lender or for every group of borrowers. I currently serve as the Chairman of the CSBS task force on predatory lending. The task force's goal is to consider anti-predatory lending standards that can be adopted by the states, or presented to Congress as a national standard.

Our challenge, and yours, is to prevent abuses without reducing the availability of credit or stifling innovation in new lending products, such as reverse mortgages, which have been a boon to many older Americans when appropriately marketed and underwritten. As you seek to understand the options for state and federal government action on this problem, I ask that you consider this point: federal preemption of state consumer protection laws and enforcement can, for all intents and purposes, deny consumers the real protection that the state can give them.

The state banking system has traditionally been the laboratory for innovation and for developing the best practices in both products and services and consumer protections. As new products and services have emerged over the past ten years, so too have new opportunities for consumer confusion and, in some cases, abuse. The explosion of the mortgage industry created a new class of lenders for nonprime borrowers, and in some cases, these lenders have engaged in predatory and fraudulent practices. Many states sought remedies through enforcement of existing state laws, new legislation, and financial education campaigns. Our efforts have reached thousands of borrowers and potential borrowers, punished and discouraged predatory lenders, and brought a national spotlight to this problem.

**Idaho's Approach**

Idaho is not one of that handful of states that have enacted specific laws against predatory lending; instead, we opted to combat instances of predatory lending in Idaho with the laws already under our jurisdiction. But there should be no doubt that even small states like Idaho have their share of instances of predatory lending.

The Idaho Credit Code, which governs finance companies, incorporates the Federal Consumer Credit Protection Act, including Truth in Lending and Fair Credit Reporting. Our Residential Mortgage Practices Act incorporates both the federal Truth in Lending and the Real Estate Settlement Procedures Act. Idaho has found these laws sufficient to take action against predatory lenders, and we have not seen a need to enact separate anti-predatory lending legislation. It may be that this is also the case at the federal level; that existing laws do offer adequate protection and remedies, as long as they are strongly and consistently enforced. No amount of lawmaking will protect consumers without the proper enforcement, including well-trained examiners to discover violations, and appropriate sanctions to back it up.

Together, these two major state laws govern the mortgage industry. One gives us authority to license, examine, and take enforcement actions against mortgage brokers and mortgage lenders. Among other anti-predatory provisions, Idaho law prohibits mortgage brokers from engaging in misrepresentations concerning mortgage loans, and from "accept[ing] any fees at closing which were not previously disclosed fully to the borrower." But it also incorporates federal standards, and authorizes our Department to take enforcement action if, for example, a mortgage broker violates the federal Real Estate Settlement Procedures Act.

A priority for my agency under this law has been to establish a program of routine examinations of mortgage brokers and mortgage lenders. We believe the process of routine examinations is critical to consumer protection. Through this process our examiners often uncover and address violations of consumer protection laws before large segments of the population are affected.

Similarly, the law that allows us to license, examine, and take enforcement actions against finance companies incorporates federal standards, specifically the federal Consumer Credit Protection Act. But it also allows the state to take action against a lender who engages in fraudulent or unconscionable conduct. For example, if the lender knows, when the loan is made, that the borrower likely cannot repay the loan, it is an unconscionable loan.

In Idaho, we believe strongly that part of our consumer protection mission is best accomplished through education. We are actively involved in the Idaho Financial Literacy Coalition (IFLC). The IFLC is comprised of individuals from government, education, all segments of the financial industry, and non-profit organizations. The goal of the IFLC is to improve the quantity and quality of information and educational programs related to personal finance by providing resources and instructions to educators, youth leaders, the elderly, and others who are need of assistance or at financial risk.

Department personnel volunteer as speakers at senior centers, and in Idaho high schools, assisting in the introduction of basic financial concepts including investing, financial planning, and consumer credit. These speakers specifically address how consumers can avoid lending and investment fraud and other abusive financial practices. The Department co-sponsors and participates in other financial education programs in

Idaho such as the Governor's Conference on Housing, the State Treasurer's Every Woman's Financial Conference, and the Financial Literacy for Youth Month.

Our Department has five staff people dedicated to investigating consumer complaints received in person, in writing, by telephone, and by email arising from transactions with mortgage brokers, mortgage lenders, and finance companies. Over the past three years, these examiners processed 617 complaints relating to these non-depository lenders, and 247 complaints relating to national banks or their operating subsidiaries. In the same period, we returned over $3.5 million to Idaho consumers as a result of resolved consumer complaints against mortgage brokers, mortgage lenders, and finance companies, and charged an additional $216,000 in fines and penalties. Our agency conducted 274 investigations of mortgage brokers, mortgage lenders, and finance companies, and 33 investigations of national banks or their subsidiaries. In the past three years, we also completed 178 enforcement actions against non-depository lending institutions.

Under the regulations recently issued by the Comptroller of the Currency, we would not have been able to take these actions if these businesses were operating subsidiaries of national banks.

**Preemption**

The states have pursued solutions to predatory lending despite what has sometimes seemed to be deliberate obstruction on the part of federal agencies, in particular the Office of the Comptroller of the Currency (OCC). The OCC began by exempting national banks from specific state laws against predatory lending and has, in recent weeks, vastly expanded that exemption. The OCC now claims that national banks and their thousands of nonbank operating subsidiaries are exempt from virtually all state laws that "condition" or affect their operations, including all state consumer protections and licensing requirements in the area of mortgage lending. The OCC has also said that the states have no authority to enforce a vast number of laws affecting national banks and their state-chartered subsidiaries, including consumer protections and laws against unfair and deceptive practices. The OCC issued these rulings despite the opposition of the National Governors' Association, the National Conference of State Legislatures, all fifty state attorneys general, all fifty state banking supervisors and countless consumer groups.

We can tell you, Chairman Craig and Senator Breaux, that the worst cases of predatory lending come from nonbank lenders – many independent, some affiliated with federally insured depository institutions, and many thinking of how to become subsidiaries of national banks and thus exempt themselves from state laws. These mortgage lenders and consumer credit companies have traditionally been licensed and regulated at the state level. In many, although not all, cases, the state banking departments are responsible for supervising these companies. In all cases, the states work constantly to coordinate their enforcement and recovery activities among the state agencies responsible for preventing predatory lending.

This is why we are so concerned with the OCC's actions. Taking the states out of enforcement for a large and growing segment of the industry can have serious consequences. We cannot understand how our citizens benefit from taking the local cop off the beat and replacing him with an OCC call center in Houston. The Idaho legislature agrees. A recently-introduced joint resolution asks the Congress to review the significant consequences of this federal regulator's preemption.

The Comptroller's recent regulations would have the effect of displacing much of the investigative and enforcement network states have created for responding to consumer complaints, many related to the operating subsidiaries and affiliates of national banks. This network has been working effectively, with millions, even hundreds of millions of dollars being returned to mistreated consumers. After an historic settlement with a single institution, in 2003 the states returned more than $500 million to consumers who had been victimized by fraudulent or deceptive trade practices.

CSBS and others have called attention to the problems created by expansive federal preemption, and OCC preemption in particular, in hearings and briefings before the Senate Banking Committee and the House Committee on Financial Services. I bring the matter of preemption to this committee's attention because these problems are very relevant to addressing the threat predatory lenders pose to senior citizens.

The states already have systems in place for referring complaints to the appropriate agencies, and to law enforcement authorities when necessary. The states dedicate hundreds of employees to handling these consumer complaints.

I put forward two final numbers for your consideration. Over the past three years, the staff of our small agency conducted 618 routine examinations of non-depository lending institutions doing business in Idaho. These examinations are the ones that will be left undone if Idaho's mortgage brokers, mortgage lenders, and finance companies continue to surrender their state licenses to us under the claim of OCC preemption. It is very often these inspections that detect small, manageable problems before they become large and costly problems. It is my understanding that the OCC rarely performs on-site, routine examinations of national bank operating subsidiaries.

Finally, if all non-depository financial institutions in Idaho – and remember, these nonbank entities are the most frequent sources of complaints – were to seek OCC preemption by becoming operating subsidiaries of national banks or federal thrifts, Idaho citizens would lose the protection of Idaho's laws and law enforcement when dealing with nearly 1,700 companies.

Mr. Chairman, although the states have had significant success in identifying and punishing predatory lenders, and returning funds to the victims, this is not an easy or a simple process. My colleagues and I all feel the strain of limited resources. With limited resources at both state and federal levels, we should be talking about sharing responsibilities, not preempting valuable resources.

State and federal regulators can and must work in a cooperative alliance that acknowledges their respective strengths. And our state/federal system of financial regulation has generally been touted as the model for cooperative federalism. This push from a federal regulator to push that system aside is dangerous.

This model of cooperative federalism is still alive in the states and among many federal regulatory agencies and national organizations. For example, CSBS is a strong alliance partner with the FDIC in its Money Smart financial education program, and a CSBS representative sits on the board of directors of JumpStart, another national financial education program. We also plan to work with the federal panel recently created by the Fair and Accurate Credit Transactions Act to ensure financial education initiatives are used at the state and local levels.

Predatory lending is an issue that affects us all. While Idaho – and, in fact, most states – have not enacted separate laws against predatory lending, we have all learned from the experiences of states that have enacted these laws or promulgated new regulations. A comprehensive account of these measures as well as state enforcement and education efforts can be found on the Regulatory Affairs portion of Conference of State Bank Supervisors' Web site at http://www.csbs.org.

Most consumers shopping for a mortgage do not understand that different sets of laws apply to different lenders. As in most states, Idaho borrowers call us if they have a problem with their bank, mortgage broker, or finance company. We are that important local office, much like the offices each of you maintains in your home district. For the elderly, a local contact is critical. And consumers rightly expect that their state officials can go to bat for them when they've been wronged. We want to be able to respond to these calls effectively, whether it's going out to the consumer's home when they can't readily come in to our office, or meeting with them in person when they drop by unexpectedly. Unfortunately, our hands are tied more and more by federal preemption.

Your examination of predatory lending offers an opportunity for a broader discussion on the appropriate interaction of state and federal laws that protect consumers. Given the sweeping preemptions of the Comptroller's recent regulations, it appears that new consumer protection laws governing mortgage lending will have to originate at the federal level, without the benefit of continued experimentation at the state level. As you know, enacting federal legislation is a long and cumbersome process. Federal laws necessarily address problems with broad strokes that may not be appropriate for both large and small organizations within the same industry. And, based on my experience, taking enforcement authority away from the states and centralizing it in Washington, D.C. is bad for the citizens of Idaho.

The state system is much better equipped to respond quickly, and to tailor solutions to the specific needs of various communities and industry sectors. If you lose the states as a laboratory for consumer protections and other innovations, you lose two great attributes of our federalist system – the ability to find out what does and doesn't work, and the ability to tailor the response to the problem. Idaho doesn't necessarily need the solution for the problems identified in New York.

Preemption has always been part of the dynamic of our dual banking system. Congressional preemption may be necessary at times to create uniform national standards, as with the recently-enacted Fair and Accurate Credit Transactions Act. The Conference of State Bank Supervisors supported congressional preemption in that case. But we strongly oppose broad regulatory preemption – such as the OCC's recent actions -- in the absence of express guidance from Congress or meaningful consultation with the states.

**Conclusion**

Predatory lending is an insidious practice that turns the American dream into the American nightmare. It steals not only the victims' money and homes, but their confidence in our financial system. We at the state level are the first line of defense against these unscrupulous businesses. We are constantly adjusting our approaches, so that we do not deter legitimate lenders or prevent access to credit by those who need it most.

A long-term solution to predatory lending requires three elements: consumer education, clear and consistent laws, and effective enforcement. My office works with community groups, churches, schools and our federal counterparts to educate consumers about the financial system and their rights and obligations, so that they can make the choices that help them reach their goals. Our examiners are physically present in the institutions we supervise, making sure that these institutions have responsible lending policies in place and adhere to those policies. Finally, we do not hesitate to take action against businesses that violate our consumer protection laws.

For the states, enforcement is becoming the weakest link. Federal preemption continues to hinder our enforcement efforts, and has created incentives for businesses to seek the regulatory structure that guarantees the fewest consumer protections. This hurts the citizens of Idaho. This hurts the citizens of the United States.

We stand ready to work with the Congress and with our federal counterparts on a coordinated stand against predatory lending. Our experience should create a valuable foundation for solutions as we go forward.

I would be happy to answer any questions the Committee may have.

The CHAIRMAN. Director Gee, thank you. I will be back to you with questions. You have made a very profound statement this morning that I want to pursue with you.

Now, let us turn to Lavada DeSalles, member of the Board of Directors of the AARP. Thank you so much for being with us this morning.

**STATEMENT OF LAVADA E. DeSALLES, MEMBER, BOARD OF DIRECTORS, AMERICAN ASSOCIATION OF RETIRED PERSONS, WASHINGTON, DC**

Ms. DESALLES. Thank you for inviting us. My name is Lavada DeSalles.

The CHAIRMAN. Lavada, thank you.

Ms. DESALLES. Certainly. As you mentioned, I am a member of AARP's Board of Directors.

I appreciate this opportunity to testify, Chairman Craig, on a matter of concern to us; that is, the practice of predatory mortgage lending. The types of loans that are being made available to today's borrowers have expanded well beyond the prime credit products traditionally offered at banks. Subprime credit lending has grown and grown rapidly. In 1984, the $35 billion in subprime mortgages represented less than 5 percent of all mortgage originations. By 2002, subprime lending had increased to $213 billion or 8.6 percent of originations.

AARP's concern regarding the growth of the subprime market is based on numerous studies that indicate that older homeowners are more likely than younger borrowers to receive a subprime loan. This is a concern because the subprime market appears to be the primary source of predatory lending practices. Loan-skimming practices appear to most often occur when a subprime loan is refinanced.

Additionally, AARP is concerned that push marketing, often conducted by subprime lenders, leads to loans that are sold and not sought. AARP continues to be concerned by research findings that the percentage and volume of foreclosures associated with subprime mortgages appears to be increasing. For older persons, the impact of foreclosure can be devastating, representing not only a loss of a lifetime of savings but the loss of one's home and a lifetime of memories, even one's independence.

AARP has seen the devastation wrought by predatory loans upon older homeowners. We have been active in working to eliminate predatory lending through litigation, advocacy, and education. In my written statement, I provide two examples of the financial problems faced by borrowers receiving predatory loans and the efforts made by our litigators to provide relief for those who have been victimized.

AARP has also been active at the Federal level, supporting antipredatory lending legislation and regulation. We have testified before numerous House and Senate committees as well as the Departments of Housing and Urban Development and Treasury, expressing our concerns about predatory lending and the need for stronger protections. AARP's efforts have also included an educational campaign entitled "They Didn't Tell Me I Could Lose My Home." Educational materials, tips on shopping for mortgages and media messages are among the resources we offer to educate homeowners about predatory mortgage lending.

AARP is pleased to report that as a result of our efforts and the efforts of many others, including leading lenders, Fannie Mae, Freddie Mac and other stakeholders, significant market changes have occurred. But clearly, more needs to be done.

In summary, assuring that older, refinanced borrowers obtain appropriate loans is critical to ensuring the current and future financial security of millions of older Americans. Predatory lending harms both homeowners and legitimate lenders.

We look forward to working with you, Chairman Craig, and with the other members of this Committee. Together, we must strive to find effective and appropriate methods for eliminating these exploitative lending practices. These practices have proven to be very devastating to older persons and their families. I would be happy to answer any questions that you may have. Thank you.

[The prepared statement of Ms. DeSalles follows:]

AARP

STATEMENT

BEFORE THE

SPECIAL COMMITTEE ON AGING

OF THE

UNITED STATES SENATE

ON

"PREDATORY LENDING: ARE FEDERAL AGENCIES PROTECTING OLDER AMERICANS FROM FINANCIAL HEARTBREAK"

FEBRUARY 24, 2004
628 DIRKSEN SENATE OFFICE BUILDING
WASHINGTON, D.C.

WITNESS: LAVADA DeSALLES
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Good morning Chairman Craig, Ranking Member Breaux, and Members of the Special Committee on Aging. My name is Lavada DeSalles. I am a member of AARP's Board of Directors. I appreciate this opportunity to testify on a matter of great concern to us – the practice of predatory mortgage lending.

The American mortgage finance system is justifiably the envy of the world. It has offered unparalleled financing opportunities under virtually all economic conditions to a very wide range of borrowers who, in no small part, have contributed to the highest homeownership rate in the nation's history – 68.6 percent.

Over 80 percent of persons 65 and older are homeowners. For older Americans, home equity has consistently been a primary source of wealth – today, accounting for approximately $2 trillion among persons 62 and older or roughly one-half of the wealth of older persons.

The process of obtaining a home mortgage has changed dramatically. Many of us remember when getting a loan meant walking into a bank or savings and loan, filling out paperwork, going home, and waiting – sometimes days – for a call from the bank as to whether the loan was approved. Not so today. Technological advances have increased the speed and efficiency of lending decisions. TV, newspapers – even the Internet – are full of ads that offer 'instant credit,' and 'guaranteed loans.' A recent study by AARP found that approximately 7 of 10 older homeowners reported having received information offering them the opportunity to borrow money against the equity in their homes. In addition, ill-intended home improvement contractors go door-to-door, 'finding' home repair 'emergencies' with home-secured loan documents in-hand and ready to sign.

The types of loans that are available to today's borrowers have expanded well beyond the 'prime' products traditionally offered at banks. Subprime lending has grown – and grown rapidly. In 1994, the $35 billion in subprime mortgages represented less than 5 percent of all mortgage originations. By 2002, subprime lending had increased to $213 billion or 8.6 percent of originations (subprime originations in recent years have represented as much as 13 percent of the mortgage market).

AARP's concern regarding the growth of the subprime market is based on numerous studies that indicate that older homeowners are more likely than younger borrowers to receive a subprime loan. This is a concern because the subprime market appears to be the primary source of predatory lending practices – in particular, subprime refinancings (as opposed to first purchases), since that's where there's home equity to skim, and as Willie Sutton said, 'that's where money is.'

In addition, AARP is concerned that aggressive 'push marketing', often conducted by subprime lenders, leads to loans that are 'sold, not sought.' In a recent study, nearly two-thirds (61%) of older borrowers with refinanced subprime loans, reported that the broker/lender – not themselves – initiated the contact. Over one-half (54%) of these older borrowers with refinanced subprime loans reported to have responded to 'guarantee' ads or sales calls.

AARP continues to be concerned by research findings that the percentage of foreclosures associated with subprime mortgages appears to be increasing. Studies in both urban and suburban areas have found that the volume of foreclosures associated with subprime loans has increased considerably in recent years. For older persons, the impact of foreclosure can be devastating – not only the loss of a lifetime of savings, but the loss of one's home and a lifetime of memories -- even one's independence.

AARP has seen the devastation wrought by predatory loans upon older homeowners and has been active in working to eliminate predatory lending through litigation, advocacy, and education.

The following cases are but two examples of the problems faced by borrowers receiving predatory loans. In the early 1990's, First Government Mortgage and Investors Corporation (First Government) operated as a mortgage broker, charging older clients sixteen points plus very high interest charges for outrageously expensive and unaffordable mortgage loans. Over the years, First Government expanded its business and became a mortgage banker (i.e., making loans through other brokers and then selling these loans to banks and other secondary market purchasers). While First Government changed its pricing practices throughout the years, the hallmarks of its business operations remained deception, unaffordable pricing and bait and switch. AARP estimated that at least one-half of the foreclosure cases that we handled throughout the 1990's came from loans originated by First Government.

In 2000, AARP represented eleven older Washington, D.C., homeowners in a lawsuit against First Government, several mortgage brokers, title companies, and the lenders who purchased their mortgage loans from First Government.[1] These older homeowners alleged violations of the federal consumer credit laws -- Truth in Lending Act (TILA) and Home Ownership Equity Protection Act (HOEPA) and deceptive practices, including high-pressure tactics employed to get them to take out loans and erroneous or misleading information that hid the actual interest rates and costs of the loans. The original plaintiff, Betty Cooper, was an older, wheelchair-bound African-American widow, living on a monthly pension. She experienced a bait and switch of her interest rate that resulted in unaffordable monthly payments. In addition, she was charged a hidden broker fee that cost her a steep **8 percent of the mortgage, and an unexplained balloon mortgage payment.** Many of the other older homeowners with First Government loans were similarly surprised to learn that their mortgage loans included large balloon payments. Moreover, despite the fact that the borrowers provided their tax returns to the brokers, in many cases, the broker and lender created phony tax returns which grossly inflated their income or invented jobs to make it appear that they would be able to afford the mortgage payments. Yet, each of these victims was struggling to make monthly payments because First Government made them loans with monthly payments 48-100 percent of their monthly incomes, with effective annual percentage rates as high as **266 percent**.

Approximately one year into the case, First Government filed for bankruptcy, initially in what appeared to be a ploy to derail the litigation. When that course of action proved unsuccessful, First Government converted to a liquidation. Unfortunately, bankruptcy filings by predatory lenders and brokers are all too common. Were it not for the important ability to hold loan purchasers, also known as assignees, responsible for at least some of the bad acts of the originating lender, many victimized, older homeowners would lose their homes. During the three years of litigation, many of

[1] *Cooper v. First Government Mortgage &Investors Corp., et al*, 1:00-CV-00536 (D.D.C. 2000). *See also*, 238 F. Supp. 2d 50 (D.D.C. 2002); 2002 U.S. Dist. LEXIS 21821, 206 F. Supp. 2d 33 (D.D.C. 2002), 2002 U.S. Dist. LEXIS 12219; 216 F.R.D. 130 (D.D.C. 2002), 2002 U.S. Dist. LEXIS 26661; 216 F.R.D. 126 (D.D.C. 2002), 2002 U.S. Dist. LEXIS 26666.

the brokers, loan purchasers and title companies settled their claims, leaving only a few parties, including First Government, to appear to face the opening day of trial in March 2003.

After hearing the homeowners' stories and testimony from one of the brokers, the jury in *Cooper* found First Government's conduct to be "outrageous," and in "willful disregard of the plaintiffs' rights," and the defendant was found to be in violation of the DC consumer protection laws, as well as TILA and HOEPA. Approximately $300,000 in compensatory damages was awarded to these victims. This federal court jury also awarded $4,125,000 in punitive damages. While First Government's bankruptcy makes collection of the majority of these damages virtually impossible, the homeowners are seeking to collect on bonds which the District of Columbia required First Government to purchase as a condition of doing business.

A second case has been recently filed which involves a mentally impaired, West Virginia couple, and highlights the issue of federal preemption -- which is making it increasingly difficult for victimized homeowners to obtain redress when they are deceived by predatory mortgage lenders. In *Phillips v. Coast to Coast Mortgage, et al*[2], the Phillipses, who subsist on a limited income of Social Security benefits, were threatened and tricked into mortgaging their debt-free home by an unlicensed mortgage broker. The broker asserted that they would lose their home if they failed to pay off car loans. A grossly inflated appraisal enabled the broker to make a $28,800 loan that was 240 percent of the home's appraised value. The borrowers were charged more than 10 percent in fees for an adjustable rate mortgage. The mortgage had an initial teaser rate of 12.5 percent which could increase to18.5 percent, but not decrease. The overvaluation of their home, combined with a significant prepayment penalty, have made refinancing impossible. These features, combined with the steep rise of their monthly mortgage payments, will inevitably lead to default and foreclosure for these homeowners.

The loan was made by the lending division of Superior Bank, a failed, federally-chartered savings bank. The bank was using a mortgage securitization scheme, creative accounting, and an elaborate corporate structure to strip home equity from homeowners nationwide, including hundreds of West Virginia homeowners. The Federal Deposit Insurance Corporation (FDIC) has reported on the misuse and demise of Superior Bank by Coast-to-Coast, Superior's parent company, through a securitization scheme that stripped millions of dollars, most of which were derived from the securitization of risky subprime mortgage loans. As master lender, and prime mover in the scheme, Coast-to-Coast controlled the structure and cost of the mortgage loans and enjoyed enormous profits. When Superior eventually collapsed, it triggered losses to the Savings Association Insurance Fund estimated at between $424-$525 million.

Coast-to-Coast and the other entities sued for this unconscionable and fraudulent loan seek to avoid responsibility for their own deceptive and fraudulent activities by seeking to enfold these actions within the cloak of Superior's preemption. According to its theory, Coast-to-Coast was free to direct the making of loans through unlicensed brokers, could profit, without risk from fraudulent and inflated appraisals, and could benefit enormously from unconscionable and deceptive loan practices -- practices that were required by its own scheme -- with impunity. This alarming tactic, in which Coast-to-Coast and other defendants are attempting to evade responsibility for their own violations of state contract and common law, challenges the authority of the states to protect their

[2] *Phillips v. Coast-to-Coast Financial Corp., et al.,* 03-C-153 (Mc Dowell Co. WV 2003).

citizens in the most basic areas of contract law and consumer protection and is becoming a regular feature of predatory lending defense. Abusive assertion of preemption is becoming a frequent defense in the predatory lending industry's battle to evade responsibility for its illicit actions.

AARP's advocacy efforts have included a multi-year campaign at both the state and federal levels. AARP has worked diligently – with industry, consumers, and policymakers alike – to protect older homeowners (such as the two cases just described) from abusive lending practices, and has actively pursued legislative solutions in more than one-half of the states. AARP has advocated, following the structure used in HOEPA, to prohibit inherently abusive lending practices, such as 1) financing single premium credit insurance and other debt cancellation agreements and 2) refinancing loans that do not provide a tangible net benefit to the borrower (i.e., loan flipping). In addition, AARP has advocated that high-cost loans (i.e., loans with very high interest rates and fees) subject borrowers to greater dangers, and should be subject to additional restrictions (that do **not** include interest rate caps), including: 1) limiting prepayment penalties and fees; 2) prohibiting mandatory arbitration clauses; and, 3) prohibiting the making of loans based solely on the value of the home rather than the borrower's ability to repay (asset-based lending).

AARP has also been active at the federal level, supporting anti-predatory lending legislation and regulation. Moreover, AARP has testified before numerous House and Senate committees, as well as the Departments of Housing and Urban Development (HUD) and Treasury, expressing concerns about predatory lending and the need for stronger protections. AARP has submitted comments to the Federal Reserve Board supporting amendments to Regulation Z to strengthen HOEPA and to the Office of the Comptroller of the Currency (OCC) in opposition to its recently adopted rules.

AARP is pleased to report that as a result of our efforts, and the efforts of many others, including leading lenders, the Government-Sponsored Enterprises (GSE's), and other stakeholders, significant market changes have occurred. For example, major lenders no longer include single premium credit insurance in their loans. In addition, recently Freddie Mac and Fannie Mae each announced that they will not purchase loans that include mandatory arbitration clauses. At least 18 states[3] have enacted laws that expand on the HOEPA protections. These laws generally cover more subprime loans and provide greater protections for borrowers facing foreclosures than HOEPA.

However, AARP continues to work with consumer advocates, policymakers, credit rating agencies, and major purchasers of mortgage loans to provide foreclosure protections for older borrowers victimized by predatory lenders. It must be noted that, even with the previously noted protections for high-cost loans; unless there is some deterrent to the purchase or assignment of possible predatory loans by the secondary market, predatory lenders will continue to receive capital, and will continue to make unaffordable loans.

In addition, AARP continues to be extremely concerned about the recent actions regarding state preemption by the OCC and Office of Thrift Supervision (OTS) and their impact upon older borrowers. Neither of these agencies has adopted strong regulations that protect borrowers from predatory practices. In addition, enforcement limitations are likely to mean that, in reality,

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[3] Arkansas, California, Colorado, Connecticut, Florida, Georgia, Illinois; Kentucky, Maine, Nevada, New Jersey, New Mexico, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, and South Carolina.

victimized older borrowers will not be able to avoid a foreclosure that was caused by predatory lending practices.

AARP's efforts have also included an educational campaign, titled "*They didn't tell me I could lose my home.*" Educational materials, tips on shopping for mortgages, and media messages are among the resources offered to educate homeowners about predatory mortgage lending. AARP has sponsored local "consumer universities" that include workshops on avoiding predatory lending, as well as statewide 'Predatory Lending Sabbath" days in several states.[4] Finally, AARP has partnered with legal services providers to train attorneys who work with victimized homeowners about the legal issues surrounding predatory loans.

In summary, homeownership is the great American dream – a commitment to personal financial security and to economic growth, creating economic prosperity for families and communities. According to one recent study, 83 percent of Americans believe that owning a home is a good investment. For older households, home equity is a key component of wealth among older households.

Assuring that older mortgage refinance borrowers obtain appropriate loans is critical to ensuring the current and future financial security of millions of older Americans. Predatory lending harms both homeowners and legitimate lenders. AARP looks forward to working with you, Chairman Craig, and with the other Members of this Committee, to find effective and appropriate methods for eliminating egregious lending practices that prove devastating to older persons and their families.

[4] Including Georgia, New York, Maryland, California, South Carolina.

The CHAIRMAN. Ms. DeSalles, thank you very much for that testimony, and we are pleased to hear that the AARP is as alert on this as you are. I will pursue some of your efforts with you in a moment.

Now, let us turn to Veronica Harding of Philadelphia, PA. She was the victim of such predatory lending, and Veronica, we are anxious to hear your story.

## STATEMENT OF VERONICA HARDING, PHILADELPHIA, PA

Ms. HARDING. First, I would like to say good morning. My name is Veronica Harding. I will be 75 years old next month. I am a retired machine operator and domestic worker. I now support myself on Social Security and a small pension. I live in a Philadelphia row house that I purchased back in 1980.

I paid $7,500 cash for my home in 1980. I guess it is worth now about $30,000. I love my home, and it is all I have to show for my lifetime working. I almost lost my house through a combination of being taken advantage of and not knowing what I was doing. I appreciate the opportunity that you give me today to tell my story. What I did, you know, when I woke up and found out what had really happened to me behind this terrible, disgraceful thing called predatory lending, I felt ashamed when I first found out what had happened to me.

I was ashamed to talk about it. But then, I realized that if I could help just one person to keep them from getting mixed up and getting into trouble with this predatory lending, then I would have done something good.

The first thing I would like to say, "I have learned the hard way that debt is like drugs. They start sending you credit cards in the mail, making you believe that instantly you can do the things, buy the things that you want to buy, that you could not really afford to do in the beginning, and you think they are doing something good for you."

Before you know it, you are in a debt that is too big for you to handle. They sent me credit cards. I used the cards, and I would occasionally borrow a couple thousand dollars to do small jobs on my home. Then, here comes the big stuff, the hard stuff. One day, a man came to my house, and he said he could get me a steel door. He told me that he thought the best thing for me to do would be to consolidate all my bills into one payment that I could pay off the door.

Well, that started off with one big mortgage company, one big mortgage. It was $17,000. But within a couple of months of taking that mortgage, I started getting calls from many companies, from that company and other companies. They all told me that they would lower my payments if I would consolidate my bills. I was not looking for anybody. They looked for me. They found me.

After refinancing my house three or four times, by 1997, the mortgage debt on my house was over $38,000. Now, remember, I have only a little money to live on. My house was all paid for. It is not even worth the $38,000 I now owe.

I really do not remember too much about the loan in 1997. I remember a nice man calling me on the telephone. He seemed to know something about me and told me that he could make it easy to pay my bills. I remember him saying, "You got the coffee, I got the danish." Honestly, I thought he was really doing me a favor. It is embarrassing to admit that I never understood what I was signing. But, you know, there are so many papers involved; these sales people, they are smooth talkers.

In fact, I realize that I did not know what I was doing. Certainly, I did not know that they were burying me alive. Attached to my written testimony are copies of my loan documents from that last loan. First of all, I want to point out the name of the company that made me the loan, the American Mortgage Reduction. Senators, do not bother looking for that company, because they went out of business soon after my loan. I think American Mortgage Reduction sold out to Conti Mortgage Company. I never even heard from that one, even though I paid them for a couple of years. Then, afterwards, I found out that I was turned over to a company named Fairbanks Capital.

That is who I have my loan with now. My point in telling you this is that you have to pay attention not only to the people who are making the loans but also to the people who are buying these loans. In my written testimony, I have given these loan documents one by one.

This morning, I want to summarize a few key points: first, I now realize that I was putting over $38,000 of mortgage debt on my house. We never talked about the amount of the loan. Remember, I was not even trying to borrow anything. They found me. This loan would make it easier for me to pay my bills. These people who come to our houses selling these mortgages never talk about how much we are borrowing or the fees we are paying. They talk mainly about the monthly payments, about how, if you will take out this loan, you will make things better for yourself. Who does not want to do that?

Second, a very big part of the debt is just fees. Of the $38,000 I was supposed to be borrowing, over $5,600 was just in fees. Third, the really scary part of the loan for me was the balloon, the balloon payment that they put on me. Now, the way that worked, I was supposed to pay $308 for 15 years, and then, in December of 2011, when I am 82 years old, I am supposed to make a payment of $29,000. Now, tell me where anybody at 82 years old is going to have money, $29,000, and have to make this payment in one lump sum. If I do not have that $29,000, they take my house.

The other thing that is amazing about it is after 15 years of paying $55,400 in payments from my Social Security, I would still owe them the amount of the last mortgage company in 1997 when they refinanced me.

It is a funny thing that just like the predatory lenders, the people who first helped me wake up to what had happened to me came knocking on my door. They were like my angels: Ira Goldstein and Rebecca Cook of The Reinvestment Fund and Paul Davies of the Philadelphia Daily News. They came separately, told me they were doing some researching on predatory lending, and they discovered me. They asked me for my loan documents, and I showed them.

They sent me to my lawyer, Irv Ackelsberg at Community Legal Services. He is the one who is fixing my problem and saving my house for me. He filed bankruptcy for me. He sued the company that has my loan and saved my house. Now, the $38,000 mortgage problem has been reduced to a $20,000 obligations that I can afford. My picture was on the front page of the Daily News in 2001, and then, I started giving talks at my church, around the city. The Mayor came to my house for a press conference, and also, I spoke at a press conference at City Hall for the graduating housing counselors for the predatory lending training program.

The last page of my testimony shows a flier with my picture on it that the city was putting into water bills, inviting people to call the predatory lending hotline and send people to the housing counselors.

Now, you have asked me for suggestions about what government agencies can do about this problem of predatory lending. Here are five things I think you should think about. First, stop acting like credit is always good. The more I have gotten involved, I have heard it said that we need to be careful about what we are doing about predatory lending, because it might dry up credit. Truth is, some kind of credit loans need to be dried up. Loans are just like food. Some food is good for you, and some food is not.

Second, stop blaming people like me for getting into trouble and start protecting us from predatory lending. For a long time, I was really ashamed about what happened to me. But now, I realize what happened to me did not happen because I was a dumb person. It happened because you are letting people like those operate in our communities. Right in my block, believe it or not, we had 19 other families caught up in the loans that the researchers who found me told me about.

I think that the loan that I have, that was sold to me should have been illegal. All of those fees, the balloon payment, they really—I was not really looking for a loan. They talked me into these loans. They are dangerous products like cigarettes, unsafe cars. Sure, we need education, but we also need protection.

Third, beware of this thing called preemption. I learned the word preemption about 3 years ago. In Philadelphia, we had a City Council hearing. We cried for help, and they heard us. They answered us with a new law against predatory lending. Two months later, some of the companies got angry. They went to Harrisburg, and they preempted it. The legislature preempted it. It seems like because the State government is higher than the city government, they can undo the things that the city has done.

Now, I hear that the Federal Government, which is higher than the State, is talking about preempting some of the good things other States have done in protecting their people. I think that is terrible. Instead of spending so much time trying to pull each other down, I think the governments should get together and work together to make a difference about these things and put protection on us.

Fourth, senior citizens need more counselors, lawyers, like we have in Philadelphia. I was just one of the lucky people who—people who helped me with what happened to me to fix my problem. Philadelphia has housing counselors, the legal services lawyers, who know about predatory lending. I hear that if I was in a different city, where they don't have these services I would probably have lost my house by now. My lawyer has explained to me that

Community Legal Services actually has had to give up Federal funding in order to continue doing the work because of restrictions that Congress placed on legal service lawyers. This is a real shame. We need more lawyers and housing counselors, and we need to let them do their job.

Fifth, spend less time talking to the big fellows, and spend more time talking to the little people like us, like me. I feel that predatory lenders can come here, hire fancy lobbyists, and tell you how wonderful they are. You probably do not get many opportunities to talk to people like me. But you should do more of that. Come to Philadelphia. I will have the coffee, and you bring the danishes. [Laughter.]

I can show you over, over hundreds, hundreds of retired, churchgoing Americans who are in real trouble and need help, and this predatory lending—and I thank you so very much for the opportunity of letting this grandmother speak a piece of her mind.

[The prepared statement of Ms. Harding follows:]

BEFORE THE SPECIAL COMMITTEE ON
AGING

Hearing on Predatory Lending:
*Are Federal Agencies Protecting Older Americans from Financial Heartbreak?*

February 24, 2004

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**Testimony of Veronica Harding**

My name is Veronica Harding. I will be 75 years young next month. I am a retired machine operator and domestic worker. I worked from the time I was 17 until I had to stop working in my 50's on account of my bad back. I support myself now on my Social Security and a very small pension.

I live by myself in the small Philadelphia row-house that I have owned for the last 24 years. I paid $7,500 cash for the house in 1980 and I think it is worth about $30,000 today. I love my house, and, it is all I have to show for my lifetime of work.

I almost lost that house, from a combination of being taking advantage of and of not knowing what I was doing. I appreciate the opportunity you are giving me today to tell the story of what was done to me, how I woke up to what was happening, and the many beautiful people that I have met along the way of getting help for myself and of starting to speak out against this disgraceful thing called predatory lending. I felt ashamed when I first discovered what I had gotten myself into, and I felt ashamed to talk about it. But then I realized that if I could help others avoid getting into this trouble, I just had to do it. By talking out, like what I am doing today, I have started to feel like a person again.

The first thing I'd like to say is that I have learned the hard way that debt is a lot like drugs. They start by sending you credit cards in the mail, making you believe that you can instantly buy the things you can't really afford, and making you think that's the smartest thing you could do for yourself. And before you know it, when you start sinking into debt that is too big to handle, they come selling you the hard stuff, the mortgages, telling you this will make everything better.

I got hooked on credit, like a lot of other folks. I'd use my cards or I would occasionally borrow a couple thousand dollars from a finance company to do some small jobs on my house. But then the hard stuff got me. One day, a man came to my house, and told me he could get me a steel security door. And, he told me, it would be a good idea to consolidate all my debt into the same loan that would pay for the door. He made it sound so easy and the smart thing to do. That first big mortgage was $17,000. But within a couple of months of taking out that mortgage, I started getting calls from that company, and then from other companies, offering to lower my payments and consolidate my bills. I ended up refinancing around three or four more times. By 1997, the mortgage debt on my home was over $38,000. Now remember, I have very little money to live on, my house was all paid for, and it's not even worth the $38,000 I now owed. I want to talk more specifically about this last loan–or, I should say, two loans–that almost put me out of my house.

I really don't remember much about this transaction. I remember the nice man who called me up on the telephone. He seemed to know something about me, and told me that he had something important to help me with my bills. I remember him saying, "You got the coffee, I got the danish." Honestly, I really thought he was doing me a favor. It's embarrassing to admit that I never understood what I was signing, but, you know, there are so many papers involved and these salespeople are very smooth talkers. The fact is, though, I now realize that I didn't know what I was doing. I certainly didn't know they were burying me alive.

Later, after I realized I had gotten myself into deep trouble and went looking for help, I started learning about the loans I signed for that day. Attached to my written testimony are some of the documents I signed. At pages 1-1 and 1-2, you can see the Settlement Statement from the loan. My lawyer has taught me that this is the document that shows you where all the money went.

First of all, I want to point out the name of the company making me the loan: American Mortgage Reduction, Inc. Senators, don't bother trying to find that company, because it went out of business soon after my loan. In fact, I don't think I ever heard from American Mortgage Reduction after the man with the papers came to my house. The loan was sold right away to a company named ContiMortgage Co. I paid them for a few years, and then I got transferred to a company named Fairbanks Capital Corp. That's who has my loan now. My point in telling you all this is that you have to pay attention not only to the people who are making the loans, but also to the companies who are buying these loans.

On the first page of the Settlement Statement you can see at Line 202 that the amount of this loan was $35,250. It may seem odd to you that I didn't know at the time that I was borrowing this much money, but remember, I wasn't trying to borrow a particular amount of money. Actually, I wasn't trying to borrow anything. They found me and told me this loan would make it easier for me to pay my bills. These people who come to our houses selling these mortgages never talk about what we are borrowing or the fees we are paying. They talk mainly about the monthly payment and about how, if you take this loan, you will be making things better for yourself. And who doesn't want to that?

You can see on the first page of the Settlement Statement that the loan was paying off a $29,000 mortgage I had at that time, with a company named Industry Mortgage Co. Note the first item listed, $5,595 in "settlement charges." These are all the fees I was charged. They are listed on the second page, page 1-2. The first two items, "loan origination fee" and "loan discount" add up to $3,525. My lawyer tells me that this is called "points," which is a fancy way of saying "fees." What makes me really angry is thinking that I was borrowing money, more money than I needed to borrow, just to pay these fees. And you can see that I had to pay even more than that, if you continue going down the rest of the settlement charges I had to pay.

Now I want to show the part of the loan that gave me the biggest shock. If you look at page 1-3 of my documents, it describes some of the terms of the loan I got myself into. It says I had to make $308/mo. payments. That much I knew, but there is something else on here that they did not explain to me when I was signing the documents. This is what they call a "balloon." The way it works is that I was supposed to pay $308/mo. for 15 years, and then, in December 2011, when I'm 82 years old, I am supposed to make a payment of $29,000! And if I can't make that payment, they get to take my house! The other thing that is amazing about this is that, after 15 years, after paying $55,400 from my Social Security, I still owe them the amount I owed the last mortgage company in 1997 when they refinanced me.

The last thing I want to point out about this loan is that it was actually two loans, again, something I didn't realize. If you go back to page 1-1, it says at the bottom that I put $2,565.88 of my own money into the transaction. But I didn't. This money came from a second mortgage that American Mortgage Reduction had me sign at the same time. If you look at pages 1-4 through 1-6, you see that I signed a second mortgage for $2,815.88, and that, after deducting more fees, I supposedly got $2,565.88. But I didn't get any money myself. This was the money they applied to the first loan.

I never made a payment on this second mortgage, no one ever sent me a bill and I didn't even know it was there, until my lawyer showed me. But it was put on my house. So that is how the $29,000 mortgage on my house became a $38,000 mortgage that I just keep paying and paying. And that doesn't even begin to explain where the $29,000 mortgage before that came from. Because I can't find the documents from the earlier refinancings, I probably will never fully understand those earlier loans.

It is funny to think that, just like the predatory lenders, the people who first helped me wake up to what had happened to me, came knocking on my door. They were like my angels: Ira Goldstein and Rebecca Mack from The Reinvestment Fund and Paul Davies, from the Philadelphia Daily News. They came separately, telling me that they were doing some research about predatory lending and that they discovered me when they were doing their research. They asked me for my loan documents, the ones I showed you today, and they sent me to my lawyer, Irv Ackelsberg, of Community Legal Services. He is the one who is fixing my problem and saving the house for me. He filed a bankruptcy for me, he sued the company that has my loan now, and that $38,000 mortgage problem is being reduced to a $20,000 obligation I can afford.

My picture was on the first page of the Daily News, and then I started giving talks at my church and around the City. The mayor came to my house for a press conference and I also spoke at a press conference at City Hall for the graduation of housing counselors from their predatory lending training program. The last page of my testimony shows the flyer, with my picture on it, that the City put in peoples' water bills, inviting them to call the Predatory Lending Hotline, that sends people to housing counselors.

You have asked me for suggestions about what government agencies can do about this problem of predatory lending. Here are a few things I think you should think about:

1. Stop acting like credit is always a good thing.

The more I've gotten involved in this issue the more I've heard it said that we have to be careful about doing something about predatory lending because that might dry up credit. The truth is, some kinds of credit, like the loan they fooled me into signing, should be dried up. Just like food, all credit isn't good for you. I know mortgages can help people buy homes. That's good credit. But I've learned that they can also be used to steal people's houses. Especially for us senior citizens, it's more important to help us save our homes from thieves and live out our years in peace than it is to help us buy new homes.

2. Stop blaming people like me for getting into trouble and start trying to protect us from predatory lending.

For a long time I was really ashamed about what happened to me. But now I realize that what happened to me didn't happen because I'm a dumb person. It happened because I trusted people and because I didn't think to ask about what I didn't understand, but more important than that, it happened because there are businesses out there that are very smart at fooling people like me. And it happened because you are letting businesses like these operate in our communities. Right on my block, 19 other people got bad loans; that's what the researchers who found me told me. The loan I got fooled into should have been illegal–all those fees, the balloon payment, me not really getting anything from the loan. I like to think of these loans like they are dangerous products, like cigarettes or unsafe cars. Sure, we need education, but we also need protection, too.

3. Beware of this thing called "pre-emption."

I learned about this word, pre-emption, three years ago. In Philadelphia, we got our City Council to hear our cries for help and they answered with a new law against predatory lending. Two months later, some of those companies who were angry about our law went to the state legislature and our law got pre-empted. It seems that because the state government is higher than the city government, they get to undo what the city does. And now, I hear that the federal government, which is higher than the states, is talking about pre-empting some of the good things other states have done to try to protect their people. I think that is terrible. Instead of spending so much time trying to upstage each other, the different governments should spend their time trying to find ways to work together.

4. Senior citizens need more housing counselors and lawyers like we have in Philadelphia.

I was so lucky that there were people who could help show me what happened to me and who could fix my problem. I hear that Philadelphia is unusual with it having housing counselors and Legal Services lawyers who know about predatory lending, and that if I were in a different city, I might have already lost my home. My lawyer has explained to me that Community Legal Services actually had to give up federal funding in order for it to continue doing its work because of restrictions Congress placed on what Legal Services lawyers are allowed to do. That is a real shame. We need more lawyers and housing counselors and you need to let them do their jobs.

5. Spend less time talking to the big fellows and more time talking to people like me. I figure that the predatory lenders come here and hire fancy lobbyists to tell you how wonderful they are. You probably don't get many opportunities to talk to people like me. But you should do more of that. Come to Philadelphia, I'll make the coffee and you bring the danish, and I'll introduce you to hundreds of retired, church-going Americans, who are in real trouble and need your help.

Thank you so much for letting this grandmother give you a piece of her mind.

# A. SETTLEMENT STATEMENT

U.S. Department of Housing and Urban Development

OMB No. 2502-0265

**B. Type of Loan**

1. ___ FHA 2. ___ FmHA 3. X Conv. Unins. 4. ___ VA 5. ___ Conv. Ins.

| 6. File Number | 7. Loan Number | 8. Mortgage Insurance Case No. |
|---|---|---|
| 24288 | | |

C. NOTE: This form is furnished to give you a statement of actual settlement costs. Amounts paid to and by the settlement agent are shown. Items marked (P.O.C.) were paid outside the closing; they are shown here for information purposes and are not included in the totals.

| D. Name and Address of Borrower | E. Name and Address of Seller | F. Name and Address of Lender |
|---|---|---|
| | | AMERICAN MORTGAGE REDUCTION, INC.<br>1653 THE FAIRWAY SUITE 209<br>JENKINTOWN, PA 19046 |

| G. Property Location | H. Settlement Agent | I. Settlement Date |
|---|---|---|
| | VALLEY SETTLEMENT COMPANY<br>Place of Settlement<br>2328 W. HAGERT STREET<br>PHILADELPHIA, PA 19132 | 12/04/96 |

| J. SUMMARY OF BORROWER'S TRANSACTION: | | K. SUMMARY OF SELLER'S TRANSACTION: | |
|---|---|---|---|
| **100. Gross Amount Due From Borrower** | | **400. Gross Amount Due To Seller** | |
| 101. Contract sales price | | 401. Contract sales price | |
| 102. Personal property | | 402. Personal property | |
| 103. Settlement charges to borrower (line 1400) | 5,595.10 | 403. | |
| 104. INDUSTRY | 29,519.78 | 404. | |
| 105. MONTGOMERY WARDS | 322.00 | 405. | |
| **Adjustments for items paid by seller in advance** | | **Adjustments for items paid by seller in advance** | |
| 106. City/town taxes to | | 406. City/town taxes to | |
| 107. County taxes to | | 407. County taxes to | |
| 108. Assessments to | | 408. Assessments to | |
| 109. ADVANTA | 2,016.00 | 409. | |
| 110. FCNB | 179.00 | 410. | |
| 111. CAPITAL ONE | 184.00 | 411. | |
| 112. | | 412. | |
| 120. GROSS AMOUNT DUE FROM BORROWER | 37,815.88 | 420. GROSS AMOUNT DUE TO SELLER | |
| **200. Amounts Paid By or In Behalf of Borrower** | | **500. Reductions In Amount Due To Seller** | |
| 201. Deposit or earnest money | | 501. Excess Deposit (see instructions) | |
| 202. Principal amount of new loan(s) | 35,250.00 | 502. Settlement charges to seller (line 1400) | |
| 203. Existing loan(s) taken subject to | | 503. Existing loan(s) taken subject to | |
| 204. | | 504. Payoff of first mortgage loan | |
| 205. | | 505. Payoff of second mortgage loan | |
| 206. | | 506. | |
| 207. | | 507. | |
| 208. | | 508. | |
| 209. | | 509. | |
| **Adjustments for items unpaid by seller** | | **Adjustments for items unpaid by seller** | |
| 210. City/town taxes to | | 510. City/town taxes to | |
| 211. County taxes to | | 511. County taxes to | |
| 212. Assessments to | | 512. Assessments to | |
| 213. | | 513. | |
| 214. | | 514. | |
| 215. | | 515. | |
| 216. | | 516. | |
| 217. | | 517. | |
| 218. | | 518. | |
| 219. | | 519. | |
| 220. TOTAL PAID BY/FOR BORROWER | 35,250.00 | 520. TOTAL REDUCTION AMOUNT DUE SELLER | |
| **300. Cash At Settlement From or To Borrower** | | **600. Cash At Settlement To or From Seller** | |
| 301. Gross amount due from borrower (line 120) | 37,815.88 | 601. Gross amount due to seller (line 420) | |
| 302. Less amounts paid by/for borrower (line 220) | 35,250.00 | 602. Less reduction amount due seller (line 520) | |
| 303. CASH FROM BORROWER | 2,565.88 | 603. CASH SELLER | |

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
SETTLEMENT STATEMENT
PAGE 2

| L. SETTLEMENT CHARGES: FILE NO.#: 24288 | PAID FROM BORROWER'S FUNDS AT SETTLEMENT | PAID FROM SELLER'S FUNDS AT SETTLEMENT |
|---|---|---|
| 700. TOTAL SALES/BROKER'S COMMISSION based on price $ @ | | |
| Division of commission (line 700) as follows: | | |
| 701. $ to | | |
| 702. $ to | | |
| 703. Commission paid at Settlement | | |
| 704. | | |
| 800. ITEMS PAYABLE IN CONNECTION WITH LOAN | | |
| 801. Loan Origination Fee % AMERICAN MORTGAGE REDUCTION | 1,762.50 | |
| 802. Loan Discount % AMERICAN MORTGAGE REDUCTION | 1,762.50 | |
| 803. Appraisal Fee to AMERICAN MORTGAGE REDUCTION | 250.00 | |
| 804. Credit Report to | | |
| 805. Lender's Inspection Fee to | | |
| 806. Mtg. Ins. Application Fee to | | |
| 807. Assumption Fee to | | |
| 808. | | |
| 809. CREDIT PAYMENT TO BRADLEES | 36.00 | |
| 810. | | |
| 811. | | |
| 900. ITEMS REQUIRED BY LENDER TO BE PAID IN ADVANCE | | |
| 901. Interest from to @ $ /day | | |
| 902. Mortgage Insurance Premium for to | | |
| 903. Hazard Insurance Premium for 1 yrs to AMERICAN MORTGAGE RED. | 560.60 | |
| 904. | | |
| 905. | | |
| 1000. RESERVES DEPOSITED WITH LENDER FOR | | |
| 1001. Hazard Insurance mo.@$ /mo. | | |
| 1002. Mortgage Insurance mo.@$ /mo. | | |
| 1003. City Property Taxes mo.@$ /mo. | | |
| 1004. County Property Taxes mo.@$ /mo. | | |
| 1005. Annual Assessments mo.@$ /mo. | | |
| 1006. mo.@$ /mo. | | |
| 1007. mo.@$ /mo. | | |
| 1008. mo.@$ /mo. | | |
| 1100. TITLE CHARGES | | |
| 1101. Settlement or closing fee to VALLEY SETTLEMENT COMPANY | 200.00 | |
| 1102. Abstract or title search to | | |
| 1103. Title examination to | | |
| 1104. Title insurance binder to | | |
| 1105. Document Preparation to BEST DOC. PREP. | 500.00 | |
| 1106. Notary Fees to | | |
| 1107. Attorney's fees to | | |
| (includes above items No: ) | | |
| 1108. Title insurance to LAWYER STITLE | 423.50 | |
| (includes above items No: ) | | |
| 1109. Lender's coverage $ 35,250.00 —— 423.50 | | |
| 1110. Owner's coverage $ —— | | |
| 1111. | | |
| 1112. | | |
| 1113. | | |
| 1200. GOVERNMENT RECORDING AND TRANSFER CHARGES | | |
| 1201. Recording Fees: Deed $ ; Mortgage $ 30.00 ; Releases $ 35.00 | 65.00 | |
| 1202. City/county tax/stamps: Deed $ ; Mortgage $ | | |
| 1203. State Tax/stamps: Deed $ ; Mortgage $ | | |
| 1204. | | |
| 1205. RECORD ASSIGMENT | 35.00 | |
| 1300. ADDITIONAL SETTLEMENT CHARGES | | |
| 1301. Survey to | | |
| 1302. Pest inspection to | | |
| 1303. | | |
| 1304. | | |
| 1305. | | |
| 1400. TOTAL SETTLEMENT CHARGES (enter on lines 103 and 502, Sections J and K) | 5,595.10 | |

I have carefully reviewed the HUD-1 Settlement Statement and to the best of my knowledge and belief, it is a true and accurate statement of all receipts and disbursements made on my account or by me in this transaction. I further certify that I have received a copy of the HUD-1 Settlement Statement.

[illegible] Buyer/Borrower

[illegible]

The HUD-1 which I have prepared is a true and accurate account of this transaction. I have caused the funds to be disbursed in accordance with this statement.

Settlement Agent

WARNING: It is a crime to knowingly make false statements to the United States on this or any other similar form. Penalties upon conviction can include a fine and imprisonment. For details see: Title 18 U.S. Code Section 1001 and 1010.

1-2

# BALLOON NOTE

**THE FINAL PAYMENT UNDER THIS NOTE IS SUBSTANTIALLY GREATER THAN THE PREVIOUS PAYMENTS. YOU MUST REPAY THE ENTIRE UNPAID PRINCIPAL BALANCE OF THE LOAN AND UNPAID INTEREST THEN DUE. THE LENDER IS UNDER NO OBLIGATION TO REFINANCE THE LOAN AT THAT TIME. YOU WILL, THEREFORE, BE REQUIRED TO MAKE PAYMENT OUT OF OTHER ASSETS THAT YOU MAY OWN, OR YOU WILL HAVE TO FIND A LENDER, WHICH MAY BE THE LEND THAT YOU HAVE THIS LOAN WITH, WILLING TO LEND YOU MONEY. IF YOU REFINANCE THIS LOAN AT MATURITY, YOU MAY HAVE TO PAY SOME OR ALL OF THE CLOSING COSTS NORMALLY ASSOCIATED WITH A NEW LOAN EVEN IF YOU OBTAIN REFINANCING FROM THE SAME LENDER.**

OWINGS MILLS, MARYLAND

US $35,250.00 December 4th, 1996
Date

[illegible], PHILADELPHIA, PA 19132
[Property Address]

## 1. BORROWER'S PROMISE TO PAY

In return for a loan that I have received, I promise to pay U.S. $35,250.00 (this amount is called "principal"), plus interest, to the order of the Lender. The Lender is AMERICAN MORTGAGE REDUCTION, INC.. I understand that the Lender may transfer this Note. The Lender or anyone who takes this Note by transfer and who is entitled to receive payments under this Note is called the "Note Holder".

## 2. INTEREST

Interest will be charged on unpaid principal until the full amount of principal has been paid. I will pay interest at a yearly rate of 9.95%. Interest will be charged until the principal has been paid in full.

The interest rate required by this Section 2 is the rate I will pay both before and after any default described in Section 6(B) of this Note.

## 3. PAYMENTS

I will pay principal and interest by making payments every month.

I will make my monthly payments, except for the final payment, will be in the amount of U.S. 308.04. Assuming all scheduled payments of principal and interest are made on their due dates, the final payment will be U.S. $29,056.62.

I will make my monthly payments on the 9th day of each month beginning on January 9th, 1997. I will make these payments every month until December 9th, 2011, on which date I will pay in full all of the remaining principal, accrued interest and any other charges, described below, that I may owe under this Note. Unless applicable law provides otherwise, all payments will be applied first to accrued and unpaid interest to the date of payment and the remainder, if any, to the unpaid principal balance. Any late charges, collection costs and expenses, dishonored check charges and payments made by the Note Holder to enforce this Note and/or to protect the Note Holder's interests under the Security Instrument (as defined in Section 9) will be assessed separately.

I will make my monthly payments at 1653 THE FAIRWAY SUITE 209, JENKINTOWN, PA 19046 or at a different place if required by the Note Holder.

## 4. BORROWER'S RIGHT TO PREPAY

I have the right to make payments of principal at any time before they are due. A payment of principal only is known as a "prepayment". when I make a prepayment.

I may make a full prepayment or partial prepayments without paying any prepayment penalty. The Note Holder will use all of my prepayments to reduce the amount of principal that I owe under this Note. If I make a partial prepayment, there will be no changes in the due dates or amounts of my monthly payments unless the Note Holder agrees in writing to those changes. Except as provided in section 5, the Note Holder earns any prepaid finance charge at the time the loan is made and no part of it will be refunded if I pay in full ahead of schedule.

## 5. LOAN CHARGES

If a law or regulation, which applies to this loan and which sets maximum loan charges, is finally interpreted so that the interest or other loan charges collected or to be collected in connection with this loan exceed the permitted limits, then: (i) any such interest and/or other loan charges shall be reduced by the amount necessary to reduce the interest and/or other loan charges to the permitted limit; and (ii) any sums already collected from me which exceeded permitted limits will be refunded to me. The Note Holder may choose to make this refund by reducing the principal I owe under this Note or by making a direct payment to me. If a refund reduces principal, the reduction will be treated as a partial prepayment. 1-3

## 6. BORROWER'S FAILURE TO PAY AS REQUIRED

(A) Late Charge for Overdue Payments

# FEDERAL TRUTH-IN-LENDING DISCLOSURE STATEMENT

(THIS IS NEITHER A CONTRACT NOR A COMMITMENT TO LEND)

File No. [illegible]

Creditor: AMERICAN MORTGAGE REDUCTION, INC.
1653 THE FAIRWAY, SUITE 209, JENKINTOWN, PA 19046

Borrower:

Date: December 4, 1996 Loan Number:

| ANNUAL PERCENTAGE RATE | FINANCE CHARGE | Amount Financed | Total of Payments |
|---|---|---|---|
| The cost of your credit as a yearly rate. | The Dollar Amount the credit will cost you | The amount of credit provided to you or on your behalf | The amount you will have paid after you have made all payments as scheduled. |
| 22.5 % | $16,369.97 | $2,815.88 | $19,185.85 |

[ ] REQUIRED DEPOSIT: The annual percentage rate does not take into account your required deposit.
PAYMENTS: Your payment schedule will be:

| Number of Payments | Amount of Payments | When Payments Are Due | Number of Payments | Amount of Payments | When Payments Are Due |
|---|---|---|---|---|---|
| | | Monthly Beginning: | | | Monthly Beginning: |
| 359 | @ 52.86 | 01/09/1997 | | | |
| 1 | @ 209.11 | 12/09/2026 | | | |

INSURANCE: The following insurance is required to obtain credit.
[ ] Credit life insurance and credit disability. [ ] Property Insurance [ ] Flood Insurance
You may obtain the insurance from anyone you want that is acceptable to creditor.

SECURITY: You are giving a security interest in: 2328 W. HAGERT STREET, PHILADELPHIA, PA 19132
[ ] The goods and property being purchased [ X ] Real property you already own.

FILING FEES: $83.00

LATE CHARGE: If payment is more than 15 days late, you will be charged 5% of the payment.

PREPAYMENT: If you pay off early, you
[ ] may [ X ] will not have to pay a penalty
[ ] may [ X ] will not be entitled to a refund of part of the finance charge

ASSUMPTION: Someone buying your property
[ ] may [ ] may, subject to conditions [ X ] may not assume the remainder of your loan on the original terms.
See your contract documents for any additional information about nonpayment, default, and required prepayment in full before the scheduled date and prepayment refunds and penalties.

The undersigned acknowledge receiving and reading a completed copy of this disclosure.
Neither you nor the creditor has become obligated to make or accept this loan, nor is any such obligation made by the delivery or signing of this disclosure

(Applicant) VERONICA HARDING Date (Applicant) Date

(Applicant) Date (Applicant) Date

NOTE: Payments above include any required mortgage insurance premiums, but do not include reserve deposits for taxes, assessments, and property or flood insurance.

Landtech Support Services Form 6/92 M-TIL

FEDERAL TRUTH-IN-LENDING AMOUNT FINANCED ITEMIZATION

Itemization of the Amount Financed of $2,815.88

$ -2,565.88 Amount given to you directly

$ N/A Amount paid on your account

Amount paid to others on your behalf:

$ 0 to appraiser

$ 0 to credit bureau

$ 83.00 to public officials

$ 0 to title insurance company

$ N/A to credit insurance company

$ 167.00 to VALLEY TITLE COMPANY, closing attorney

$ 0 to , title search

$ ______ to ______

$ ______ to ______

$ ______ to ______

$ ______ to ______

$ ______ to ______

$ ______ to ______

$ ______ to ______

$ ______ to ______

$ 0 Prepaid finance charge

I(We) acknowledge receipt of the original of this Federal Truth-In-Lending Amount Financed Itemization form, this 4th day of December, 1996.

VERONICA HARDING

# NOTE

December 4th, 1996

PHILADELPHIA, PA
[City] [State]

, PHILADELPHIA, PA 19132
[Property Address]

## 1. BORROWER'S PROMISE TO PAY

In return for a loan that I have received, I promise to pay U.S. $2,816.88 (this amount is called "principal"), plus interest, to the order of the Lender. The Lender is AMERICAN MORTGAGE REDUCTION, INC.. I understand that the Lender may transfer this Note. The Lender or anyone who takes this Note by transfer and who is entitled to receive payments under this Note is called the "Note Holder".

## 2. INTEREST

Interest will be charged on unpaid principal until the full amount of principal has been paid. I will pay interest at a yearly rate of 22.5%.

The interest rate required by this Section 2 is the rate I will pay both before and after any default described in Section 6(B) of this Note.

## 3. PAYMENTS

### (A) Time and Place of Payments

I will pay principal and interest by making payments every month.

I will make my monthly payments on the 9th day of each month beginning on January 9th, 1997. I will make these payments every month until I have paid all of the principal and interest and any other charges described below that I may owe under this Note. My monthly payments will be applied to interest before principal. If, on December 9th, 2026, I still owe amounts under this Note, I will pay those amounts in full on that date, which is called the "maturity date".

I will make my monthly payments at 1653 THE FAIRWAY, SUITE 209, JENKINTOWN, PA 19046 or at a different place if required by the Note Holder.

### (B) Amount of Monthly Payments

My monthly payment will be in the amount of U.S. $ 52.86.

## 4. BORROWER'S RIGHT TO PREPAY

I have the right to make payments of principal at any time before they are due. A payment of principal only is known as a "prepayment". When I make a prepayment, I will tell the Note Holder in writing that I am doing so.

I may make a full prepayment or partial prepayments without paying any prepayment charge. The Note Holder will use all of my prepayments to reduce the amount of principal that I owe under this Note. If I make a partial prepayment, there will be no changes in the due date or in the amount of my monthly payment unless the Note Holder agrees in writing to those changes.

## 5. LOAN CHARGES

If a law, which applies to this loan and which sets maximum loan charges, is finally interpreted so that the interest or other loan charges collected or to be collected in connection with this loan exceed the permitted limits, then: (i) any such loan charge collected shall be reduced by the amount necessary to reduce the charge to the permitted limit; and (ii) any sums already collected from me which exceeded permitted limits will be refunded to me. The Note Holder may choose to make this refund by reducing the principal I owe under this Note or by making a direct payment to me. If a refund reduces principal, the reduction will be treated as a partial prepayment.

## 6. BORROWER'S FAILURE TO PAY AS REQUIRED

### (A) Late Charge for Overdue Payments

If a Note Holder has not received the full amount of any monthly payment by the end of Fifteen calendar days after the date it is due, I will pay a late charge to the Note Holder. The amount of the charge will be 5% of my overdue payment of principal and interest. I will pay this late charge promptly but only once on each late payment.

### (B) Default

If I do not pay the full amount of each monthly payment on the date it is due, I will be in default.

### (C) Notice of Default

If I am in default, the Note Holder may send me a written notice telling me that if I do not pay the overdue amount by a certain date, the Note Holder may require me to pay immediately the full amount of principal which has not been paid and all the interest that I owe on that amount. That date must be at least 30 days after the date on which the notice is delivered or mailed to me.

### (D) No Waiver By Note Holder

Even if, at a time when I am in default, the Note Holder does not require me to pay immediately in full as described above, the Note Holder will still have the right to do so if I am in default at a later time.

### (E) Payment of Note Holder's Costs and Expenses

If Note Holder has required me to pay immediately in full as described above, the Note Holder will have the right to be paid back by me for all of its costs and expenses in enforcing this Note to the extent not prohibited by applicable law. These expenses include, for example, reasonable attorneys' fees.

## 7. GIVING OF NOTICE

Unless applicable law requires a different method, any notice that must be given to me under this Note will be given by delivering it or by mailing it by first class mail to me at the Property Address above or at a different address if I give the Note Holder a notice of my different address.

Any notice that must be given to the Note Holder under this Note will be given by mailing it by first class mail to the Note Holder at the address stated in Section 3(A) above or at a different address if I am given a notice of that different address.


Think You Have
A Bad Home Loan?
Afraid you'll lose your home?
Call for FREE HELP
215-523-9520
Don't Borrow Trouble™
City of Philadelphia
John F. Street, Mayor
NTI
Freddie Mac

The CHAIRMAN. Well, Ms. Harding, thank you very much. If you are a little person, that is a pretty loud voice, and I think it is being heard outside Philadelphia today, and we thank you for that testimony.

Now, let me turn to all of you with questions.

Gavin, you just heard Ms. Harding talk about preemption, and you spoke pretty forcefully about preemption and the Comptroller of the Currency. Does your association have any further views about the role of Federal regulations in general, especially, we are talking about in regard to GAO's recommendation for further empowering the Board of Governors of the Federal Reserve? If you would speak to that and also your frustration again about what is happening to preempt States from the kind of enforcement authority that you have had?

Mr. GEE. Yes; thank you, Mr. Chairman. Well, as I understand, the GAO recommendation is to empower the Federal Reserve to grant them more authority over essentially subsidiaries of holding companies.

The CHAIRMAN. That is correct, yes.

Mr. GEE. Nonbank entities that engage in lending. Let me say, Mr. Chairman, that we work very closely with the Federal Reserve. They are our partner in State-chartered Federal Reserve member banks and also with bank holding companies, we work closely with them. We have a very good working relationship with the Federal Reserve.

We believe that it is appropriate, certainly, to have more regulators and more cops on the beat, if you will, with respect to predatory lending. I believe our concern in this area is that based on the OCC preemption, what you will have by empowering the Federal Reserve is with nonbank entities, you will have jurisdiction shared by the FTC, the Federal Reserve and the States, whereas, because of OCC preemption, national banks and their subsidiaries will only have a single regulator, and you will not have that oversight; you will not have examination that is currently being provided by the States. You will not have that in the Federal Reserve. I assume they will not have jurisdiction also over those subsidiaries of national banks.

The CHAIRMAN. That is what I was just going to ask. That would include the subsidiaries of national banks within the national banks' holding companies, would it not?

Mr. GEE. It would include the subsidiaries of the national banks. Quite frankly, that is our major concern is those subsidiaries of the national banks. There are hundreds and hundreds, if not thousands, of those companies. We are seeing those companies turn in their licenses where they are currently licensed by the State. These are entities that are actually chartered by the States; have historically been chartered by the States.

Most States, like we do in Idaho, examine those entities. We license many of those entities, and it is those entities now that we are being preempted from exercising not only any kind of licensing or regulatory authority over, but our office and the Attorney Generals' offices in our States are being preempted from taking any kind of enforcement action against those entities. We do not have the ability to respond to consumer complaints and inquiries. As you probably know, Senator, in our State, the OCC has no office, no presence in Idaho.

When consumers, particularly elderly folks, have complaints or concerns, they like to come in; they like to visit with us. Often, we will go out to their homes. We have five people on my staff dedicated to dealing with those kinds of consumer complaints and inquiries, whereas, the OCC has no presence in our State. You have to call an 800 number in Houston. That number is not even listed in our phone books to my knowledge. So, all of that is being preempted by this recent action of the OCC in dealing with national bank subsidiaries and national banks themselves.

Let me just mention, in our State, Idaho may be somewhat unique. We only have one national bank actually headquartered in Idaho, a community bank. But national bank branches in Idaho represent about 70 percent of the market share in Idaho. So, a lot of the complaints and inquiries we receive are against national banks and national bank subsidiaries.

So to take the States out, to take our ability to respond to our own consumers, just seems to me to be a huge policy mistake.

The CHAIRMAN. Well, I believe I concur with you on that. You know, having once been a State legislator, but also understanding what the average person thinks when they think of government and when they think of help from government, they think local and State almost always at the beginning of that thought process, who can they reach the quickest, or who do they know or know someone who might know. Sometimes, our Federal Government agencies are—I will not say inaccessible but say daunting to access, maybe, is a better word for it.

Mr. GEE. Well, absolutely, and we believe at the State level, we are the first line of defense.

The CHAIRMAN. Yes.

Mr. GEE. We are the first ones people call. They know to call the State banking departments. They know to call the State financial regulators. They look to us for help and assistance, and for us, now, to be preempted by this very large class of potential mortgage lenders, mortgage brokers, finance companies, virtually anybody in the lending business, now, that is a subsidiary of a national bank, we are preempted. Our ability to help those people, our ability to examine, license, regulate in any way has been preempted by this most recent OCC ruling.

The CHAIRMAN. All right; thank you for that statement and that response. We will pursue that with the Comptroller, and, as I am sure, others are. I think when we see the impact of that kind of regulation, we get more State examiners and more finance directors like you coming forward in that area, that is something that I think Congress is going to want to take a look at. So I thank you very much for being here.

Mr. GEE. Thank you, Mr. Chairman.

The CHAIRMAN. Ms. DeSalles, what do you think the Federal Government should do to obtain the necessary data about how this particular fraud impacts our nation's seniors? It sounds like AARP is attempting to gain a grasp of the impact of it; obviously, your educational outreach and all of that. Have you, yourself, polled the membership of the AARP specific to this area of concern? Of course, my question is how the Federal Government might gather that kind of information.

Ms. DESALLES. I am not aware of any specific polling. Certainly, we have heard about numerous situations as was so eloquently described by Ms. Harding. It has been brought to our attention in reports from all of our States. People look to AARP for assistance in this area. But to be more specific, I am not aware of any specific polling of our membership on this issue.

As far as the Federal Government's data collection, I have not read, of course, the GAO report. I just got a copy of it today.

The CHAIRMAN. Right.

Ms. DESALLES. But we have a very well-respected research arm at AARP, and we are fully in support of any effort to add to the body of knowledge through data collection. I do not have a specific recommendation to offer, Senator Craig.

The CHAIRMAN. Well, we might challenge AARP to look at its membership and maybe do some information gathering in this area. I will have to tell you that we had the CEO of AARP in Idaho last week testifying at a health conference, and a comment was because a young man in the audience had turned 50, they said the reason we had not caught Osama bin Laden was because he had not yet turned 50, and AARP had not gone out to find him. [Laughter.]

Ms. DESALLES. That sounds like Bill Novelli.

The CHAIRMAN. So I suspect that we might look to you, also, as a way of finding out reaction from an older community of Americans as it relates to this impact. So we will be engaging you and AARP as it relates to that.

Any other—go ahead.

Ms. DESALLES. I will ask staff to see if we have done—it is possible that we have done some polling on that issue that I am unaware of.

The CHAIRMAN. Well, what often happens, and as I turn to Ms. Harding, the thing that she said so clearly often happens in these situations: elderly people I guess—I can use a Western phrase—hunker down, or they are quiet about something they did because they are embarrassed about it.

Ms. DESALLES. Absolutely.

The CHAIRMAN. They will not come forward and speak up, or they do not know where to go to speak up. So, they walk away maybe having lost a home or a large chunk of their equity or their assets simply because they are embarrassed. They feel they were taken. I am thinking of you and a way to access an information base that might tap that kind of concern or response that we might not otherwise be able to gain.

Ms. DESALLES. I will have my staff get back to you on that.

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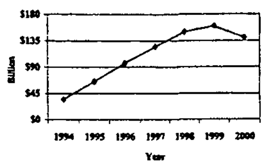
DATA DIGEST

## SUBPRIME MORTGAGE LENDING AND OLDER BORROWERS

### INTRODUCTION

The subprime (that is, non-prime or below "A" rated credit) mortgage lending industry has grown significantly in recent years, expanding from a $35 billion industry in 1994 into a $140 billion industry in 2000 (Figure 1).

**Figure 1: Increase in Subprime Mortgage Originations (1994-2000)**




Source: Inside Mortgage Finance Publications. (2001).
Prepared by AARP Public Policy Institute.

Subprime mortgages currently represent 13 percent of total mortgage originations,[1] an increase from 4 percent of originations in 1994 and 12 percent in 1999.[2]

Most subprime lenders are mortgage or finance companies, although lenders can also be thrifts, banks, or affiliates of banks. Historically, subprime loans have been made to borrowers with blemished (or non-existent) credit records,[3] and the borrower is charged a higher fee to compensate for the greater risk of delinquency and the higher costs of loan servicing and collection.[4]

There is increasing concern about the growth in subprime lending for several reasons. First, there is growing evidence that many borrowers who qualified for less costly loans received subprime loans. One study found that between 10 percent and 35 percent of "A-" subprime borrowers qualified for "A" mortgages, but received and were paying for more expensive subprime mortgages.[5]

Second, the percentage of foreclosures associated with subprime mortgages appears to be increasing. A recent study in Chicago found that 25 percent of foreclosures in 1998 involved borrowers holding mortgages with high and extremely high interest rates, up from 10 percent in 1993.[6] Similarly, in Atlanta, while the overall volume of foreclosures declined by 7 percent between 1996 and 1999, the volume of foreclosures started by subprime lenders grew by 232 percent.[7]

Third, there is growing evidence of predatory lending practices in the subprime lending market.[8] Practices such as charging exorbitant

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[1] Analore, A. Inside Mortgage Finance Publications. Personal communication (February 20, 2001).

[2] Inside Mortgage Finance Publications. *The Mortgage Market Statistical Annual.* Vol. II. (2000).

[3] Includes recent delinquencies, foreclosures, bankruptcies, low credit risk scores, and high debt service to income ratios. See Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision. *Expanded Guidance for Subprime Lending Programs.* (January 2001). <http://www.fdic.gov>

[4] Williams, R., Nesiba, R., et. al. "The Changing Face of Inequality in Home Mortgage Lending." Notre Dame Sociology Working Paper 2000-11. (November, 2000).

[5] Federal Home Loan Mortgage Corporation. (1996).

[6] NietoGomez, A., et. al. *Preying on Neighborhoods: Subprime Mortgage Lending and Chicagoland Foreclosures.* National Training and Information Center. (September 1999).

[7] Gruenstein, D. and Herbert, C. *Analyzing Trends in Subprime Originations and Foreclosures: A Case Study of the Atlanta Metro Area.* Abt Associates Inc. (February 2000).

[8] U.S. Department of Housing and Urban Development and U.S. Department of Treasury.

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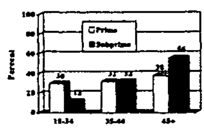
fees and interest rates often occur when subprime borrowers are unsure about their credit history and loan eligibility, or are unaware of mortgage details (balloon payments and prepayment penalties, for example).

Fourth, specific demographic groups are disproportionately represented among subprime borrowers. Recent analyses of Home Mortgage Disclosure Act (HMDA) data reveal that minorities with incomes similar to non-minorities are significantly more likely to receive a subprime mortgage.[9]

Similarly, there is evidence that older homeowners are being targeted. A recent study found that borrowers 65 years of age or older were 3 times more likely to hold a subprime mortgage than borrowers less than 35 years of age.[10] Figure 2 shows that for borrowers 45 and older, 56 percent of mortgages were subprime, while for borrowers younger than 35, only 12 percent of mortgages were subprime.

**Figure 2: Prime and Subprime Mortgage Borrowers by Age**




Source: Federal Home Loan Mortgage Corp. *Subprime Lending: Characteristics of Older Borrowers.* (2000) Prepared by AARP Public Policy Institute (n=4,342)

## METHODOLOGY

This Data Digest presents results from a study of 4,342 mortgage borrowers who had acquired first lien mortgages between January 1996 and June 1997.[11] Respondents were asked an extensive array of questions related to their mortgages. Survey responses were matched with lending firms[12] and credit scores.[13] Regression analyses identified financial risk, demographic variables, and a variety of other factors as being significant in the likelihood of a borrower having a subprime mortgage.[14] Analyses conducted for this Data Digest examine older borrowers,[15] and the differences between older prime and subprime borrowers.

## FINDINGS

### *Financial Risk Factors*

For two financial risk factors, credit history and loan-to-value (LTV), older subprime borrowers had higher risk than older prime borrowers. *Credit History*. Figure 3 shows that older borrowers with lower-risk FICO scores (that is, 680 and above) were less likely to hold a subprime mortgage than older borrowers with higher-risk FICO scores. However, 11 percent of older subprime borrowers had lower-risk FICO scores.

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*Curbing Predatory Home Mortgage Lending: A Joint Report.* (June 2000).

[9] Ibid.

[10] Lax, H., et. al. *Subprime Lending: An Investigation of Economic Efficiency.* Unpublished paper (February 2000).

[11] Borrowers were randomly selected from a sample of borrowers generated by DataQuick, a proprietary firm that collects and analyzes mortgage transaction data from county records.

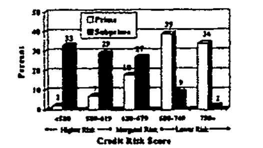
[12] Using industry sources and information from HUD and the Federal Reserve Board, a list of approximately 50 lenders was created representing those institutions that primarily make subprime loans.

[13] For this study, FICO credit scores were identified for the borrowers. FICO refers to the Fair, Isaac and Company credit risk scoring models, the most widely used models to measure consumer credit. This method uses score models and mathematical tables to analyze a borrower's credit history and condense this information into a single numerical value used to predict future credit performance. FICO scores generally range from 300 to 850, with higher scores indicating better credit history.

[14] Due to the small sample of older borrowers, analyses in this Data Digest are limited to cross-tabulations.

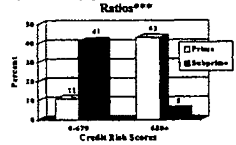
[15] Raca, P. "Subprime Lending: Characteristics of Older Borrowers." Presentation to AARP (November 2000). Older borrowers are defined as borrowers 45 years of age and older.

Figure 3: Credit Risk Scores* of Older Prime and Subprime Mortgage Borrowers**




*Loan-to-Value (LTV)*.[16] Figure 4 shows older borrowers with low LTV ratios (defined as below 80%). Of these older borrowers with low LTV ratios, approximately one-half (48%) had FICO scores of at least 680. While most older borrowers with low LTVs and high FICO scores held prime mortgages (43%), 5 percent held subprime mortgages.

Figure 4: Credit Risk Scores* of Older Prime and Subprime Mortgage Borrowers** with Low LTV Ratios***

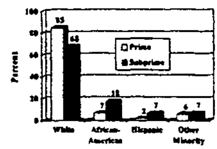



### *Demographic Factors*

Older female and minority (non-white) borrowers were more likely to hold subprime mortgages than were older male and non-minority borrowers.

*Gender*. Older female borrowers held 45 percent of subprime mortgages and only 28 percent of prime mortgages.
*Ethnicity*. Older African-American borrowers held 18 percent of the subprime mortgages and 7 percent of the prime mortgages (Figure 5). Older Hispanic borrowers held 7 percent of the subprime mortgages and only 2 percent of prime mortgages. Conversely, older white borrowers held 68 percent of the subprime mortgages and 85 percent of the prime mortgages.

Figure 5: Older Prime and Subprime Mortgage Borrowers* by Ethnicity




### *Additional Factors*

*Application Hurdles.*
Three application hurdles, asking a borrower to pay off debts, turning down a borrower for a mortgage, and asking a borrower to provide additional documentation, were examined. Of older borrowers who had been asked to pay off debts or had been turned down for a mortgage, a higher percentage were subprime borrowers.
*Asked to Pay off Debts*. Fifty percent of older subprime borrowers were asked to pay off debts compared to 10 percent of older prime borrowers.
*Turned Down for a Mortgage*. Over one-fourth (26%) of older subprime borrowers had been turned down for a mortgage, compared to 3 percent of older prime borrowers.
*Asked to Provide Additional Documentation*. More than 4 of 10 older borrowers were asked to provide additional documentation, 41 percent of older subprime borrowers and 46 percent of older prime borrowers.

[16] LTV is the principal amount of the loan as a percent of the value of the home. The lower the LTV, the smaller the loan relative to the collateral in the home and, therefore, the lower the risk of the mortgage.

*Life Disruptions.*
Older subprime borrowers were more likely to have reported a decrease in income or have major medical expenses/illness "within the past few years" than were older prime borrowers.
*Decrease in Income.* Over one-third (36%) of older subprime borrowers reported a decrease in income within the past few years, compared to 10 percent of older prime borrowers.
*Medical Expenses/Illness.* Over one-third (38%) of older subprime borrowers reported either a major medical expense or illness, compared to 13 percent of older prime borrowers.

*Search Behavior.*
Older subprime borrowers were less likely to report having searched for the best available interest rate than were older prime borrowers. Older subprime borrowers were also more likely to respond to lender advertisements than were older prime borrowers.
*Interest Rate Searching.* Approximately 6 of 10 (58%) older borrowers holding subprime mortgages reported searching "some" or "a lot" for the lowest interest rate available, compared to 71 percent of older prime borrowers.
*Responding to Advertisements.* Over one-third (35%) of older subprime borrowers reported having responded to advertisements offering "guaranteed approvals" or "mortgage loans for people who may have had credit problems," compared to 6 percent of prime borrowers.

*Financial Perceptions and Mortgage Preparedness.*
Older subprime borrowers were less likely than older prime borrowers to feel in control of their finances and less well prepared for taking out a mortgage.
*In Control of Finances.* Seven percent of older subprime borrowers and 5 percent of prime borrowers either disagreed or strongly disagreed that they were in control of their finances.
*Mortgage Preparedness.* Older subprime borrowers were less likely to be prepared for taking out a mortgage, as 15 percent of subprime borrowers reported that they were not familiar with common mortgage terminology compared to 4 percent of prime borrowers.

## SUMMARY

As expected, financial risk (that is FICO scores and LTV) was a key factor in the likelihood of an older borrower having a subprime or prime mortgage. However, significantly, 11 percent of older borrowers with high FICO scores held subprime mortgages.

In addition to financial risk, a number of other borrower factors differentiated older subprime and prime borrowers. These included key demographic variables, as well as application hurdles (asked to pay off debts and turned down for a mortgage), life disruptions, search behavior, financial perceptions, and the borrower's mortgage preparedness.

Demographic variables suggest that older female and minority borrowers were more likely to hold a subprime mortgage than older male and non-minority borrowers.

Other factors also revealed distinctions between older subprime and prime borrowers: subprime borrowers were more likely to have been turned down for a mortgage, and to have responded to an advertisement offering "guaranteed approvals" or "mortgage loans for people who may have had credit problems."

Written by Neal Walters and Sharon Hermanson
Public Policy Institute
Consumer Team
March 2001

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DATA DIGEST

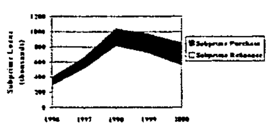
# OLDER SUBPRIME REFINANCE MORTGAGE BORROWERS

## INTRODUCTION

The subprime mortgage lending industry originated $173 billion in loans in 2001,[1] representing 11 percent of total mortgage originations.[2] Historically, subprime (that is, nonprime or below "A" rated credit) loans have been made to borrowers with blemished—or nonexistent—credit records; typically, borrowers are charged a higher fee to compensate for the greater risk of delinquency and the higher costs of loan servicing and collection.[3]

The majority of subprime loans are refinance loans. According to Home Mortgage Disclosure Act (HMDA) data, the subprime home refinance market ranged from 74 percent of subprime loans in 1996 to 65 percent of subprime loans in 2000 (Figure 1).

Figure 1: Subprime Home Purchase and Refinance Lending: 1996-2000




Source: AARP analysis of HMDA data

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While borrowers may refinance to reduce the interest rate of their mortgage, many borrowers liquefy some of their home equity as a source of funds for other expenditures.[4] This can reduce the amount of equity a borrower has in a home, and increase both the monthly payment amount and the loan's length of maturity.[5]

For borrowers with less than perfect credit, or no credit, getting a legitimate home purchase subprime loan may be the first step toward homeownership. For subprime refinance borrowers, however, there are concerns about several aspects of the subprime mortgage lending market.

First, market segmentation in mortgage lending results in differential access to prime credit for many borrowers.[6] Studies have shown that minority[7] and older[8] borrowers are disproportionately represented in the subprime refinance market. Further, two recent studies suggest that between 30 percent[9] and 50 percent[10] of subprime mortgage borrowers could qualify for lower-cost "A" loans, but are paying for more expensive subprime loans instead.

Second, there is growing evidence of predatory lending practices in the subprime mortgage market. One recent study found that more than one-third of the subprime refinance borrowers

[1] Inside Mortgage Finance Publications. *Inside B&C Lending* (February 11, 2002).

[2] Inside Mortgage Finance Publications. *Inside B&C Lending* (February 15, 2002).

[3] Williams, R., Nesiba, R., et al. "The Changing Face of Inequality in Home Mortgage Lending." Notre Dame Sociology Working Paper 2000-11 (November 2000).

[4] Canner, G., et al. Recent Developments in Home Equity Lending. *Federal Reserve Bulletin* (April 1998).

[5] Brady, P., et al. The Effects of Recent Mortgage Refinancing. *Federal Reserve Bulletin* (July 2000).

[6] See, for example, National Training and Information Center. *Citigroup: Reinventing Redlining* (June 2002).

[7] Center for Community Change. *Risk or Race? Racial Disparities and the Subprime Refinance Market* (May 2002).

[8] Walters, N., and Hermanson, S. (2001). *Subprime Mortgage Lending and Older Borrowers*. AARP Public Policy Institute. DD57.

[9] Federal Home Loan Mortgage Corporation. *Automated Underwriting Report: Making Mortgage Lending Simpler and Fairer for America's Families* (September 1996).

[10] Carr, J., and Kolluri, L. *Predatory Lending: An Overview*. Fannie Mae Foundation (2001).

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examined in the study may have had predatory terms included in their loans.[11]

Third, there is concern about the increasing percentage of foreclosures associated with subprime mortgage lending. Studies in both urban[12] and suburban[13] areas have found that the volume of foreclosures associated with subprime loans has increased considerably in recent years.

## METHODOLOGY

This data digest presents results from a national study[14] of 1,008 subprime and prime refinance mortgage borrowers at least 65 years of age who acquired first lien mortgages between January 1999 and December 2000. Borrowers were selected randomly from public mortgage records[15] and identified as subprime or prime.[16] Using the sample of prime and subprime borrowers, a telephone survey was conducted to obtain information from borrowers about their mortgage experience, including their search behavior, their knowledge about the mortgage process, and their current satisfaction with the mortgage they received.

## FINDINGS

### *Demographic Factors**

Older borrowers who were widowed, female, black, and less educated held a significantly greater percentage of subprime loans than older borrowers who were married, male, non-black, and more educated. Widows, for example, accounted for more than one-third (36%) of subprime loans, compared to 28 percent of prime loans. Similarly, blacks accounted for nearly one-third (35%) of subprime loans, compared to only 18 percent of prime loans.

| | Prime Loans (%) | Subprime Loans (%) | Total Loans (%) |
|---|---|---|---|
| **Marital Status** | | | |
| Married | 59 | 50 | 57 |
| Widowed | 28 | 36 | 30 |
| Other | 13 | 14 | 13 |
| **Gender** | | | |
| Male | 50 | 43 | 48 |
| Female | 50 | 57 | 52 |
| **Race** | | | |
| White | 73 | 58 | 69 |
| Black | 18 | 35 | 23 |
| Other | 9 | 7 | 8 |
| **Hispanic Origin** | | | |
| Yes | 3 | 7 | 4 |
| No | 97 | 93 | 96 |
| **Education** | | | |
| <= H. S. Degree | 53 | 59 | 54 |
| > H. S. Degree | 47 | 41 | 46 |

### *Use of Broker or Lender*

Older subprime refinance borrowers were more likely to have used a broker to obtain their loans. More than one-half (53%) of subprime borrowers used a broker, compared to only one-third (34%) of prime borrowers.

[11] Stein, K., Libby, M. *Stolen Wealth: Inequities in California's Subprime Mortgage Market.* California Reinvestment Committee (November 2001).

[12] See, for example, National Training and Information Center. *Preying on Neighborhoods: Subprime Mortgage Lending and Chicagoland Foreclosures* (September 1999); Gruenstein, D., and Herbert, C. *Analyzing Trends in Subprime Originations and Foreclosures: A Case Study of the Atlanta Metro Area.* Abt Associates Inc. (February 2000).

[13] AARP and Abt Associates Inc. *Analyzing Trends in Subprime Originations and Foreclosures in New York: Suffolk, Nassau, and Westchester Counties* (forthcoming).

[14] The national study, conducted by Market Facts for the AARP Public Policy Institute and the Federal Home Loan Mortgage Corporation, included home purchase and refinance mortgage borrowers at least 18 years of age.

[15] Borrowers were selected randomly from a sample of borrowers generated by DataQuick, a proprietary firm that collects and analyzes mortgage transaction data from county records. Due to the geographic distribution of the sample of borrowers, weighting was necessary. Weights by state are prepared and used to compute estimates for the various characteristics included in the survey to adjust for oversampling or undersampling from a particular state.

[16] Using the prime and subprime list established by Housing and Urban Development (HUD), as well as industry sources and the Federal Reserve Board, a list of lenders was created representing those institutions that make primarily subprime loans.

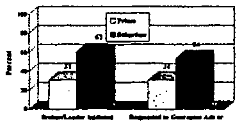
* The statistical analysis of the variable "income" does not meet the assumption of homogeneity of variance necessary for the appropriate use of F distribution on which the test of significant differences is based. Therefore, the statistical result from analysis of income differences between the two groups of borrowers was not included.

*Search Behavior*

Sixty-one percent of older refinance subprime borrowers reported that the broker or lender, rather than the borrowers, initiated contact before getting the loan, nearly two times more than reported by older prime borrowers (31%) (Figure 2).

Over one-half (54%) of older refinance subprime borrowers reported that they responded to advertisements or sales calls that guaranteed approval, while only 31 percent of prime borrowers did so (Figure 2).

Figure 2: Older Prime and Subprime Refinance Mortgage Borrowers*: Search Behavior



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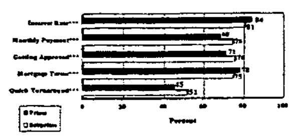
*Refinance borrowers at least 65 years of age

**$p$< 001

Prime and subprime borrowers differed in their assessment of the importance of several loan features. Low monthly payments, getting approved, and a quick turnaround were the loan characteristics more important to subprime than prime borrowers, while interest rate and mortgage terms were more important to prime than subprime borrowers (Figure 3).

Figure 3: Older Prime and Subprime Refinance Mortgage Borrowers*: Importance of Loan Characteristics**



AARP Public Policy Institute

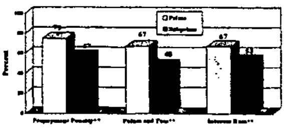
*Refinance borrowers at least 65 years of age

** Borrowers who responded "Very Important" ***$p$< 001

*Understanding of Loan Terms and Familiarity with the Mortgage Process*

Older subprime refinance borrowers were less likely than older prime refinance borrowers to report completely understanding three key loan terms: prepayment penalties, points and fees, and interest rate (Figure 4).

Figure 4: Older Prime and Subprime Refinance Mortgage Borrowers*: Completely Understood Loan Terms



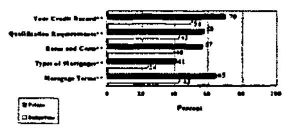
AARP Public Policy Institute

*Refinance borrowers at least 65 years of age

**$p$< 001

Older subprime refinance borrowers were less likely to be familiar with the mortgage process than were older prime borrowers. (Figure 5). Subprime borrowers were less likely to be familiar with their credit records, loan qualification requirements, mortgage rates and costs, types of mortgages available, and basic mortgage terms.

Figure 5: Older Prime and Subprime Refinance Mortgage Borrowers*: Familiarity with the Mortgage Process



AARP Public Policy Institute

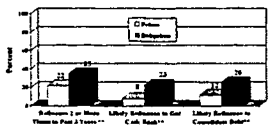
*Refinance borrowers at least 65 years of age

**$p$< 001

*Mortgage Refinancing*

Older subprime refinance borrowers were more likely to report having refinanced more than once in the past three years, and more likely to consider refinancing within the next 12 months to get cash back or consolidate debts than were older prime borrowers (Figure 6).

Figure 6: Older Prime and Subprime Refinance Mortgage Borrowers*: Mortgage Refinancing



AARP Public Policy Institute
*Refinance borrowers at least 65 years of age
**p<.001

***Borrower Perception of Mortgage Received***
Older subprime refinance borrowers were less likely than older prime borrowers to feel they received: the loan that was best for them, rates and terms that were fair, and accurate and honest information. In addition, subprime borrowers were less likely to want the same loan again or to recommend the broker/lender to a friend (Figure 7).

Figure 7: Older Prime and Subprime Refinance Mortgage Borrowers*: Borrower Satisfaction

AARP Public Policy Institute
*Refinance borrowers at least 65 years of age **p<.001

When asked if their loans were different from what they expected, nearly one-half (47%) of subprime borrowers said yes, compared to only 20 percent of prime borrowers. Of those who responded that the loan was different from expected, 71 percent of subprime borrowers and 50 percent of prime borrowers reported that the loan was worse than expected.

**SUMMARY**

Older borrowers who were widowed, female, black, and less educated held a significantly greater percentage of subprime loans than older borrowers who were married, male, non-black, and more educated. In addition, they were more likely to have:

- used a broker to obtain their current loan;
- had the lender/broker initiate the contact;
- responded to guaranteed approval advertisements;
- refinanced two or more times within the past three years;
- been dissatisfied with their loans; and
- received a loan different from what they expected.

In addition, these older subprime borrowers were less likely to:

- identify loan characteristics associated with the cost of the loan (interest rate and mortgage terms) as important, while more likely to report quick turnaround, approval, and monthly payment to be important;
- completely understand three loan terms: prepayment penalty, points and fees, and interest rate; and
- be familiar with the mortgage process.

These results suggest that older prime and subprime refinance borrowers had significantly different experiences with refinancing their mortgage. Because home equity is the largest component of the wealth of older households, protecting this equity and expanding access to credit on fair and affordable terms is critical to ensuring the current and future financial security of millions of older Americans.

Written by Neal Walters and Sharon Hermanson
AARP Public Policy Institute, July 2002
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PPI PUBLIC POLICY INSTITUTE

DATA DIGEST

# EXPERIENCES OF OLDER REFINANCE MORTGAGE LOAN BORROWERS: BROKER- AND LENDER-ORIGINATED LOANS

## INTRODUCTION

Historically, mortgages were originated and held primarily by financial institutions such as savings and loans, commercial banks, and insurance companies. Mortgage documents, underwriting criteria, credit requirements, and appraisals varied from institution to institution. With the development of the secondary mortgage market and the standardization of loans in the late 1970s, mortgage brokers began originating loans by serving as intermediaries between the borrower and the entity funding the loan (that is, lenders or wholesalers).[1]

The number of mortgage brokers grew at an average annual rate of 14 percent between 1991 and 1998.[2] In 2000, 30,000 mortgage brokerage companies, with an estimated 240,000 employees, accounted for 55 percent of all home loans originated in that year.[3]

Mortgage brokers provide retail lending services, including counseling borrowers on loan products, collecting application information, ordering required reports and documents, and otherwise gathering data required to complete the loan package and mortgage transaction.[4] Some mortgage brokers indicate that they work with a number of funding sources and are in a position to shop for the best loans for borrowers.[5]

However, a concern has been raised that mortgage brokers may focus more on the short-term profitability incurred at the origination of the loan rather than on the long-term performance of the loan since they are intermediaries who do not hold loans through maturity. For instance, the question of whether the compensation system for mortgage brokers inevitably results in higher interest rates or higher costs for borrowers has been widely debated, and the U.S. Department of Housing and Urban Development (HUD) has conducted three rule-makings over the past seven years regarding mortgage broker fees[6] to try to ensure that borrowers are not overcharged.

Aggressive "push marketing"[7] by some mortgage brokers has also raised a concern that many loans, particularly refinance loans,[8] are "sold, not sought."[9] In addition, mortgage brokers originate approximately half of all subprime mortgage loans,[10] which have been identified as the primary source of predatory lending practices.

According to Harvard's Joint Center for Housing, regulatory oversight has not kept pace with changes in the mortgage industry. A growing share of mortgage loans, including the vast majority of subprime loans, is not subject to federal Community Reinvestment Act (CRA) requirements,[11] and regulation of mortgage brokers as a profession generally occurs at the state level outside of the regulatory structure for mortgage lending. State oversight of mortgage brokers is a patchwork of laws and regulations. Some states have no licensure requirements, and more than two-thirds do not have examination requirements.[12] Practices of concern to regulators include multiple refinancing, excessive up-front fees (such as inappropriate points and closing costs), asset-based lending without regard to the borrower's ability to repay,

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[1] U.S. Department of Housing and Urban Development. *Regarding Lender Payments to Mortgage Brokers*, 1999. Retrieved June 12, 2002 from http://www.hud.gov/offices/hsg/sfh/res/resp0222.cfm

[2] Wholesale Access. *Mortgage Brokers 1998*, 1999.

[3] National Association of Mortgage Brokers. *Industry facts*, 2000. Retrieved June 12, 2002 from http://www.namb.org/consumers%5Cind_facts.htm

[4] *Federal Register* 67 (145) (July 29, 2002): 49, 140.

[5] Ibid.

[6] U.S. Department of Housing and Urban Development. 1999. *op. cit.*

[7] U.S. Senate Committee on Banking, Housing, and Urban Affairs, testimony of Thomas Miller, Iowa Attorney General, at a hearing on Predatory Mortgage Lending: The Problem, Impact, and Responses, July 26, 2001.

[8] K. Engel and P. McCoy, "A Tale of Three Markets: The Law and Economics of Predatory Lending." *Texas Law Review* 80 (6) (May 2002).

[9] Center for Community Change. *Risk or Race? Racial Disparities and the Subprime Refinance Market*, May 2002.

[10] U.S. Senate Committee on Banking, Housing, and Urban Affairs, testimony of Neill Fendly, National Association of Mortgage Brokers, at a hearing on Predatory Mortgage Lending: The Problem, Impact, and Responses, July 27, 2001.

[11] Joint Center for Housing Studies of Harvard University. *The State of the Nation's Housing 2002*.

[12] Four states do not require licensure (Alaska, Colorado, Montana, and Wyoming). AARP Public Policy Institute. *Mortgage Brokers: A Summary of State Laws*. Forthcoming.



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overaggressive marketing, and targeting of groups such as minorities[13] and older persons.[14]

## METHODOLOGY

This data digest presents results from a national study[15] of 1,008 borrowers age 65 and older (hereafter referred to as older borrowers) who acquired prime or subprime refinance loans between January 1999 and December 2000. Borrowers were selected randomly from public mortgage records[16] and identified as having either prime or subprime loans.[17]

A telephone survey of these borrowers was conducted, and borrowers were asked an extensive array of questions, including whether they obtained their loan from a lender or broker. Statistical results for this report were weighted[18] to correct for the disproportionate sampling design and for any systematic non-response that could bias results to ensure sample estimates appropriately represented the national population of borrowers. Findings (other than prime or subprime status) reported in this data digest are self-reported data obtained from the telephone survey.

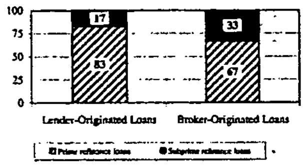
## FINDINGS

Nearly half (49 percent) of refinance loans among older borrowers were lender-originated loans, and 39 percent were broker-originated.[19]

### Refinance Loan Type: Prime and Subprime

Broker-originated refinance loans (33 percent) were nearly twice as likely as lender-originated loans (17 percent) to be subprime loans (see Figure 1).

*Figure 1.* **Lender- and Broker-Originated Refinance Loans: Prime and Subprime (%)**

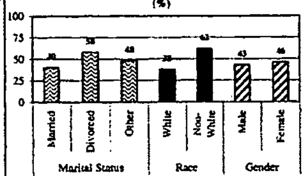



*Source.* AARP Mortgage Borrower Survey, 2001 (N=1,008)

### Demographic Factors

Broker-originated refinance loans were more prevalent than lender-originated loans among older refinance loan borrowers who were divorced, female, or non-white (see Figure 2).

*Figure 2.* **Prevalence of Broker-Originated Loans Among Older Borrowers by Demographic Factors (%)**




*Source.* AARP Mortgage Borrower Survey, 2001

*Marital Status.* Older refinance loan borrowers who were divorced (58 percent) were more likely than married borrowers (40 percent) to have broker-originated loans.

*Race.* Broker-originated loans accounted for a larger share of loans among non-white borrowers: 64 percent of black borrowers and 66 percent of Asian or Pacific Islander borrowers had broker-originated loans, compared to 38 percent of white borrowers.

*Gender.* Older female borrowers (46 percent) were slightly more likely than older male borrowers (43 percent) to have broker-originated loans.

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[13] Center for Community Change. Risk or Race? *Racial Disparities and the Subprime Refinance Market*, May 2002.

[14] N. Walters and S. Hermanson. *Subprime Mortgage Lending and Older Borrowers*. Washington DC: AARP Public Policy Institute (DD57). 2001.

[15] The national study, conducted by Market Facts for AARP's Public Policy Institute and the Federal Home Loan Mortgage Corporation, included 7,942 mortgage borrowers (purchase and refinance) at least 18 years of age.

[16] Loans were randomly selected from a list of first lien borrowers generated by DataQuick, a proprietary firm that collects and analyzes mortgage transaction data from county records.

[17] Using industry sources and information from HUD and the Federal Reserve Board, a list of approximately 50 lenders was created representing those institutions that primarily make subprime loans.

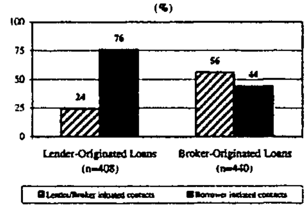
[18] Due to the disproportionate geographic distribution of the sample of mortgage borrowers, weighting of raw survey data was necessary. Weights by state were computed through a multistage procedure to compute national estimates of mortgage borrowers that match stratification control counts based on HMDA data to adjust for oversampling or undersampling of borrowers from particular states. This weighting procedure inflates the raw numbers of the survey participants to approximate the estimates of total population of mortgage borrowers represented in HMDA data.

[19] Borrowers also reported loans originated by home improvement contractors (1 percent), other (11 percent), and both lenders and brokers (1 percent).

**Search Behavior**
Older mortgage borrowers with broker-originated refinance loans reported more broker-initiated contact, more reliance on the broker to find the best loan, and a higher response to advertisements that guaranteed loan approvals.

*Initiation of Contact*. More than half of older borrowers (56 percent) with broker-originated loans reported that the brokers initiated the contact with them, while less than one-fourth (24 percent) of older borrowers with lender-originated loans reported the lender had done so (see Figure 3).

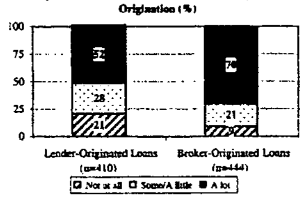
*Figure 3*. **Initiation of Contacts by Loan Origination (%)**




*Note*. Due to rounding, the sum may not equal to 100%.
*Source*. AARP Mortgage Borrower Survey, 2001

*Counted on Lenders or Brokers to Find the Best Mortgage.* Seventy percent (70 percent) of older borrowers with broker-originated refinance loans reported that they relied "a lot" on their brokers to find the best mortgage for them, compared to only half (52 percent) of older borrowers with lender-originated loans (see Figure 4).

*Figure 4*. **Reliance on Lenders or Brokers by Loan Origination (%)**




*Note*. Due to rounding, the sum may not equal to 100%.
*Source*. AARP Mortgage Borrower Survey, 2001

*Responded to Advertisements*. Forty percent (40 percent) of older borrowers with broker-originated loans reported that they responded to guaranteed loan advertisements at least "a little," compared to 31 percent of borrowers with lender-originated loans.

**Mortgage Terms**
Older borrowers with broker-originated refinance loans were more likely than borrowers with lender-originated loans to report that they had paid points for a mortgage and have loans with a prepayment penalty.

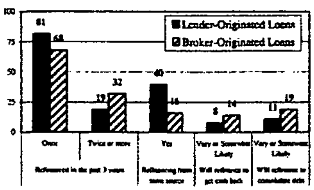
*Paid Points for Mortgage*. Older refinance loan borrowers with broker-originated loans (25 percent) were more likely to report that they paid points for a mortgage than borrowers with lender-originated loans (15 percent).
*Prepayment Penalty*. Older borrowers with broker-originated refinance loans (26 percent) were twice as likely as borrowers with lender-originated loans (12 percent) to report having a loan with a prepayment penalty.

**Mortgage Refinancing**
Older refinance loan borrowers with broker-originated loans were more likely than older borrowers with lender-originated loans to refinance frequently, less likely to go back to the same broker, and more likely to predict they will refinance.

*Number of Times Refinanced in the Past Three Years*. Approximately one-third (32 percent) of older borrowers with broker-originated refinance loans reported having refinanced two or more times in the past three years, compared to 19 percent of older borrowers with lender-originated loans.
*Refinancing from the Same Lender or Broker*. Among older borrowers with broker-originated loans, only 16 percent reported that they returned to the same broker to refinance, while 40 percent of older borrowers with lender-originated loans did so.
*Will Refinance to Get Cash Back*. Fourteen percent of older borrowers with broker-originated loans responded that they were either "somewhat" or "very" likely to refinance within the next 12 months to get cash back, compared to eight percent of older borrowers with lender-originated loans.
*Will Refinance to Consolidate Debt*. Almost twice as many older borrowers with broker-originated loans (19 percent) as borrowers with lender-

originated loans (11 percent) responded that they were "somewhat" or "very" likely to refinance within the next 12 months to consolidate debts.

*Figure 5.* **Differences in Refinancing Patterns Among Older Borrowers by Loan Origination (%)**

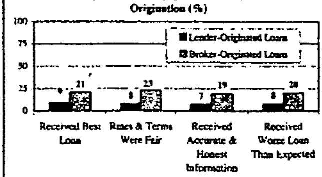



*Source.* AARP Mortgage Borrower Survey, 2001 (N=1,008)

**Borrower Perception of Mortgage Received**
Older borrowers with broker-originated loans were more likely than older borrowers with lender-originated loans to respond that the loans were not the best for them, the rates and terms were not fair, and they did not receive accurate and honest information from their brokers. Borrowers with broker-originated loans also reported that they obtained worse loans than they expected (see Figure 6).

Received Loan that Was Best for Them. Twenty-one percent (21 percent) of older borrowers with broker-originated loans reported that they did not receive a loan that was best for them, compared to nine percent of older borrowers with lender-originated loans.
Mortgage Rates and Terms Were Fair. Older borrowers with broker-originated loans (23 percent) were nearly three times more likely than older borrowers with lender-originated loans (eight percent) to report that they did not feel the rates and terms of their mortgage were fair.
Received Accurate and Honest Information. Nineteen percent of older borrowers with broker-originated loans reported that they did not feel they had received accurate and honest information about their loans, compared to only seven percent of older borrowers with lender-originated loans.
Received Worse Mortgage than Expected. Twenty percent of older borrowers with broker-originated loans reported that they received loans worse than expected, compared to eight percent of borrowers with lender-originated loans.

*Figure 6.* **Older Refinance Loan Borrowers: Perceptions of Mortgage Received by Loan Origination (%)**




*Note.* Percentages shown reflect "Strongly disagree" or "somewhat disagree" responses except for "Received Worse Loan" ("yes" responses).
*Source.* AARP Mortgage Borrower Survey, 2001 (N=1,008)

## SUMMARY

This study finds that borrowers with broker-originated loans were much more likely to report that they did not initiate the contact about the loan, and they relied more on the broker than borrowers with lender-originated loans. In addition, borrowers with broker-originated loans were more likely to report having received loans with less favorable terms such as prepayment penalties and points paid upfront than borrowers with lender-originated loans. Considering the high degree of reliance on mortgage brokers by older borrowers, especially among minority and female borrowers, in making important mortgage-related decisions, more research is needed to better understand how borrowers are affected by the ever-increasing diversity in lending products and retailers.

Furthermore, because home equity is a key component of wealth among older households, assuring that older mortgage refinance borrowers obtain appropriate loans, regardless of who originates them, is critical to ensuring the current and future financial security of millions of older Americans.

*Written by Kellie K. Kim-Sung and Sharon Hermanson*
*AARP Public Policy Institute, January 2003*
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The CHAIRMAN. Great. Thank you very much.

Well, Ms. Harding, your testimony is important to this Committee. I think it exemplifies the very kind of thing that we are pursuing here. We have high-quality professional people in the lending business, and some of them, most of them, are very credible. There are others who are not, and of course, that is where we are looking. Your experience, I think, clearly speaks to that.

I think your recommendation, your five recommendations really are very critical to us. You have heard Senator Stabenow and myself and others talk about educating and outreach and an effort to educate people to beware, to ask the questions, or to know what to ask, or to know who to ask to be able to get the right questions asked. All of that becomes important.

I am pleased that you have mentioned preemption. We do think local as it relates to government, because that is where we access it the quickest, and it is the most obvious to most every citizen. So I think all of those recommendations are important, and we thank you very much for that.

Your testimony today certainly adds to the overall work this Committee does. We do not authorize. By that, I mean we do not write legislation. That is not the role of this Committee. The role of this Committee is to build a record and to hand it to the Banking Committee or the Finance Committee, to be advocates for people like you who found yourself in a very difficult situation and to be able to build a record around that and to make recommendations to these committees as to what they might do.

So before I close this hearing, let me ask if you have any further comment you would like to make.

Ms. HARDING. The further one that I would like to say is that what bothered me was that when I read in the paper last month that we had in Philadelphia, there were 1,120 homes up for sheriff's sale. It made me feel that some of these people who were losing their homes had gotten caught up in these bad loans, this predatory lending. My heart just goes out for these people. It is so sad.

The CHAIRMAN. Surely.

Ms. HARDING. It is really sad what we are going through.

But like I said before in my testimony, I am so glad that I have met good people. But the only way that you meet good people, you have got to be a good person yourself.

The CHAIRMAN. Well, thank you very much. I think you fill that category. I do not often get to Philadelphia, but when I do, I will bring the danish. [Laughter.]

Ms. HARDING. I will have the coffee.

The CHAIRMAN. All right; if you will have the coffee, I will bring the danish.

To all of you, thank you very much for your testimony and your active involvement in this area. We appreciate it. The Committee will continue to pursue, to identify the numbers. Gavin, we are going to take a very serious look at these new regulations coming out of the OCC and the impact they are having on State regulators and the role that you are not being allowed to play now.

So I will also be quizzing my colleagues on the Banking Committee as to the whys and the wherefores of those regulations. Thank you all very much, and the Committee will stand adjourned.

[Whereupon, at 11:24 a.m., the Committee adjourned.]

# APPENDIX

Senate Special Committee of Aging
Hearing on Predatory Lending:
Are Federal Agencies Protecting Older Americans from Financial Heartbreak?
February 24, 2004

Mr. Chairman and members of the Committee, thank you for holding this important hearing. I appreciate the opportunity to provide testimony on the problem of predatory mortgage lending, particularly as it affects older Americans. Although we cannot quantify the harm that predatory practices inflict on seniors, we know that many face the loss of lifetime savings—and of homes that house memories, allow for continued independence, and enable older Americans to remain active members of longstanding communities.

My name is George Brown, and I am the Senior Vice President of the Center for Responsible Lending (CRL) and the Director of our Washington, D.C. office. My personal interest in housing issues specific to older Americans goes back many years. I served as the Associate Deputy Assistant Secretary for Neighborhoods with the U.S. Department of Housing and Urban Development. At HUD, I was Senior Advisor to the Secretary on elderly housing policy and programs and a principal author of the Section 202 Elderly Housing Program. I have lectured on Special Housing Needs at Columbia and Yale Universities. I was also Managing Partner in the first minority-owned development in Richmond, Virginia, which involved the adaptive reuse of an historic hospital into rental housing for seniors.

I am proud now to be representing CRL, a nonprofit, nonpartisan research and policy organization that promotes responsible lending practices and access to fair terms of credit for low-wealth families. CRL is dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is an affiliate of the Center for Community Self-Help, a North Carolina-based community development financial institution. Since 1980, Self-Help has provided over $3 billion in financing in 48 states, enabling more than 37,000 families to become homeowners.

CRL is encouraged that the US Senate Special Committee on Aging has focused on the topic of seniors harmed by predatory lending. Homeownership has traditionally represented most families' primary opportunity to build wealth for their children and economic security for their own old age. Unfortunately, predatory mortgage lending has become a significant threat to homeownership efforts. **CRL estimates that predatory mortgage lending costs Americans $9.1 billion annually, stripping home equity from many minority, low-income, and elderly homeowners.**

At CRL, we hear from victims of predatory lending all the time, and Self-Help has worked hard to help people get out from under bad loans. Last May, we heard from a couple in Michigan who had lost their home of forty years to predatory lenders. In November, we heard of an 84 year-old Californian with Alzheimer's who had been talked into signing a reverse mortgage; she got out of the contract, but apparently never recovered her fees. Some years ago, we learned about Ms. Dezell Wiley. In 1967, Ms. Wiley purchased a home in Durham, North Carolina, for $13,500 in cash. By February 2000, at the age of 89, Ms. Wiley owed more than $70,000 on the same house because of <u>five</u> refinance loans taken between 1994 and 1997.

Several of Ms. Wiley's loans included a balloon payment and financed unnecessary credit insurance and exorbitant fees.

The problem of excessive fees 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 remaining in his or her home is reduced by the amount of fees owed. In addition, the fees are forever because, even if another lender refinances a family just one week later, the borrower's wealth is still permanently stripped away.

To illustrate this point, I thought it might be useful to turn your attention to the testimony of an elderly African American homeowner from Washington, DC, whose story was included in the Joint HUD/Treasury Report on predatory lending that was published four years ago.

> *Ms. H, a widowed 81 year old African-American homeowner who lives in Washington, D.C. testified at the Baltimore forum about her experience. In 1999, she was induced by a mortgage broker to refinance an existing $118,000 mortgage loan into a new loan for $129,000.*
>
> *Ms. H. testified that the broker persuaded her to take the new loan by claiming it would retire existing unsecured debt, lower her monthly payments, cover her real estate taxes and insurance, and lower her interest rate. None of these assertions was true. In fact, Ms. H.'s new loan did not pay off any unsecured debt, raised her monthly payments, did not cover her tax and insurance obligations, and, after a two year period, will significantly increase her interest rate. Moreover, the new loan provided Ms. H. with absolutely no other tangible benefit of any kind. Not only were no unsecured debts paid off, but she received no cash out from the loan. The mortgage broker, however, made $3,850 as a result of the transaction.*
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> *The same mortgage broker had originated Ms. H.'s prior mortgage loan, taken out in 1997. That loan contained a substantial prepayment penalty if paid off in less than three years; thus, Ms. H. paid significant sums in the form of a prepayment penalty, in addition to her closing costs, on the 1999 refinancing. The mortgage broker's combined compensation on the two loans exceeded $12,000.*[1]

Ms. H. was a victim of a practice known as loan flipping, where a loan is refinanced in order to extract additional fees, with no net benefit to the borrower. The use of funds from the 1999 loan to pay a prepayment penalty on the first loan exacerbated the harm of the refinance, stripping equity from the home. The reduction in equity effectively trapped Ms. H. in the costly 1999 loan, making it more difficult for a responsible lender to refinance her into a more affordable product. Both loan flipping and prepayment penalties are now illegal in Self-Help's home state of North Carolina and in other states that have followed North Carolina's lead.

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[1] Joint HUD/Treasury Report on Recommendations to Curb Predatory Home Mortgage Lending (April 20, 2000), p. 20.

Unfortunately, many lenders continue to resist seriously addressing flipping or excessive prepayment penalties on subprime loans, even in their best practices.

Finally, I wanted to emphasize two key points from testimony before this Committee by Ms. Veronica Harding, a 74 year-old Philadelphia resident who almost lost her home to predatory lenders. Two aspects of Ms. Harding's story bear special emphasis. First, Ms. Harding testified that she never went looking for a refinance loan on the house she paid cash for back in 1980. Rather, unscrupulous lenders came to her. "Push marketing" is common in the subprime market, so "fixes" to predatory lending that rely on disclosure and education to help borrowers "shop" simply fail to take into account the realities of the market. Rather, market-based solutions, like the North Carolina law, that 1) seek to make the costs of a loan simple and clear to the borrower by encouraging lenders to rely on interest rate rather than hidden fees, and 2) establish protections for the most risky and costly loans in the market, are a much more effective way to address predatory lending.

Second, Ms. Harding testified that she has learned that many of her neighbors also got caught up in predatory loans. Unfortunately, predatory lenders are known to target certain neighborhoods. The odds are good that one victim of predatory lending lives down the street or around the corner from another. In this way, whole communities are affected, especially when foreclosures become rampant.

Unscrupulous lenders frequently target older Americans. Seniors may be open to promises of ready cash if they live on modest, fixed incomes that do no cover property tax increases, necessary repairs to older homes, and unanticipated medical expenses. They may also have built up a great deal of equity in their homes—which predatory lenders are more than eager to strip away.

**States' responses to the predatory lending epidemic are reducing predatory lending without reducing access to credit.**

<u>North Carolina's landmark anti-predatory lending legislation is working as intended.</u>

In 1999, Self-Help founded the Coalition for Responsible Lending, which now represents over three million people through eighty organizations, as well as the CEOs of 120 financial institutions. That year, the Coalition spearheaded an effort to enact market-based, common sense state legislation that would protect borrowers from predatory lending practices. Ultimately, N.C. Senate Bill 1149 was passed with overwhelming bipartisan support. It was endorsed by: North Carolina Bankers Association (128 community banks and thrifts), North Carolina Association of Financial Institutions (5 big banks), North Carolina Mortgage Bankers Association, North Carolina Association of Mortgage Brokers, and North Carolina Credit Union Network (180 credit unions).

In 2001, the North Carolina General Assembly, with the endorsement of the banking industry, passed companion legislation to license mortgage brokers and to spell out their affirmative duties. During the 2003 legislative session, the North Carolina legislature demonstrated its continuing support for the 1999 and 2001 reforms by extending their reach to open-end loans, closing what may have become a significant loophole. Clearly, state legislators view the North Carolina law as a great success.

The governing principle of North Carolina's law is fairly simple: deter exorbitant fees (that, when financed, permanently strip equity from homeowners) and encourage lenders to garner compensation through interest rates, over which lenders can compete to arrive at a price that is a true reflection of the loan's risk. Therefore, the North Carolina law prohibits the most blatantly abusive practices (all of which involve the accumulation of fees) and establishes special protections for borrowers entering into "high-cost" loans. Moreover—and importantly—special attention is paid to identifying the fees that count toward categorizing a loan as "high-cost" in the first place.

Mr. Chairman, we at CRL would be more than happy to discuss with you and Members of the Committee--in great detail--the operation of North Carolina's law; the aspects of the anti-predatory lending law that are particularly tailored to North Carolina; and the lessons that we have learned over the past five years in North Carolina and in other states where we have provided technical assistance. What's important for me to say now, however, is that North Carolina's law is working.

Recent research clearly shows that the North Carolina law is having its intended effect. Borrowers continue to have access to a wide variety of competitively priced loans from a wide variety of lenders. At the same time, North Carolina has reduced predatory lending.

Industry data attests to the robust subprime market in North Carolina. An analysis by a leading industry trade journal, Inside B&C Lending, found that top North Carolina subprime lenders continue to offer a full array of products for borrowers in North Carolina—with little or no variation in rate compared to other states.[2] In addition, a Morgan Stanley & Co. survey of 280 subprime branch managers and brokers found that tougher predatory lending laws have not reduced subprime residential lending volumes in any significant way.[3]

Our own analysis of home loans reported to federal regulators as originated under the Home Mortgage Disclosure Act (HMDA) shows that subprime lending continues to thrive in North Carolina.[4] In 2000, North Carolina was still the sixth most active state for subprime lending, with North Carolina borrowers 20 percent more likely to receive a subprime loan than borrowers in the rest of the nation. One in every three loans to low-income North Carolina families (annual incomes of $25,000 or less) was subprime, the highest such proportion in the country. In addition, the study finds that the North Carolina law saved homeowners $100 million in its first year.

The best research in the field was recently completed by the Center for Community Capitalism at the Kenan-Flagler Business School of the University of North Carolina in June

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[2] Inside B&C Lending. 2001. Lenders Will Try to Pin Down Effects of NC Mortgage Law. March 5.
[3] Morgan Stanley. 2002. Channel Check: Surprisingly Strong Subprime Growth. Diversified Financials. August 1.
[4] Ernst, Keith, John Farris, and Eric Stein, "North Carolina's Subprime Home Loan Market After Predatory Lending Reform", Center for Responsible Lending (August 2002) (available at http://www.mbaa.org/state_update/2002/nc/nc_study_0814.pdf).

2003.[5] The University of North Carolina study concluded that the North Carolina law succeeded in reducing the incidence of loans with predatory terms, perhaps most notably leading to a 72% drop in subprime prepayment penalties with terms of three years or longer.

On the crucial issue of credit availability, the report found that loans to North Carolina borrowers with substantially impaired credit actually increased by 31 percent after implementation of the North Carolina law. In a corollary finding, researchers noted that subprime loans to borrowers with credit scores above 660—those who could more easily qualify for low-cost conventional loans—declined by 28%, while, according to HMDA data, overall loans by primarily prime lenders increased by 40% in the state from 2000 to 2001. This finding suggests a reduction in "steering" of borrowers to loans with a higher price than that justified by their credit history. In addition, researchers noted that subprime home purchase loans overall increased by 43 percent following passage of the law.

While the number of subprime home purchase loans in North Carolina increased, the number of subprime refinance loans with predatory terms did drop significantly. The UNC study notes that the reduction in originations can be attributed to subprime refinance originations that contain at least one predatory lending characteristic: prepayment penalty terms that exceed three years, subprime balloon payments, and loan-to-value ratios of 110 percent or more. UNC considers these high LTV loans as proxies for refinance loans that provided little or no benefit to the borrower, but likely resulted in increased fees to the lender, or abusive, unnecessary originations. **In short, the study suggests that the reduction of subprime refinances is consistent with a "weeding out" of bad loans since passage of the law.**

Surprisingly, even though the North Carolina law significantly limited fees, the UNC study also found that, after the law was fully implemented, North Carolina's mean origination interest rates were consistent with corresponding national rates and actually increased slightly less than the national average increase. This result implies that the fees being charged before the implementation of the law were not genuinely priced to borrower risk, but represented excessive fees extracted from North Carolina's most vulnerable populations. In other words, as Professor Michael Stegman, one of the study's authors reported, "[t]he study shows that since the North Carolina law went into full effect, the subprime market has behaved just as the law intended. The number of loans with predatory characteristics has fallen without either restricting access to loans to borrowers with blemished credit or increasing the cost of these loans."[6]

Those who live and work in the state know that loans remain widely available. Joseph Smith, North Carolina's Banking Commissioner, has commented that "[d]uring the last twelve months, over seventy-five percent of formal complaints to [his office] ... have involved

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[5] Quercia, R.G., Stegman, M.A., and Davis, W.R. 2003. "The Impact of North Carolina's Anti-Predatory Lending Law: A Descriptive Assessment." Center for Community Capitalism, University of North Carolina at Chapel Hill (available at http://www.kenan-flagler.unc.edu/assets/documents/CC_NC_Anti_Predatory_Law_Impact.pdf). Note: As acknowledged in the study, the Center for Responsible Lending provided financial support to enable the research.

[6] "STUDY: NC Predatory Lending Law Cuts Abuses, Does Not Dry Up Credit for Borrowers", Center for Community Capitalism June 25, 2003 press release (available at http://www.kenan-flagler.unc.edu/News/DetailsNewsPage.cfm?id=466&menu=ki).

mortgage lending activities [but] .... [n]ot one of these complaints has involved the inability of a North Carolina citizen to obtain residential mortgage credit."[7]

**Education, counseling, and disclosures are not a significant part of the solution to predatory lending.**

As you know, the report just released by the General Accounting Office only reinforces the need for greater efforts to protect homeowners through high standards for lenders and strong enforcement of those rules. Significantly, "GAO's review of literature and interviews with consumer and federal officials suggest that while tools such as consumer education, mortgage counseling, and disclosures are useful, they may be of limited effectiveness in reducing predatory lending."[8]

The GAO report carefully delineates the limitations of preparing homeowners to protect themselves in the marketplace. First, "[e]ven an excellent campaign for consumer education is unlikely to provide less sophisticated consumers with enough information to properly assess whether a loan contains abusive terms."[9] This is because mortgage loans are complex; predatory lenders use aggressive tactics intended to confuse consumers; and those targeted by predatory lenders may be hard to reach with educational campaigns. Id.

Second, "[t]he role of counseling in preventing predatory lending is likely to be limited."[10] The GAO report explains that counselors may not have access to full, final terms of a loan before closing.

Finally, on the subject of disclosures, GAO found that "the inherent complexity of loan transactions may limit any impact on the incidence of predatory lending practices."[11] Moreover, unscrupulous lenders use disclosure forms as a legal shield for abusive practices, not as a protection for homeowners. Lenders control the preparation of documents that are eventually presented (in tall stacks) to consumers at closings. Lenders are in the position to bury disclosures and to make them appear technical and unimportant. "In the average home equity loan, it is not uncommon for the consumer to receive a multiple-page mortgage, a promissory note, and 50 or more accompanying documents describing various aspects of the mortgage loan."[12]

In 1992, the Department of Education completed the National Adult Literacy Survey; that study found that over 40 million Americans had very low levels of literacy skills. "New research measuring the literacy of the U.S. population demonstrates that even consumers who might take the time and trouble to 'read' contemporary consumer contract documents are unlikely to

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[7] North Carolina Office of the Commissioner of Banks, Joseph A. Smith, Jr. letter to Comptroller John D. Hawke, Jr. (October 2, 2003) (available on request).
[8] "Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending" (GAO 2004), at p. 6.
[9] Id. at p. 13.
[10] Id.
[11] Id. at p. 14.
[12] Alan M. White and Cathy Lesser Mansfield, "Literacy and Contract," 13.2 Stanford Law & Policy Review 233, 239 (2002), hereinafter "White and Mansfield."

understand them. The same literacy research suggests that many, if not most, consumers are unable to extract critical information on contract terms from federally mandated disclosure documents."[13] Most startlingly, "96% of American adults cannot extract and compute credit cost information from contract and disclosure documents."[14]

The conclusions of the GAO and other researchers support a basic principle of anti-predatory lending efforts in North Carolina and other states. We cannot rely on a "buyer beware" approach. Rather, we must make it more difficult for unscrupulous lenders to make abusive loans.

**State and federal regulatory agencies should work together to combat predatory lending.**

The OCC's decision to preempt state laws and limit state enforcement powers was a mistake that should be rectified.

While North Carolina was the first state in the nation to pass strong anti-predatory lending legislation, others have followed and identified appropriate solutions for their particular contexts.[15] States have truly served as laboratories of democracy by helping to refine solutions for such issues as the appropriate definition and threshold for points and fees, the scope of loans included under the law's protections, and meaningful remedies for borrowers who seek to defend their homes against foreclosures caused by predatory lending. Like AARP, CRL believes the best remedy against predatory lending is clear and specific standards that 1) prohibit abuses such as loan flipping and financed single premium credit insurance, and 2) establish protections on high-cost loans that limit high fees, including prepayment penalties, and prohibit both asset-based lending and mandatory arbitration clauses.

Unfortunately, one federal regulatory agency is working to limit the effectiveness of state laws such as North Carolina's. No homeowners—young or old—will benefit from limiting the reach of state-based consumer protections. In fact, older Americans—who, like Ms. Harding, may initially be ashamed of admitting that they entered into bad loans—will suffer more if local help is unavailable to them when they need it.

With total disregard for Congressional intent, the Office of the Comptroller of the Currency has invented its own standard for preemption—one that essentially allows it to preempt any state law that it doesn't like. Under the OCC's new rule, states may not "obstruct, impair, or condition a national bank's ability to fully exercise its federally authorized real estate lending powers." The only state laws that the OCC does not purport to preempt are those that "only incidentally affect" a bank's activities. Furthermore, the OCC has pronounced that state officials may not investigate consumer complaints against national banks and may not take enforcement actions of any type against national banks. The OCC extends this preemption rule to all operating subsidiaries of national banks.

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[13] Id. at 234.
[14] Id. at 238.
[15] Perhaps the most notable states in this regard include New Mexico, New York, and New Jersey—however, Illinois, Massachusetts, California, South Carolina, Arkansas, and Georgia have all made contributions to the pioneering efforts of states to identify solutions that protect homeowners and promote a thriving market.

We at CRL believe that the new rule will promote predatory lending by banks and their subsidiaries. First, the OCC has not only preempted strong state law protections, but it has replaced them with vague and inadequate standards. The OCC relies on a prohibition of asset-based lending and a reference to the FTC Act's ban on unfair and deceptive practices. Rather than prevent practices by making clear to lenders what they may and may not do—as state anti-predatory lending laws have done—the OCC is planning to rely on a post-hoc "we'll know it when we see it" approach to predatory lending. Second, the OCC ignores existing evidence of predatory lending within national banks and their affiliates and subsidiaries. Finally, the OCC's rule encourages banks to change their subprime lending affiliates into operating subsidiaries, increasing the OCC's responsibility for policing the subprime market and decreasing the states' ability to regulate subprime lenders.

<u>Federal agencies have improved regulations by attending to lessons developed at the state level, and they have joined with states to enforce laws that protect homeowners.</u>

The battle against predatory lending requires cooperation between state and federal actors and among federal agencies charged with regulating financial institutions and protecting consumers.

The Federal Reserve Board took important action in 2001 when it moved to incorporate financed credit insurance within the scope of charges evaluated as a point or fee under HOEPA. The Federal Reserve did not arrive at this conclusion in a vacuum, however. Indeed, North Carolina adopted a similar provision in its 1999 law.

Similarly, some 35 states have statutory provisions relating to prepayment penalties on home loans. However, federal law had been interpreted to preclude them from enforcing those laws against state-chartered finance companies and mortgage brokers in the context of adjustable rate mortgages and other alternative mortgage transactions. Not surprisingly, lenders increasingly structured transactions to take advantage of this rule of preemption. As predatory lending escalated in recent years, prepayment penalties in home loans came under renewed scrutiny; a number of states moved to prohibit them outright or to limit their application. In recognition of these developments, the Office of Thrift Supervision revised federal regulations--and restored the states' ability to apply their laws.

The Federal Trade Commission has also cooperated with state attorneys general and bank commissioners on large, successful enforcement actions such as those taken against First Alliance Mortgage Company, the Associates, and Mercantile Mortgage Company.

<u>No one federal agency should ever have exclusive jurisdiction over predatory lending—for any financial institutions.</u>

In some of its enforcement actions, the FTC has partnered with sister agencies at the federal level. In fact, the GAO Report's sole recommendation is that the Federal Reserve Board and the FTC exercise <u>concurrent</u> jurisdiction over non-bank subsidiaries of bank holding companies. This recommendation takes into account that both regular examinations of bank practices and more consumer-driven investigations of particular activities may be necessary to root out abuse. If the recommendation is adopted, Congress should make clear that it is increasing the number of cops on the beat, not removing any. The FTC, the Federal Reserve Board, and the states should have concurrent jurisdiction over non-bank affiliates of bank holding companies.

In order to effectively combat predatory lending, it is essential that the federal government continue to partner with states to provide protections for the nation's homeowners, rather than take away from effective efforts at the state level.

Of course, private rights of actions and opportunities for individuals to raise defenses at foreclosure proceedings will always be necessary, too, to ensure that those harmed can seek redress. Even where laws protect homeowners, many subprime lenders have sought to preclude private legal action through pre-dispute mandatory arbitration clauses. Fannie Mae and Freddie Mac have recently announced that they will not buy subprime loans that contain mandatory arbitration clauses, but the GSEs cannot rid the market of such loan terms on their own. In fact, because of the Federal Arbitration Act, states have not been able to address mandatory arbitration clauses in their own predatory lending legislation. In this area, Congress clearly can and should act.

**Conclusion**

Predatory lending is epidemic. There is no shortage of work for both state and federal regulators to do—together. Older Americans will have more secure futures if predatory lending is addressed through strong laws and vigilant enforcement of those laws.

American
SECURITIZATION
FORUM

***Statement of The American Securitization Forum***
***Submitted for the Record***

***Before the***
***Senate Special Committee on Aging***

***Chairman Larry Craig***

***Hearing on Predatory Lending: Are Federal Agencies Protecting Older Americans from Financial Heartbreak***

***February 24, 2004***

The American Securitization Forum (ASF), an adjunct forum of The Bond Market Association, is a broadly-based professional forum of participants in the U.S. securitization market. Among other roles, ASF members act as investors, issuers, underwriters, dealers, rating agencies, insurers, trustees, servicers and professional advisors working on transactions involving securitizations of residential mortgages and other types of financial assets.

Securitization—the process by which individual, illiquid assets are converted into marketable capital market instruments—has produced substantial benefits for consumer and business borrowers, corporations who need capital to grow their businesses and produce and retain jobs, and institutional investors, including public and private pension funds and money managers, who invest in the multi-trillion dollar securitization market in the United States. In the well-intentioned effort to eliminate predatory lending abuses, it is critically important to preserve the efficiency and benefits of the securitization market.

## History and Overview of Securitization

Securitization is the creation and issuance of debt securities, or bonds, whose payments of principal and interest derive from cash flows generated by separate pools of assets. It has grown from a non-existent industry in 1970 to approximately $7 trillion as of the end of 2003. Financial institutions and businesses of all kinds use securitization to immediately realize the value of a cash-producing asset and use the proceeds from a securitization transaction to generate additional loanable funds. These are typically financial assets such as loans, but can also be trade receivables or leases. In most cases, the originator of the asset anticipates a regular stream of payments. By pooling the assets together, the payment streams can be used to support interest and principal payments on debt securities. When assets are securitized, the originator receives the payment stream as a lump sum rather than spread out over time. Securitized mortgages are known as mortgage-backed securities (MBS), while securitized assets—non-mortgage loans or

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other assets with expected payment streams—are known as asset-backed securities (ABS).

To initiate a securitization, a company must first create what is called a special purpose vehicle (SPV) in the parlance of securitization. The SPV is legally separate from the operating company that originated and/or is selling the assets in order to give the investor greater assurance that the assets will serve as a dedicated cash flow stream to support the securitization issuance. Typically a company sells its assets to the SPV. The payment streams generated by the assets can then be repackaged to back an issue of bonds. Or, the SPV can transfer the assets to a trust, which becomes the nominal issuer. In both cases, the bonds are exchanged with an underwriter for cash. The underwriter then sells the securities to investors. Unlike other bonds, securities backed by mortgages usually pay both interest and a portion of the investor's principal on a monthly basis.

**Mortgage-Backed Securities**

The first mortgage-backed securities arose from the secondary mortgage market in 1970. Investors had traded whole loans, or unsecuritized mortgages, for some time before the Government National Mortgage Association (GNMA), also called Ginnie Mae, guaranteed the first mortgage pass-through securities that pass the principal and interest payments on mortgages through to investors. (Ginnie Mae is a government agency that guarantees securities backed by HUD- and Veterans Administration-guaranteed mortgages.) Ginnie Mae was soon followed by Fannie Mae, a private corporation chartered by the federal government—along with Freddie Mac—to promote homeownership by fostering a secondary market in home mortgages.

Pass-throughs were a dramatic innovation in the secondary mortgage market. The whole-loan market, the buying and selling of mortgages, was relatively illiquid. This presented a risk to mortgage lenders who could find themselves unable to find buyers if they wanted to sell their loan portfolios both quickly and at an acceptable price. Holding the loans also meant exposure to the risk that rising interest rates could drive a lender's funding cost higher than its interest income. But trading whole loans meant a raft of details and paperwork that made the business relatively costly and inefficient. MBS changed that. By combining similar loans into pools, the government agencies are able to pass the mortgage payments through to the MBS certificate holders or investors. This change made the secondary mortgage market more attractive to investors and lenders alike. Investors now had a liquid instrument and lenders had the option to move any interest rate risk associated with mortgages off of their balance sheet.

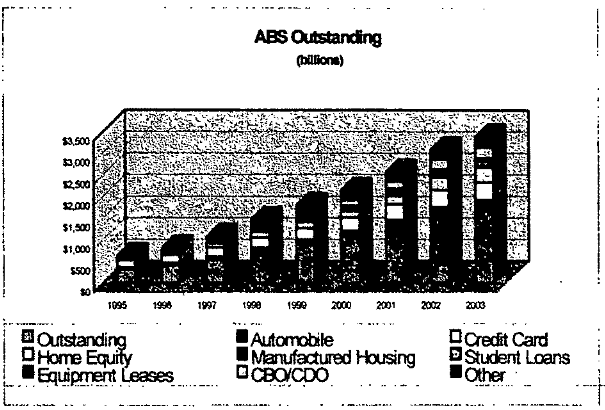
Growth in the pass-through market inevitably led to innovations especially as originators sought a broader MBS investor base. In response, Fannie Mae issued the first collateralized mortgage obligations (CMO) in 1983. A more complicated twist on pass-throughs, CMOs redirect the cash flows of trusts to create securities with several different payment and associated cash flow risk features. The central goal with CMOs was to address prepayment risk—the main obstacle to expanding demand for pass-throughs.

Prepayment risk for MBS investors is the unexpected return of principal stemming from consumers who refinance the mortgages that back the securities. Homeowners are more likely to refinance mortgages when interest rates are falling. As this translates into prepayment of MBS principal, investors are often forced to reinvest the returned principal at a lower return. CMOs accommodate the preference of investors to lower prepayment risk with classes of securities that offer principal repayment at varying speeds. The different bond classes are also called tranches (a French word meaning slice). Some tranches—CMOs can include 50 or more—can also be subordinate to other tranches. In the event loans in the underlying securitization pool default, investors in the subordinate tranche would have to absorb the loss first.

As part of the Tax Reform Act of 1986, Congress created the Real Estate Mortgage Investment Conduit (REMIC) to facilitate the issuance of CMOs. Today almost all CMOs are issued in the form of REMICs. In addition to varying maturities, REMICs can be issued with different risk characteristics. REMIC investors—in exchange for a higher coupon payment—can choose to take on greater credit risk. Along with a simplified tax treatment, these changes made the REMIC structure an indispensable feature of the MBS market. Fannie Mae and Freddie Mac are the largest issuers of this security.

**Asset-Backed Securities**

The first asset-backed securities (ABS) date to 1985 when the Sperry Lease Finance Corporation created securities backed by its computer equipment leases. Leases, similar to loans, involve predictable cash flows. In the case of Sperry, the cash flow comes from payments made by the lessee. Sperry sold its rights to the lease payments to an SPV.




Interests in the SPV were, in turn, sold to investors through an underwriter.

Source: The Bond Market Association

Since then, the market has grown and evolved to include the securitization of a variety of asset types, including auto loans, credit card receivables, home equity loans, manufactured housing loans, student loans and even future entertainment royalties. Credit card receivables, auto and home-equity loans make up about 60 percent of all ABS. Manufactured housing loans, student loans and equipment leases comprise most of the other ABS. And the industry continues to look for new assets to securitize such as auto leases, small-business loans and "stranded cost recovery" ABS. (The latter refers to bonds backed by fees some newly deregulated utilities have won authority to include in future billings as an offset of previous investment.)

## How Securitization Works

ABS and MBS represent an interest in the underlying pools of loans or other financial assets securitized by issuers who often also originate the assets. The fundamental goal of all securitization transactions is to isolate the financial assets supporting payments on the ABS and MBS. Isolation ensures payments associated with the securities are derived solely from the segregated pool of assets and not from the originator of the assets. By contrast, interest and principal payments on unsecuritized debt are often backed by the ability of the issuing company to generate sufficient cash to make the payments.

### Origination and Servicing

The assets used in securitizations are created—or originated—in a number of ways. When a lender extends a loan or acquires another revenue-producing asset such as a lease, they are creating assets that can be securitized. Other assets, such as the balances due on credit card accounts or a corporation's accounts receivable can also be securitized. Because they initiate the securitization chain, the lenders, credit card companies and others are also called originators. Originators often retain a connection to their assets following a securitization by acting as a servicer—the agent collecting regular loan or lease payments and forwarding them to the SPV. Servicers are paid a fee for their work. Some originators contract with other organizations to perform the servicing function, or sell the servicing rights.

### Asset Transfer or the "True Sale"

In the vast majority of securitizations, it is critical that the transfer of assets from the originator to the SPV is legally viewed as a sale, or "true sale." The proceeds of the securities are remitted to the originator as the purchase price for the assets. If the asset transfer is not a "true sale," investors are vulnerable to claims against the originator of the assets. The cash flows backing the securities or the assets themselves could be ruled a part of the originator's estate and used to satisfy creditors' claims if a true sale did not occur. Legally separating the assets also protects the originator.

Investors can turn only to the SPV for payments due on the ABS and MBS, not to the general revenues of the originator.

### Special Purpose Vehicle and the Trust

The SPV can either be a trust, corporation or form of partnership set up specifically to purchase the originator's assets and act as a conduit for the payment flows. Payments advanced by the originators are forwarded to investors according to the terms of the specific securities. In some securitizations, the SPV serves only to collect the assets which are then transferred to another entity—usually a trust—and repackaged into securities. Individuals are appointed to oversee the issuing SPV or trust and protect the investors' interests. The originator, however, is still considered the sponsor of the pool.

### Underwriter

Underwriters—usually investment banks— serve as intermediaries between the issuer (the SPV or the trust) and investors. Typically, the underwriter will consult on how to structure the ABS and MBS based on the perception of investor demand. The underwriter may, for example, advise the SPV to issue different tranches each with specific characteristics attractive to different segments of the market. Underwriters also help determine whether to use their sales network to offer the securities to the public or to place them privately. Perhaps most importantly, underwriters assume the risk associated with buying an issue of bonds in its entirety and reselling it to investors.

### Credit Enhancement

Credit enhancement is common in securitization transactions. Depending on the nature of the transaction and the type of assets, the securitization pool may need such support to attract investors. Enhancement or support can come from the assets themselves or from an external source. Examples of internal enhancements include subordinating one or more tranche, or portion, of the securities issued. This practice places the claims of one tranche over another. Any defaults affecting the securities must be absorbed by a subordinate tranche before the senior tranche is affected. Over-collateralization of asset pools is also used to enhance credit. This occurs when the amount of assets placed in a securitization pool exceeds the principal amount of bonds issued.

External credit enhancements can include a surety bond or a letter of credit from a financial institution. Both options serve as guarantees that investors will receive the payments associated with the securities. GSEs enhance the credit of the MBS they issue by guaranteeing the timely repayment of principal and interest.

### Credit Rating

Virtually all ABS and MBS are rated by independent rating agencies whose analyses is watched closely by investors as a guide to the credit quality of the securities. In almost all cases, rating agencies monitor the performance of the securities on an ongoing basis.

**Dealers**
Just as in other bond markets, dealers play an important role once an issue is initially distributed. For most bond investors, liquidity—the ability to easily buy or sell a security—is an important characteristic. By offering prices at which they will buy or sell bonds to the investment community, dealers provide this service. Bonds typically trade more actively closer to their date of issue. Because bond investors—usually institutional investors such as pension funds and insurance companies—hold most bonds to maturity, trading in bonds declines as they draw nearer to their stated maturity date. The issuance volume of a certain bond, a bond's credit rating and whether it was issued publicly or privately can also affect liquidity. All ABS and MBS are traded on the dealer-based, over-the-counter markets so liquidity depends in part on the ability and willingness of dealers to maintain an inventory, or make a market, in a certain bond.

## Benefits of Securitization

**Less Expensive, More Broadly Available Credit**
The public benefits of securitization are evident in a number of ways. Chief among these is the contribution of securitization to lower borrowing costs both for individuals and corporations. The existence of a liquid secondary market for home mortgages increases the availability of capital to make new home loans. Financial institutions that realize the full value of their loans immediately can turn around and re-deploy that capital in the form of a new loan. This is often the most efficient way to raise new funds in the capital markets and the savings are passed on to the borrower.

Consumers other than homebuyers also benefit from lower borrowing costs. Securitization can lower a firm's financing costs as well. MBS and ABS are often designed to carry a higher credit rating than the originating firm would otherwise realize for other types of bonds. Higher credit ratings mean the security is less risky and translates into a lower interest rate for the originator as investors do not demand the same risk premium. The originator passes the savings on to the consumer in the form of lower lending rates.

Securitization also aids in the geographic dispersion of capital to areas that may otherwise be deprived of credit options. Traditionally, depository institutions have provided credit in the areas where they accepted deposits. By securitizing loans, however, the lender generates capital for new loans that may come from a different location. This linkage to the capital markets broadens the range of regions where depository institutions obtain capital to provide credit.

By subjecting the lending decisions of financial institutions to valuation by the capital markets, securitization also encourages an efficient allocation of capital. Financial institutions and others who securitize assets depend, of course, on investors. Investors seek an appropriate return based on a level of risk. If the asset pools are not of a sufficient quality, for example, investors will demand a higher interest rate as compensation. At its most basic level, securitization is the process of isolating risk and repackaging it for investors. This increases efficiency in the capital market by removing intermediary steps between investors and the risk they are assuming. A money manager, for example, may be interested in a mortgage-backed bond that pays interest and principal on a monthly basis, but not in the debt securities issued by the originator of the securitized assets.

Securitization reallocates risk at many levels. By shifting the credit risk of the securitized assets (for a price) to ABS and MBS investors, financial institutions can reduce their own risk. As the risk level of an individual institution declines, so does systemic risk, or the risk faced by the financial system overall.

**More Options for Investors**

As noted above, investors benefit from the legal segregation of the securitized assets. The segregation protects the payment stream on the MBS and ABS from a bankruptcy or insolvency. Higher-rated securitized instruments generally offer higher yields than similar sovereign government issues. The actual size of this yield premium, the yield the securities pay in excess of similar government securities—will depend on the credit quality of the assets and the structure of the transaction. Pension funds—which comprise much of the market for MBS and ABS—pay close attention to this premium as they seek a wide variety of safe fixed income products with attractive yields. Insurance companies, money managers and other institutional investors with needs for fixed-income securities with specific features are also large ABS/MBS investors.

The ability of issuers to vary the terms of securities backed by the same asset pool through different securitization techniques also makes MBS and ABS attractive to investors. In a sense, issuers can tailor the coupon, maturity and seniority of a security according to a particular investor's needs. This flexibility not only boosts investor interest in ABS and MBS, but also contributes to more efficient capital markets by ensuring investors and money managers have access to the most appropriate securities.

**Flexibility for the Originator**

Securitization also benefits the financial institution or corporation that originates the securitized asset. Without securitization, a bank making a home loan usually would hold that loan on its books, recognizing revenue as payments are made over time. To realize the value of the loan immediately, the bank can sell the whole loan to another institution, though this is generally not economical unless the loan is very large. Furthermore, a bank would have to rely on its existing funding sources, such as deposits, to originate new loans Securitization offers an important funding resource..The more efficient option is to pool similar loans together, as discussed above, and enter into a securitization transaction.

The process makes even more sense for originators with assets considered illiquid, such as equipment leases or the balance due on a credit card. The latter comprises an asset class called credit card receivables that account for approximately 20 percent of outstanding ABS. Similar to banks securitizing home loans, credit card companies are able to use the securitization process to provide more credit and manage their balance sheets.

Originators realize another benefit from securitization as the transfer of the asset to an SPV removes it from the firm's balance sheet. This can help the originator improve certain measures of financial performance such as return-on-assets (ROA). A way to gauge a firm's efficiency, ROA tells observers how many dollars are earned for every dollar of assets on its books. Moving an asset off of the balance sheet while simultaneously increasing income has a positive effect on ROA and demonstrates to investors a more efficient use of capital. Banks realize a unique advantage from securitization. Removing loans from their balance sheet can lower regulatory capital requirements, or the amount and type of capital banks must hold given the size of their loan portfolio, to reflect lowered risk.

The segregation of assets that takes place in a securitization can also effectively lower the firm's financing costs. This occurs when the securities issued by the SPV carry a lower overall interest rate than the originating firm pays on its debt. As the firm receives the proceeds from the securitization it has, in effect, achieved cheaper financing than might have been extended to the firm based solely on its own credit rating.

## Conclusions

Securitization reflects innovation in the financial markets at its best. Pooling assets and using the cash flows to back securities allows originators to unlock the value of illiquid assets and provide consumers lower borrowing costs at the same time. MBS and ABS securities offer investors an array of high quality fixed-income products with attractive yields. The popularity of this market among issuers and investors has grown dramatically since its inception 30 years ago to about $7 trillion in outstanding MBS/ABS today.

The success of the securitization industry has helped many individuals with subprime credit histories obtain credit. Securitization allows more subprime loans to be made because it provides lenders an efficient way to manage credit risk. Efforts to curb "predatory" lending that inhibit the legitimate use of securitization by assigning liability to the purchaser of a loan or some other means, threaten the success of the beneficial subprime market. Secondary market purchasers of loans, traders of securitized bonds and investors are not in a position to control origination practices loan-by-loan. Regulation that seeks to place disproportionate responsibilities on the secondary market will only succeed in driving away the capital loan purchasers provide in the subprime market.

The ASF urges Congress to move with great care as it addresses the problem of predatory lending. The secondary markets are a tremendous success story that has helped democratize credit in this country. Well intended, but overly restrictive, regulation in this area could easily do more harm than good. This is particularly the case when state and local governments craft disparate anti-predatory lending statutes that place different compliance burdens on the secondary market. For this reason, the ASF urges Congress to consider legislation to pre-empt the authority of state and local governments in the area of predatory lending and to construct a safe harbor from assignee liability for secondary market participants.

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THE BOND MARKET ASSOCIATION

***Statement of The Bond Market Association***
***Submitted for the Record***

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***Chairman Larry Craig***

***Hearing on Predatory Lending: Are Federal Agencies Protecting Older Americans from Financial Heartbreak***

***February 24, 2004***

The Bond Market Association represents approximately 200 securities firms and banks that underwrite, trade, and sell fixed-income securities both domestically and internationally.

The secondary market for mortgage debt—the segment of the financial industry that purchase and repackage loans as mortgage-backed securities or MBS—witnessed tremendous growth over the past decade. At present, there are about $5 trillion in mortgage-related bonds outstanding, or nearly a quarter of all fixed income securities. Such significant participation by the capital markets in the mortgage lending business benefits consumers in the form of lower interest rates and more widely available credit. No doubt there are thousands, if not millions, of families who were able to find mortgage financing and purchase a home because of the secondary market.

This success has come with some setbacks, however, as the volume of subprime loans extended to consumers has ballooned and incidents of predatory lending appear to have increased. There can be no question that such abusive lending practices are bad and should be stopped. In response to this trend, state and local governments have pursued many different anti-predatory lending initiatives. Some of these efforts would place new responsibilities on participants in the secondary market. Some initiatives adopt an approach that could make loan purchasers the subject of lawsuits by borrowers who believe the lender committed lending abuses.

The Bond Market Association opposes the concept of extending liability to the purchaser or assignee of a loan for violations of which they had no knowledge. The Association supports the right of borrowers to defend themselves in the event an assignee seeks to foreclose on their property. But the concept of "assignee liability" embodied in recent anti-predatory lending measures goes a step further. It would grant borrowers the ability to seek redress from the loan purchaser for virtually any alleged violation during the origination process. This is bad public policy that will ultimately shrink the supply of credit available to subprime borrowers. It is important that well-intentioned proposals to combat predatory lending—such as the statutes discussed below—not seek to use the secondary market as an enforcement tool. Moreover, subprime borrowers would benefit from a single national standard as opposed to the present variety of state and local predatory lending laws. Disparate and conflicting rules in multiple jurisdictions will raise the cost of credit as secondary market participants pass on compliance costs or withdraw funding which limits competition among lenders.

## Georgia and New York: Examples of the Wrong Approach

With the expansion of the subprime market has come increased scrutiny from regulators and consumer groups concerned with alleged abusive tactics used by some lenders. The practice has no clear-cut definition, but is commonly called predatory lending. Generally, a predatory lender is one who violates consumer lending laws to take financial advantage of a borrower in the course of originating a loan or else uses legal loan features or lending tactics in an abusive way. Examples include loading up loans with points and fees that are disproportionate to the amount an individual is borrowing, as well as outright fraud and misrepresentation. Loans extended without regard to a borrower's ability to repay or with features such as balloon payments that are unfavorable to borrowers can also be considered predatory. Predatory lending is sometimes also associated with home improvement contractors who offer to arrange financing for cash-poor homeowners.

As predatory lending captured headlines in the late 1990s, regulators at the state and local level began to address the issue. One of the first to act was the state of North Carolina with a 1999 statute that defines a high-cost loan more narrowly than the federal HOEPA (Homeowner Equity Protection Act) standard in addition to prohibiting certain practices. Several other states and some cities have passed similar anti-predatory lending laws with varying effects on the secondary market.

Generally, state and local initiatives sought to tighten the definition of a high-cost loan under HOEPA. In Georgia, lawmakers approved the Georgia Fair Lending Act (GFLA) which included an assignee liability provision that would hold secondary market participants responsible for the actions of lenders should they purchase predatory loans. The Georgia law proved so disruptive to the mortgage market—mortgage rates reportedly jumped a quarter of a percentage point as market participants withdrew—the legislature was forced to repeal the assignee liability provisions.

Like other anti-predatory lending legislation, GFLA expanded the definition of covered loan established under HOEPA using sometimes vague criteria. More importantly from the Association's perspective, anyone who purchased a covered loan, or is assigned the loan, would have become liable for the actions of the originator and face potentially unlimited damages.

Under GFLA, assignees—including loan purchasers and securitization trusts—are subject to claims that borrowers might raise against lenders whether or not the assignees knew of the circumstances giving rise to the alleged violation.. The secondary market signaled early on that the Georgia law would disrupt that state's mortgage market when Freddie Mac announced it would no longer purchase loans covered by the law. Several other financial institutions followed suit and at least 40 lenders[1] left the Georgia market because of the law. The legislature has since repealed parts of GFLA and many lenders have returned.

While several lenders and secondary market participants lobbied against GFLA and announced intentions to leave the market early on, the critical blow to the new statute came when the three major credit rating agencies said they would not rate pools of mortgages that included Georgia loans. Without credit ratings, the MBS backed by pools including at least one Georgia loan would be shunned by many traditional investors such as pension funds or endowments that are only permitted to invest in "rated" securities. The secondary market, then, would likely stop purchasing these loans. The rating agencies called for revisions to clarify the circumstances under which assignees could be held liable and a reasonable limit on the damages borrowers could seek. The legislature recognized losing the secondary market as a funding source for the Georgia mortgage market would ultimately hurt Georgia borrowers by raising mortgage rates.

Aside from Georgia, rating agencies have also assessed the effect a law enacted in New York State would have on investors in pools that contained loans covered by the statute. The agencies concluded they would decide whether to rate such pools on a case-by-case basis so long as they only included a minimal amount of "high-cost" loans as defined by a law that became effective April 1, 2003. Even this relatively limited uncertainty will increase the cost of securitizing New York State loans, which in turn will put upward pressure on mortgage rates in that state. Ultimately, disrupting the secondary market for subprime loans will always hurt the subprime borrower in the form of higher interest costs and fewer borrowing opportunities.

If investors cannot be certain of the risk associated with investing in MBS because of the jurisdiction in which one of the loans backing the security was originated, they will demand a higher return. Under such a scenario, MBS will become less attractive as a source of mortgage loan funding. Subprime borrowers will face higher interest rates and less available credit.

**Clarifying Assignee Liability**

Under current law, civil actions brought against lenders for infractions of HOEPA may also be brought against an assignee of the lender if the violation is "apparent on the face

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[1] See *Georgia Rattles US Home Equity Market: State legislation to Protect Sub-Prime Borrowers Is Threatening a Sector Worth $132 billion last Year*, by Jenny Wiggins, Financial Times, Feb. 13, 2003, p. 21.

of the loan document."[2] An assignee or the purchaser of a mortgage will not be subject to the claims and defenses of the borrower if a "reasonable person exercising ordinary due diligence, could not determine" the mortgage was a high-cost loan under HOEPA.[3] Unfortunately, neither this standard nor subsequent court decisions have effectively settled the question of what "apparent on the face" means in practice. The recent Georgia and New York State laws compound this problem by creating still more standards for assignee liability.

The presence of loans originated using predatory practices in the pools of loans backing mortgage securities is not in anyone's best interest. Not only do predatory lenders target individuals with risky credit profiles, but the terms of predatory loans often promote default. The more defaults a MBS pool experiences, the less attractive the security becomes to investors. Securitizers of mortgages, then, have a clear incentive to eliminate from pools any loans they can identify that violate applicable predatory lending laws.

Though recently enjoined by a New York state court, a recent New York City law sought to employ the secondary market as *de facto* policeman by requiring an arbitrary level of due diligence on loan pools in order to escape liability for subprime lending violations. Complying with the due-diligence level set by this statute could have significantly raised the cost of purchasing covered mortgages, which would in turn increase borrower costs.

In many cases, such screening would simply be impossible. The bill required assignees to determine whether subjective loan origination standards were met, such as whether the terms of a loan were misrepresented or whether the loan provides a "net tangible benefit" to the borrower. The purchaser of a loan cannot know what a lender told a borrower. Nor does the purchaser have unique insight into what type of loan or specific loan features are suitable for that borrower. Blanket assignee liability under these circumstances is unreasonable. Assignees have neither the opportunity to identify violations in advance of purchasing the loans, nor the ability to mitigate legal exposure once they do identify violations.

Nonetheless, this approach would have effectively held assignees responsible for the conduct of lenders by threatening to void the assignee's interest in the loans they have purchased unless the arbitrary due-diligence level is met.

**Preemption: The Need for a National Standard**

Several other states and localities are pursuing—or have enacted—legislation similar to the new Georgia and New York laws. Not only are these initiatives unduly restrictive, but their substantive provisions are frequently inconsistent from one jurisdiction to another. This fragmented approach to legislating the parameters of "acceptable" and "unacceptable" subprime lending threatens to balkanize the subprime credit industry in

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[2] 15 U.S.C. 1641(a)

[3] 15 U.S.C. 1641(d) l

the United States. The outcome might well be a return to the days of severely limited credit opportunity and significant regional and local disparities in credit availability for those who need credit most.

The development also presents a new compliance burden for lenders and secondary market participants. Multi-state lenders must constantly adjust lending practices and underwriting standards as new statutes with varying definitions of predatory lending emerge in different states. In some instances—Georgia, for example—lenders will choose to withdraw completely from the market for certain loans. In other cases, lenders may choose to adjust underwriting guidelines to minimize the chance of violating new standards. In doing so, subprime lenders run the risk of violating the federal Fair Lending Act, which prohibits the denial of credit under certain circumstances. This type of regulatory confusion only creates a disincentive for lenders to participate in the subprime market at all. The preservation of credit for borrowers in all markets is one of the strongest arguments available in favor of federal preemption of state and local predatory lending laws.

**The Need for a National Standard for Assignee Liability**

The Association believes limiting and clarifying the potential liability to which a secondary market participant can be exposed and making that standard applicable nationally, is the best way to address predatory lending without disrupting the secondary market for subprime loans. Such an approach would strike a better balance between consumer protection and market forces than any state or local initiative enacted or introduced to date. We urge these committees to consider the need for preemptive legislation in order to ensure subprime borrowers enjoy continued access to credit that is reasonably priced and widely available.

Broad assignee liability provisions are not necessary to ensure that borrowers have remedies available to them in the event of a foreclosure on their home. Regardless of whether the original lender or an assignee holds a loan, if the loan was made on predatory terms, borrowers should have the right to make such a claim.

There can be no doubt predatory lending is a harmful practice with which no reputable part of the American financial industry wants to be associated. Threatening secondary market participants with assignee liability to enlist them as enforcers of acceptable lending practices, however, makes their participation in the market for subprime residential mortgage market largely untenable from an economic perspective. Withdrawing the liquidity provided by the secondary market will deny credit to thousands of subprime borrowers. The access tens of thousands of deserving borrowers once had to mortgage credit would be lost.

Placing the burden of enforcement of anti-predatory lending rules on the secondary market is bad public policy with consequences that are both undesirable and unnecessary.

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# Testimony of the Coalition for Fair and Affordable Lending (CFAL)

**on**

# "Predatory Lending: Are Federal Agencies Protecting Older Americans From Financial Heartbreak?"

**before the**

## U.S. Senate Special Committee on Aging

**February 24, 2004**

## Introduction & Summary Overview

The Coalition for Fair and Affordable Lending[1] ("CFAL") appreciates the opportunity to submit this testimony to the Senate Special Committee on Aging.

We commend Chairman Craig for holding this hearing to focus attention on the harm that older Americans may suffer due to abusive mortgage lending practices. CFAL's members abhor such practices and believe that federal legislative action and other measures are needed to prevent such abuses. We believe that this can and should be done in a manner that also preserves senior citizens' and others' access to affordable mortgage credit.

Without question, some lenders and mortgage brokers engage in inappropriate lending practices that need to be stopped. Many of these abuses are fraudulent, deceptive and illegal. Enhanced enforcement together with more consumer financial education and counseling opportunities are needed to help prevent them. However, significant new federal statutory requirements also are needed to remove gaps or weaknesses in current law.

CFAL believes that it is imperative that Congress promptly pass such new federal requirements. H.R. 833, the Ney-Lucas bill in the House, effectively addresses many of

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[1] The Coalition for Fair and Affordable Lending (CFAL), launched January of 2003, was formed to advocate national, uniform fair legislative standards for nonprime mortgage lending. CFAL's members make around one-third of all nonprime mortgage loans.

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the current law's shortcomings. We hope that Senate and House Members will work together to further refine that bill's provisions as may be needed to address any additional concerns and gain broader bipartisan support. We want to work constructively with you and other interested parties to help craft a fair and balanced refined legislative proposal that can be the basis for the new federal law that Congress can act on this year.

Due to gaps in current federal law, states and localities have passed numerous laws in the past several years that are intended to address concerns over improper mortgage lending practices. Unfortunately, this well intended legislation has become an arbitrary and irrational patchwork of state and local laws that is proving to be unduly burdensome and costly. Moreover, federally chartered depositories, as well as some state chartered entities, are being exempted from these state and local laws' requirements. This creates not only an unlevel regulatory playing field for lenders, but also confusion and inconsistent levels of protection for borrowers. Many consumers are not being adequately or equally protected by these measures, and the national housing finance market is being disrupted.

Accordingly, CFAL thinks that the new federal fair lending rules should apply uniformly so that all mortgage lenders are governed by them and that every American borrower receives the same effective protections. And, we want to see both federal and state regulators actively enforce these nationwide standards.

Congress clearly has the power to pass legislation providing for uniform national standards for nonprime lending. We believe that such uniform rules are badly needed and that it is sound public policy for Congress to establish them.

As Committee members know, housing is critically important to our nation. Not only is home ownership "the American dream," and central to the welfare and stability of families and communities, it is vital for our nation's economy. Housing has been an essential economic engine for us. Millions of Americans rely on their home equity to help meet their credit needs, and this is especially important during tighter economic times. We clearly need to ensure that they are not abused in the mortgage lending process, but we also must make certain that "protective" measures do not harm them by limiting their access to needed credit or unnecessarily increasing its cost.

Today's nonprime mortgage industry has truly become an interstate business that is increasingly dominated by large nationwide lenders. The primary reason that this business has grown dramatically in the last decade and has been able to provide credit at relatively low rates to millions of Americans who could not have qualified for conventional financing is the development of a strong secondary market for nonprime loans. Our industry has become much more automated, standardized and efficient, and now securitizes the majority of the loans we originate. About 65% of the roughly $350 Billion in nonprime mortgages originated last year were securitized. Securitization has

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let us bring in vast amounts of capital from the national and global markets. This has both enabled us to make far more credit available and to dramatically decrease the rates we charge borrowers. However, overreaching legislation, regardless of how well-intended, can easily disrupt our capital markets, and have a horrendous adverse impact on both credit availability and borrowers' credit costs. Unbalanced legislation can also hurt not only those who it is primarily intended to protect (e.g., those perceived as being most vulnerable), but it can also injure the many other people who make up the larger part of the overall nonprime market.

Simply put, housing and housing finance is very special and important for both personal and national interests. In order to continue making reasonably priced mortgage credit available to more and more Americans, industry needs clear, consistent and workable lending standards, not a hodgepodge of differing and often inappropriate restrictions. Congress is in the best position to set such standards, and we ask that you do so.

CFAL's members are flexible and open to compromise and reasonable changes to the initial Ney-Lucas proposal as a part of an overall refined bipartisan proposal that provides fair uniform national standards. Among other things, we believe that workable refinements could:

- ✓ Cover many more loans;
- ✓ Further restrict prepayment penalties;
- ✓ Enhance "anti-flipping" requirements;
- ✓ Provide an effective right to cure unintentional violations;
- ✓ Impose very tough penalties for intentional violations;
- ✓ Address assignee liability concerns while ensuring that borrowers have effective recourse when violations occur; and
- ✓ Increase funding for state and federal enforcement efforts and for expanded consumer education and counseling services.

Before outlining how the current federal law should be changed and strengthened, we will explain a few important points about nonprime mortgage lending.

<u>"Nonprime" Lending *Products* vs. "Predatory" Lending *Practices*</u>

Literally millions of Americans are unable to qualify for the lowest rate mortgages available in the so-called "prime"[2] (a/k/a "conventional" or "conforming") market because they have less than perfect credit, <u>or</u> they can not meet some of the other tougher underwriting requirements of the prime market. These borrowers, who generally

[2] The term "prime" in the mortgage context does not refer to the "prime" interest rate that banks charge their best customers for loans; instead, it refers to the lower rate that mortgage lenders charge the lowest risk borrowers who qualify for mortgages that are bought by Fannie Mae and Freddie Mac, the two large housing government sponsored enterprises ("GSEs").

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are considered as posing higher risks, must rely on the so-called "nonprime"[3] market which offers many more customized mortgage *products* to meet customers' varying credit needs. And, as one would reasonably expect, they will pay a somewhat higher rate to offset their greater risk. Substantially higher servicing costs also increase the costs of these loans. It is in this "subprime" or "nonprime" lending segment where most concerns over improper lending practices have been raised.

"Predatory lending" is how many people refer to a variety of lending *practices* that may involve actual or perceived abuse with regard to the sale of nonprime mortgage *products*. Although "predatory lending" is a generic term without precise definition,[4] it has been used to describe these questionable practices because the perpetrator often is said to "prey upon" people who are more likely to be vulnerable or desperate for credit.

Due in part to earlier misleading, but widely circulated media stories, as well as the actual higher level of abusive practices that have occurred in this nonprime part of the market, many parties have unfortunately <u>confused</u> "nonprime" *products* with "predatory" *practices*. Accordingly, some have thought "nonprime lending" literally was the same as "predatory lending", failing to recognize that abuses are *practices* occurring in only a relatively small portion of the overall nonprime *product* market. Although this misperception today is far less prevalent than several years ago, this confusion still clouds the public policy debate.[5]

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[3] Customers who are viewed as posing higher risks, for a variety of reasons---most often because of some defects in their credit records, are considered to be of lesser credit quality or <u>below</u> "prime" and hence are termed "subprime" or less pejoratively, "nonprime" borrowers. *"Banking regulators generally designate a 'subprime' borrower as having one of the following characteristics: two or more 30-day delinquencies in the last 12 months; one or more 60-day delinquencies in the last 24 months; judgment, foreclosure, repossession, or charge off in the prior 24 months; bankruptcy in the last 5 years; a high default probability as measured by a credit score of 660 or below; or a debt service-to-income ratio of 50% or greater. (See OCC Bulletin 2001-6.) Generally, a credit score of 680 qualifies a borrower for consideration for a prime loan, whereas a score below 620 virtually eliminates the possibility."* OCC working paper "Economic Issues in Predatory Lending" (July 30, 2003) (hereinafter cited as "OCC Analysis"), p. 8.

[4] *"There is no single, generally accepted definition of a 'predatory loan.' Indeed, disagreements over the definition of predatory lending have often served to confuse the debate over this issue....The term has been employed loosely by community groups, policymakers and regulators to refer to a wide range of practices....Within the academic literature on predatory lending, economists typically suggest that judgments as to whether a loan's price is high or abusive in the absence of additional concrete economic analysis of underlying risks, costs and other fundamentals, such as the level of demand for credit, are not a valid basis for defining predatory lending. These analysts point out that without a precise definition, many of the published figures on predatory lending abuses become less convincing. There have been a variety of estimates on the societal costs of predatory lending released in the media. However, a closer examination of some of these studies suggests that with even slight definitional or methodological changes, a case could be made for significantly smaller estimates of abusive lending costs."* OCC Analysis, p. 6.

[5] Most consumer advocates now admit that "nonprime lending" should <u>not</u> be equated with "predatory lending", and that legitimate nonprime lending has "democratized" credit and helps millions of Americans who can not qualify for prime mortgage rates meet their credit needs. They claim that they are only trying to stop the abusive practices, not legitimate lending. But, by <u>their actions</u> (i.e., the overly restrictive

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In any case, it is important for policy makers to understand that "nonprime" mortgage lending is, for the most part, not only wholly legitimate and non-abusive, but also critically important for meeting the credit needs of the millions of Americans who are unable to qualify for "prime" mortgage credit. This nonprime market last year amounted to about $350 billion, or about 10% of the overall mortgage market.. Over half of these loans were originated through brokers, and about 65% were sold into the secondary market and securitized.. Today, one of the major reasons for the availability of nonprime credit and its relatively low rates is this securitization process. Securitization has provided the capital from the national and international markets to fund these higher risk loans. This has made mortgage credit much more available and dramatically decreased costs to borrowers. As Federal Reserve Board Governor Gramlich said in a recent speech:

***"One of the important stories of the 1990s was the huge growth in subprime lending. In dollars, subprime mortgage originations grew by a factor of seven over the 1994-2002 period. Since low-income and minority borrowers are much more likely to rely on subprime credits, these groups have benefited disproportionately from the expansion. One visible outcome has been an increase in home ownership rates for low-income and minority borrowers. This represents a welcome extension of home mortgage and other credit to previously underserved groups--a true democratization of credit markets. Millions of low- and moderate-income families now have a chance at owning a home and building wealth. This rapid growth of subprime credit may have created problems..., but there is plenty of good news in this area."***[6]

## "Nonprime" Customers

Contrary to common misperceptions and some parties' erroneous contentions, "nonprime" borrowers are not primarily extremely poor and desperate minorities and senior citizens. In fact, most are in their 40s and 50s, have incomes in the $50,000 - $75,000 range, and are not minorities. In many cases, they again become "prime" customers after experiencing temporary problems because of some adverse life event (e.g., a divorce; job loss; or serious medical illness). In others, they may remain unable to qualify for lower prime rates due to ongoing poor management of their finances, or a tendency to periodically become overextended economically. And in many situations, the borrower may have good credit, but might not meet certain of the other strict underwriting requirements for prime loans (e.g., inadequate income documentation; limited down payment or cash reserves; or the desire to take more cash out in a refinancing than conventional loans allow).

legislative provisions that they are advocating) many advocates indicate that they in fact favor significantly curtailing nonprime credit availability.

[6] Remarks of FRB Governor Edward Gramlich, "*An Update on the Predatory Lending Issue*" (October 9, 2003).

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Although they pose somewhat higher risks than prime rated customers, and sometimes are slower paying, the vast majority of nonprime borrowers pay in a timely manner and they are good customers. Nonprime lenders utilize risk-based pricing and generally charge rates that vary based on the particular customer's risk level.[7] Overall, these customers now are given loan products that have average rates only about 2% higher than prime rates, and many are only a fraction of a percent more. This is a far cry from the 15% to 20% rates many people mistakenly think are charged by most nonprime lenders.

**How HOEPA Works (and Doesn't Work)**

In 1994, Congress recognized that higher risk mortgage borrowers may be more likely to be subject to more coercive or inappropriate lending practices. Accordingly, it then passed the federal Home Ownership and Equity Protection Act ("HOEPA")[8] to provide additional disclosures and substantive protections for certain of the highest cost mortgage loans.

HOEPA applies only to certain "closed-end" loans (a/k/a "HOEPA loans") for refinancing prior loans that "trigger" its provisions by having annual percentage rates ("APRs") above a set level or "points and fees" in excess of a specified percentage of the loan amount.[9] HOEPA does not apply to loans made to purchase a home, or to loans that are structured on an "open-end" basis.

In addition to special warning disclosures, loans subject to HOEPA and its implementing regulations have certain limitations or prohibitions on contract terms or sales practices such as prohibiting: negative amortization, which occurs when the payments made do not reduce the principal balance; increasing interest rates upon default; balloon payments on loans less than 5 years; payments made only to a home improvement contractor from loan proceeds; refinancing within 12 months unless it is in the borrower's "interest"; and making loans without regard to ability to repay on a

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[7] *"[T]he gap between prime and subprime rates is largely explained by differences in risk and servicing costs between the two markets and that subprime rates therefore do not appear to be particularly out of line with underlying risk and cost considerations....The risks and costs associated with subprime lending are significantly higher than those in the prime sector. These factors account for the lion's share of the pricing differential between subprime and prime mortgages. In addition, there are indications that demand for subprime credit is currently outstripping available supply....Therefore, the empirical data do not support the contention that subprime providers are earning economic rents [a/k/a "abnormally high profits"].* OCC Analysis, pp. 13, 16-17.

[8] 15 U.S.C. §§ 1602(aa), 1639. Implementing HOEPA regulations issued by the Federal Reserve Board can be found at 12 C.F.R. § 226.32.

[9] HOEPA's APR triggers are 8% for first liens and 10% for junior liens. The law's points and fees trigger covers loans when the total points and fees (counting only certain specified items) exceeds 8% of the total loan amount, and exceeds an indexed base amount, which is $499 for 2004.

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"pattern and practice" basis. HOEPA also applies expanded assignee liability on covered loans for essentially ALL claims and defenses that the borrower could have raised against the loan originator, including those arising under other statutes and common law.

Although HOEPA does provide some limited safeguards, it now generally is accepted that this federal law has serious defects.

**Advocates' Concerns** - Advocacy groups essentially contend that HOEPA is inadequate because it: (1) applies to only a relatively small portion of higher cost loans; and (2) fails to mandate many substantive protections that are needed to prevent certain abusive practices.

**Industry's Concerns** – Responsible lenders acknowledge that HOEPA does not contain some restrictions that are needed to protect borrowers from certain abusive practices. However, they note that the current statute also is fundamentally flawed because it: (1) includes unclear requirements so lenders may not know what they must do; (2) fails to provide a meaningful "right to cure" unintentional errors; (3) mandates unduly severe penalties; and (4) imposes liability on assignees who could not reasonably know of violations.

**HOEPA's Perverse Effects** - It is now widely recognized that HOEPA has the practical effect of prohibiting borrowers from being able to obtain legitimate nonprime loans instead of simply restricting inappropriate practices. Few lenders make loans that are subject to this statute and there are virtually no secondary market purchasers of the relatively few that are made.[10] The HOEPA loans that are originated are held by portfolio lenders who are likely to charge an even higher price *due not to the borrower's*

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[10] HOEPA poses two types of risk for legitimate lenders. The first is *reputational* (i.e., concerns whereby companies do not want to have their reputations hurt by being associated with loans that may be perceived as "high cost"). More frequently, however, the concern has to do with the *legal* risk that arises from HOEPA's provisions. In practice, given how the current restrictions are worded, the main compliance problem here has little or nothing to do with the limitations on practices such as loan flipping, repayment ability or negative amortization. The problem is that lenders sometimes inadvertently miscalculate whether or not certain loans cross HOEPA's thresholds. This puts them in a "got you" situation as they will not have given the required special HOEPA disclosure notice which has to be given before the loan is made. There is inadequate provision for correction in this case or for most other unintentional mistakes. This means that the lender has violated the law. Penalties include having the loan rescinded at any time during its first three years and being required to refund all fees and payments made by the borrower. Lenders understandably consider this an extremely severe penalty, and many do not think it is worth the risk of making loans in these circumstances. Moreover, HOEPA's sweeping assignee liability provisions mean that secondary market purchasers would likewise be liable for such a miscalculation or other unintended violation about which they neither knew, nor reasonably could have known. Not surprisingly, therefore, there is virtually no secondary market and no securitization of HOEPA loans. And, as noted above, only certain portfolio lenders make these loans, and when they do it generally is at higher rates due not to the borrowers' credit risk, but to the law's risks.

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*credit, but to the higher legal and reputational risks and reduced competition caused by the law itself!*

The bottom line here is that for many of the most needy borrowers, HOEPA's "protections" are providing relatively little real benefit, and it is likely to come at higher costs due to the law's provisions. We seriously question whether this is what Congress intended, and recommend that Congress restructure as well as broaden HOEPA so this perverse effect is not allowed to continue.

**State & Local Initiatives**

Congress has failed to update HOEPA despite widespread acknowledgment among both consumer advocates and industry groups that statutory changes are needed. Not surprisingly therefore, starting in 1999 with North Carolina[11] many states and localities have enacted, or are seriously considering enacting their own laws to prohibit perceived abusive mortgage lending practices.[12]

Some of the enacted and proposed state and local measures include two significant types of loans that are not covered under HOEPA: (1) loans for the purchase of a home (a/k/a "purchase money loans");[13] and (2) open-end loans (e.g., home equity lines of credit where the amount of the loan can go up and down and the borrower is not initially paying off the loan by amortizing the amount by set payments over a set number of months).[14]

In most cases, the state and local initiatives use the federal HOEPA law's threshold / trigger-based model as the general framework on which they overlay their own requirements. In essence, these non-federal laws include "trigger" provisions that provide that nonprime mortgage loans that have annual percentage rates ("APRs") above a certain level or "points and fees" in excess of a specified percentage of the loan amount are subject to the state or local law's requirements.

[11] Many advocates have contended that the NC law should serve as the model for other state laws, or even for a revised federal HOEPA. In that regard, it is worth noting that although some states essentially started with proposals close the NC statute, significant changes have been made elsewhere during the legislative process. Thus, for example, by the time the Georgia Legislature finished with it's work on the first version of that state's law, key NC concepts had "mutated" like a SARS virus---e.g., assignee liability and draconian penalties were added; limitations on the anti-flipping "net benefit" test were removed. Subsequent analysis also has shown the NC law and its impact may be quite a bit different and less favorable than its proponents have asserted. *See* OCC Analysis at pages 18-22; 24-25; and *"Trigger Happy: Enactment And Aftereffects Of North Carolina's 'Predatory Lending' Law,"* by Donald C. Lampe (July 2003) (copy available on CFAL's website).
[12] See the information on CFAL's website regarding various state/local measures at: http://www.cfal.ws/resources.htm .
[13] For example: California; Georgia; Kentucky; New Jersey; New Mexico; New York; North Carolina; South Carolina.
[14] For example: Arkansas; Connecticut; Georgia; New Jersey; New Mexico; New York; North Carolina.

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The more restrictive[15] laws lower the trigger percentages so that they apply to far more loans than the federal law. In particular, the "points and fees" trigger is often significantly lowered by both decreasing the percentage number (e.g., 8% to 5%) and by including more items within the definition of a "fee" so the percentage is exceeded more often (e.g., by counting indirect broker compensation). Thus, in real terms, the percentage reduction is far greater than at first may appear (e.g., 8% to 5% really in effect can be about 3%).

Sometimes, in addition to "high cost" loans, a second category is created (typically called "covered" loans) where certain loans are subject to some, but not all the requirements that apply to the very highest cost loans. The requirements in either case generally include restrictions on additional practices and/or more stringent restrictions than those found in the federal HOEPA law.

What is especially important to understand for present purposes is that NONE of these various state and local laws are the same. Requirements differ widely. Moreover, not only is there a patchwork of different state/local laws, but some quite frankly are too weak, failing to provide adequate protections. Others are excessive, imposing undue requirements and unnecessarily limiting credit availability. And, MOST states do not have laws that effectively plug HOEPA's gaps.

There is no question but that too many older Americans and other nonprime borrowers are subjected to inappropriate practices which should be prevented. There also is no question but that vast numbers of borrowers who are not victims of such practices can become victimized by poorly crafted "protective" legislation that restricts nonprime credit availability or unnecessarily increases its cost.[16] This unfortunately is occurring in all too many cases where state and local "anti-predatory lending" laws are being passed.[17] Legislators therefore need to exercise care to ensure that they do not unintentionally

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[15] One point that should be understood is that the often-made claim that a harsher state law provides "greater consumer protection" than HOEPA or another state's law can be very misleading. Different, "more restrictive," or "tougher" do not necessarily mean "better" or more appropriate protection of borrowers' interests. In fact, the opposite may be true. Sometimes more actual protection is provided. Other times the law is so restrictive that legitimate practices or products are prohibited, and it is against consumers' interests for this to occur. Put another way, "greater protection" labels may be more political advocacy terms used all too often to disguise unbalanced legislation that can hurt, more than help, many borrowers.

[16] As noted in the OCC Analysis, *[t]here is a good deal of empirical evidence to suggest that anti-predatory statutes impede the flow of mortgage credit, especially to low income and higher-risk borrowers, and any reductions in predatory abuses resulting from these measures is probably achieved at the expense of many legitimate loans.*" OCC Analysis, p. 20.

[17] In Georgia, for example, we saw the Legislature pass a very onerous bill that resulted in a literal shutdown of nonprime mortgage lending in that state. After this occurred, Georgia legislators had to pass major amendments to correct some of the worst excesses.

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curtail well-priced, affordable nonprime credit from legitimate, responsible lenders, or make it more expensive. With careful drafting and balanced provisions, however, they can prevent abuses while preserving credit availability.

**Finding Workable Solutions and Setting Balanced Lending Standards**

Congress should act to bridge the gap that exists between what is in HOEPA and what actually is needed to prevent real abuses. It also should refine certain of HOEPA's provisions to make the law more workable. From a technical perspective, we think that it is relatively easy to draft language that effectively prohibits abusive practices while allowing legitimate nonprime lending to continue. The more difficult question, however, has been whether there is enough political will and discipline to adopt appropriate changes. We believe that there is a growing bipartisan willingness to do so. CFAL believes that in most cases, the policy choices are reasonably clear, and thus it should be possible to develop reasonable and workable bipartisan solutions on most issues without great disagreement. Some of the key issues where policy decisions are needed include the following:

## LOAN ORIGINATION-RELATED ISSUES

- **Restricting Prepayment Penalties** – Prepayment penalties are fees that are charged when a borrower pays off a loan earlier than had been agreed when the loan was made. Prepayment penalties are part of a lender's fundamental pricing consideration. Loan pricing is based on having loans on the books long enough to recover various origination costs that are amortized through the planned and agreed upon number of monthly payments. When the loan has a prepayment penalty, either the rate or the points the borrower pays will be lower; if no penalty applies, they will be higher. Thus, by utilizing a prepayment clause a lender can make a loan more affordable for many cash-strapped consumers.

  CFAL believes that there is nothing inappropriate about a prepayment penalty that is properly disclosed and fairly structured, and that borrowers can receive major benefits from such provisions primarily through lower interest rates. However, we also recognize that sometimes prepayment penalty features are not adequately disclosed and explained to customers. In some cases the time duration of the penalty and the penalty amount may be excessive.

  Thus, we support adding further reasonable limitations on prepayment penalties. In crafting such limitations, it is important for Congress to ensure not only that the penalty is not excessive, but also that it is in fact enough to allow the lender to give the borrower who accepts it a significant benefit (e.g., a lower interest rate).

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HOEPA limits prepayment penalties to 5 years. CFAL believes that Congress should further refine these limitations as follows:

1. **Informed Choice** - If a loan is offered with a prepayment penalty, the borrower always should be given the choice of a loan without the penalty, and the penalty should be clearly disclosed and explained to the borrower;
2. **Maximum 3-Year Time Limit** - The time duration of the penalty should be limited to a maximum of 3 years (or 2 years where an adjustable rate product is involved); and
3. **Amount Limit** - The amount of the penalty should be limited to what is allowed by California's law, which is 6 months interest on 80% of the outstanding loan balance.

➢ **Prohibiting "Loan Flipping"** – When a loan is refinanced frequently with the borrower receiving no real benefit and paying loan closing fees and costs that have the effect of stripping away the borrower's equity, loan "flipping" is said to occur. There is no question that flipping has been a significant problem. Consumer advocates and lenders agree that loan "flipping" is abusive and should be prohibited. There is disagreement, however, on how this should be done.

Under implementing regulations issued by the Federal Reserve Board, HOEPA essentially prohibits covered loans from being refinanced by the same lender within 12 months "unless the refinancing is in the borrower's interest."[18] The regulations indicate that this determination is to be made on a case by case basis taking into account relevant circumstances.

Consumer groups usually favor using a differently worded test and applying it to loans for a much longer period of time. In particular, advocates argue that the statutory test should be that the loan should not be made unless there is a *"reasonable tangible net benefit"* to the borrower. This phraseology was first used in the North Carolina "anti-predatory lending" statute.[19]

CFAL's members and other lenders certainly want to stop loan flipping, but feel strongly that there are better ways of crafting an effective restriction than using an undefined "tangible net benefit" test.[20]

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[18] 12 C.F.R. § 226.34(a)(3).

[19] As noted earlier, there has been much discussion, pro and con, regarding the NC statute. Suffice it to say here that experience has shown that no reputable lenders are known to be making loans that are deemed "high cost" under this law. This NC law has significant qualifications on this test (*e.g., a requirement that the flipping violation be "knowing" or "intentional" and a limitation on the ability of a plaintiff's attorney to collect attorney's fees if a reasonable settlement of a dispute is rejected*) that have made the law such that most lenders can continue to do business, albeit not in the "high cost" area.

[20] Some parties favor using the somewhat different approach of simply imposing a very tough but relatively short term (e.g., 1 year) prohibition on refinancing a "high cost" loan with another "high cost" loan (as is done in H.R. 833). CFAL would find such a restriction workable and believes it would be effective during

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CFAL believes that Congress should recognize that however the flipping test is worded, clear statutory guidance should be given so that lenders can know with reasonable certainty what they are required to do. Providing such guidance is fair to all parties, facilitates compliance and enforcement, and helps avoid unnecessary and costly lawsuits. We suggest that the basic approach for crafting such a test should involve:

(1) choosing the most suitable wording----"*identifiable benefit,*" which is used in California's law and is proving to be workable is significantly clearer than "tangible net benefit," which seems to require some type of unspecified mathematical netting calculation;

(2) regardless of the term used, including NC's key qualifications (i.e., that the flipping be "*knowing or intentional*" and that the awarding of attorney's fees be limited to encourage settlements and discourage lawsuits);

(3) providing a number of specific "safe harbor" examples to give lenders meaningful guidance on what is intended to be an acceptable "benefit"; and

(4) setting a reasonable limit on the length of time the "flipping" restriction applies (e.g., 2 years).

- **Financing Points and Fees** – Many consumer advocates assert that lenders are engaging in a "predatory" practice when they allow customers to borrow the money needed to pay mortgage closing costs and finance these costs as a part of the total loan amount. These advocates contend this has the effect of stripping away the borrower's equity. They argue that nonprime lenders should instead be required to incorporate all closing costs into the loan interest rate.[21]

CFAL's members and other lenders have a fundamental disagreement with these advocates' position, which we consider extreme and against consumers' best interests.[22] Nonprime borrowers rarely have extra cash available to pay closing costs.[23] They are not required to finance their closing costs, but borrowers

its term. However, we recognize that many parties are insisting on a longer term "borrower benefit" test of some type.

[21] In fact, in a joint letter to House Financial Services Committee Chairman Oxley, many of the most active national advocacy groups termed such financing as "the most egregious predatory lending practice." Thus, it appears they are contending that all nonprime lenders are engaging in predatory practices since all such lenders, as far as we know, allow borrowers to finance such costs. The same might be said of most prime lenders who also allow borrowers to finance costs.

[22] It should be remembered that when effective prohibitions are added to prevent loan flipping, "equity stripping" becomes much less of a problem. Borrowers will not be repeatedly refinancing their loans in a short time period so they will not be repeatedly using equity to pay loan closing costs.

[23] There are basically four options facing the consumer: (1) if their credit is adequate, and assuming no prohibition on "indirect" financing is applicable as it is in NJ, they can borrow the cash needed for closing elsewhere---typically at higher cost, unsecured rates *(e.g., a cash advance at a 19.99% APR via an AARP-sponsored credit card)*---and usually have much higher total monthly payments; (2) if they can afford it---and most can not---they can pay a higher rate with higher monthly payments as some consumer groups are

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choose to do so in most cases because they determine that it is in their interest. (Many prime borrowers also choose to finance their closing costs.) Lenders have found that borrowers prefer paying these costs over the term of the mortgage. They want and need lower monthly payments. Having a higher rate with closing costs included as some have suggested would mean higher monthly payments, making mortgage credit much less affordable.

We support requiring a disclosure that financing points and fees is optional, but CFAL believes that most legislators will agree that borrowers, both prime and nonprime, should continue to have the right to finance their loan closing costs. At most, some reasonable limitation on the amount of such costs that could be financed (e.g. at least 5%, depending on what is included in the costs definition) might be considered.

- **Mandatory Arbitration** – Many lenders include a clause in the loan terms that any disputes between the borrower and lender must be settled by a mandatory arbitration procedure instead of by court litigation. Consumer groups generally claim that mandatory arbitration clauses are inherently oppressive and deny borrowers their legal rights. They argue that arbitration is unfair and likely to favor the lender over the borrower. Lenders counter by noting that Congress has clearly indicated that arbitration is an acceptable alternative dispute resolution process. They say that arbitration is fair to both parties, and point out that it usually is much quicker and less expensive for borrowers. In addition, lenders point out that mandatory arbitration is allowed and often required in many other types of consumer financial transactions (e.g., real estate sales; securities; credit cards). Lenders also acknowledge that they favor using arbitration to resolve disputes because this approach helps facilitate settlements and prevents costly class action lawsuits.

  CFAL does not believe that requiring arbitration is inherently unfair, but we do support at a minimum imposing certain further statutory restrictions on arbitration clauses to ensure greater fairness to borrowers. In this regard, we think that the so-called "New York rule" is a reasonable solution. This rule would only allow arbitration clauses which require that: (1) the arbitration be conducted in accordance with the standards set forth by a recognized national arbitration association; (2) it must be held in the federal judicial district where the loan property is located; and (3) the lender must pay all reasonable costs of the first 2 days of the arbitration. If Congress should determine, however, to prohibit

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advocating; (3) they can not get the loan and not be able to use their home equity to meet their financial needs, and possibly be forced into bankruptcy and/or foreclosure; or (4) they can sell their house and get their needed cash from their home equity.

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mandatory arbitration, we believe that it is imperative to provide lenders with a more meaningful right to cure unintentional violations.

- **Rulemaking for Additional Prohibitions** – Although this should not be a contentious issue, we want to recommend that Congress ensure that there is an effective administrative procedure in place so that new prohibitions or further refinements can be added as may be needed based on subsequent experience and circumstances. It is highly likely that unscrupulous actors will find creative new ways to take unfair advantage of borrowers. Therefore, we believe that regulators should be able to move promptly to stop such practices without having to wait for new legislative authority. Congress should consider whether the existing Federal Reserve Board rulemaking authority is adequate, or whether a different approach is needed.

## LIABILITY & PENALTIES-RELATED ISSUES

- **Meaningful Right to Cure** – One of HOEPA's biggest flaws is its failure to provide a meaningful right to cure unintentional mistakes. CFAL believes that it is absolutely essential that such a right be provided for in any amendments. We recommend that lenders be given at least 90 days to correct an error after they learn of it either through their own actions or from the borrower or other persons such as a regulatory audit. Correction should entail whatever is required to make the borrower whole, including full restitution and payment for any loss or actual damages caused by the error. This right to cure should not apply, however, if the violation is considered willful or intentional.

- **Penalties** – Consumer groups have repeatedly sought to have state and local legislators adopt very onerous penalties for violations of "anti-predatory lending" laws. Also, consumer advocates have sought to allow "predatory lending" claims to be raised as defenses in every foreclosure action.

  We believe that many of the penalties advocated by consumer groups are excessive and unfair. In fact, having extremely severe penalties is one of the reasons that many lenders have been reluctant or even unwilling to continue making loans in Georgia earlier and as we are starting to see now in New Jersey and elsewhere. When onerous or unclear requirements are coupled with excessive penalties, the legal risks rise to unacceptable levels. Not only does this tend to limit credit availability, but it also causes higher prices for borrowers to offset the undue legal risks. We also are understandably concerned that legitimate foreclosure proceedings will be stymied by an open-ended provision allowing "predatory lending" claims to be raised in every foreclosure proceeding.

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CFAL's members will support strong penalties, but we do ask that all penalties be graduated or proportional to the harm done, as well as to whether the violation was willful or intentional. Very tough monetary penalties should apply to willful violators who are the truly "bad actors". We would welcome the opportunity to work on a bipartisan basis with legislators to develop balanced, proportional penalty provisions.

➢ **Assignee Liability** – Consumer advocates have contended that traditional "holder in due course" type protection should be ended and that all assignees of nonprime loans should be strictly liable for any violations that occurred before the assignee obtained the loan even if the assignee had no knowledge of, or even could not reasonably have known of, the violation. These advocates contend that the secondary market is providing the funding for predatory loans, and that strict assignee liability is needed to cut off such funding. They maintain that such liability will force secondary market purchasers[24] to better police those from whom they buy loans.

Nonprime lenders and secondary market purchasers are strongly opposed to extending such strict liability to all nonprime loans.[25] We question whether it is appropriate to impose any liability on assignees, other than perhaps larger lenders who buy loans from smaller correspondent lenders. Today, only larger lenders with substantial resources are able to securitize loans. They clearly have the resources to ensure the borrower receives a full recovery of any damages. Moreover, they are in the best position to police the practices of their brokers, loan officers and correspondents.

The North Carolina law, which consumer advocates tout, does not include such strict assignee liability provisions. In contrast, imposing broad assignee liability in Georgia resulted in secondary market purchasers refusing to buy loans and loan rating agencies like Standard & Poor's and Moody's being unable to rate loans. This resulted in Georgia's nonprime lending market being shut down, and

[24] They typically do not mention that such purchasers include pension funds and other bond buyers who will be very reluctant, and most often unwilling to continue making capital available for mortgage loans if such liability is imposed.

[25] As observed earlier, HOEPA currently applies such liability to "high cost" loans and that this is a major reason that most lenders do not make such loans. (HOEPA's assignee liability is so broad that it essentially makes the assignee liable for any violation of any law committed by the originator, even if the violation is not a violation of HOEPA.) Currently, virtually no private secondary market purchasers, including Fannie Mae and Freddie Mac, will buy such "high cost" loans. The relatively few such loans that exist appear to be ones made by retail lenders who keep them in their own portfolios. The cost of such loans, when available, also is generally significantly higher for the borrower not because of their credit risk, but because of the higher legal risk and reduced competition caused by the law. This is one of the perverse effects of the current statute.

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Georgia's legislature taking emergency action to address this unintended consequence of its earlier legislative actions

Legislators must be extremely cautious in making changes that upset secondary market dynamics because unfettered access to the capital markets is largely responsible for having dramatically increased nonprime credit availability and for lowering costs for millions of Americans. Lenders and secondary market purchasers believe that it is very unfair to impose liability when there is no reasonable way that the loan or securities holder could have known of the violation. In any case, we feel that liability generally should apply only if the assignee by reasonable due diligence knew or should have known of a violation of the law based on what is evident on the face of the loan documents.

CFAL's members include many of the largest securitizers in the nonprime mortgage business. We again want to work closely with Senators, as well as Wall Street investment bankers, the rating agencies, the GSEs and other key players in the securitization process to develop workable provisions on this liability issue so that mortgage capital.

## SCOPE OF HOEPA'S COVERAGE

- **Expanding to Cover Other Types of Nonprime Loans** – At the present time HOEPA only applies to certain "closed-end" loans involving a refinancing of an existing mortgage. It does not cover either "open-end" loans, such as home equity lines of credit, or loans for the purchase of a home. A number of state measures have applied restrictions to such open-end and/or purchase money loans.[26] CFAL believes that it would be appropriate to expand the federal law so that its protections cover both of these types of loans. We feel that this is both proper policy and consistent with our support for uniform national lending standards for nonprime lending, which will be discussed further momentarily.

- **Expanding Coverage by Changing HOEPA's APR and "Points and Fees" Triggers** – As noted earlier, HOEPA currently only applies to a relatively small part of the nonprime market---i.e., certain of the highest cost loans where the APR or points and fees exceed specified threshold levels. Advocacy groups have consistently sought to extend coverage at both the federal and state levels by significantly lowering the trigger levels. We are unwilling to support such reductions unless HOEPA's current flaws are corrected <u>and</u> any new restrictions are truly balanced and workable. Our opposition is based on the very real concern that doing so would expose lenders and secondary market participants to unacceptable risk levels on far more loans. This would destroy large portions of

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[26] Please refer back to footnotes 13 and 14.

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the nonprime market, greatly limiting borrowers' credit access and increasing their costs. However, if HOEPA is restructured in a reasonable and fair manner, we are quite open to discussing expanding it to cover more nonprime loans.

## UNIFORMITY & ENFORCEMENT-RELATED ISSUES

- **National Uniformity and Enforcement** – The irrational patchwork of state and local "anti-predatory lending" laws that is developing is not workable. None of these laws is the same, and requirements vary greatly. Provisions are often arbitrary, unclear and totally impractical for lenders to implement. Well intended, but poorly crafted state and local requirements are having unintended negative consequences for borrowers. Most states also still have no effective borrower safeguards in place.

Today, nonprime lending is clearly a nationwide, interstate business that is highly dependent on the national capital markets in order to make affordable mortgages available to the millions of Americans who can not qualify for conventional financing. We need consistent, nationwide requirements to be able to do so effectively and efficiently. Senior citizens and other borrowers need protections not only from abusive lending practices, but also from differing, poorly crafted state and local laws that limit their access to affordable credit and force them to pay more.

CFAL therefore strongly supports prompt Congressional action to provide clear, effective and workable uniform national fair lending standards[27] for nonprime mortgage loans. These standards should provide equal protections for all Americans and apply to all mortgage originators, regardless of how they may be structured or chartered.

We also believe that state officials should have an active role along with federal authorities in enforcing these national standards. In that regard, we believe that Congress should consider having nonprime lenders pay a reasonable fee into a central fund when they originate a mortgage. This fee could be used as a funding mechanism for state and community based education programs and quite possibly for state enforcement efforts.

* * *

CFAL is confident that Congress can fairly resolve these issues and pass effective national standards for fair lending that protect nonprime borrowers

[27] Both Fannie Mae and Freddie Mac also have now expressed their support for uniform national standards, as have many other lenders and trade groups.

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without unduly limiting their access to affordable mortgage credit. We look forward to working constructively with Committee members and all other interested parties to help enact such legislation.[28]

[28] *Please contact CFAL's Executive Director, Wright H. Andrews (202-742-4245,. wandrews@butera-andrews.com), if you have questions or would like further information about CFAL's positions.*

TESTIMONY SUBMITTED BY THE:

# CONSUMER MORTGAGE COALITION

## BEFORE THE

## SPECIAL COMMITTEE ON AGING

## UNITED STATES SENATE

**"Predatory Lending:**

**Are Federal Agencies Protecting Older Americans**

**From Financial Heartbreak"**

February 24, 2004

The Consumer Mortgage Coalition ("CMC"), a trade association of national residential mortgage lenders, servicers, and service providers 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 policy makers 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***
- ***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 multi-tiered, 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 procedures 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

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[1] The Mortgage Reform Working Group ("MRWG") was an ad-hoc group, comprised of over 20 trade associations and consumer advocate organizations, that was organized at the request of former Congressman Rick Lazio (R-NY) with the goal of reaching a compromise on a comprehensive mortgage reform proposal that would streamline and simplify the mortgage process for consumers

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.

***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

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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.

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.

The Administration has proposed a rule that, if implemented correctly, would give consumers the option to choose and the industry an option to offer a guaranteed mortgage package. When modified appropriately, the rule will do what HUD intended it to do – vastly simplify the process by which consumers shop for and obtain mortgage loans in this country and significantly reduce closing costs. While the proposed rule has proven to be controversial, the benefits of the Guaranteed Mortgage Package ("GMP"), *if structured correctly*, are extraordinary.

The Administration should be applauded for taking the lead in advancing an initiative that will result in consumer savings of $10.3 billion per year – almost $1,000 per mortgage loan -- by removing outdated regulatory barriers. The Administration's RESPA reform proposal will expand homeownership opportunities more than any other proposal that we have seen in years. In fact, it is the most significant pro-consumer regulatory proposal from any agency ever to have been proposed.

The savings to consumers come from two effects of the proposed rule. First, the elimination of Section 8 for packagers allows, for the first time, for leverage and competition to be brought to the selection and pricing of ancillary settlement services. Today, Section 8 of RESPA effectively prevents volume discounts, average cost pricing, or other cost-reducing arrangements to be negotiated between loan originators and settlement service providers. Removing this regulatory barrier opens this who process up to competition, which will force prices down.

Second, bundling of settlement costs into a single guaranteed number makes it easier and much more likely for consumers to comparison-shop based on this number (together with interest rate and points). Borrowers today shop on interest rate and points, but not settlement costs. These costs, which are delineated in a laundry list of items seldom understood, are viewed as an unpleasant, but unavoidable, fact of life. The "packaging" approach will change that. With just a few key figures to shop with, borrowers will be better informed, shop better and reach better deals.[2]

[2] It should be noted that services are required as a condition for the borrower to obtain the loan. They are not services that are performed for the benefit of the borrower, but are rather services that are performed for the lender and investor to ensure that their collateral interests are protected.

As mentioned earlier, the Administration's GMP proposal will also help prevent predatory lending. Under the packaging approach, consumers will receive relevant, guaranteed information about a loan early in the process to promote comparison-shopping. Moreover, simplifying comparisons will increase the likelihood of consumer understanding of their mortgage loan and make more difficult the deception that characterizes abusive loans. Consumers will no longer face unwelcome surprises at the closing table of increased or hidden fees. Borrowers will be empowered under packaging to make logical, informed choices about settlement fees and costs in the context of a single number that is guaranteed, and loan originators and packagers will have to abide by their guarantee.

The details of any final rule, however, are key to ensuring that the rule will actually achieve the goals of reducing costs and streamlining and simplifying the mortgage process, while simultaneously reducing the liability and needless litigation that continues to plague the industry.

- ***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 twelve 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 three 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% 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.

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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

- ***Uniform, National Rules*** 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.

  A uniform set of national rules 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 example, the City of Philadelphia enacted anti-predatory-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 support a single, nationwide standard that cannot be undermined by myriad local initiatives.

  In recent years, the Office of the Comptroller of the Currency has taken a leading role in developing detailed regulatory guidance aimed at both predatory lending and unfair and deceptive acts and practices.[3] Indeed, the OCC issued a final rule recently that directly addresses these issues by creating an anti-predatory lending standard for real estate and consumer lending and codifying the applicability of the FTC Act to national banks and their subsidiaries in connection with real estate and consumer lending activities.[4] These guidelines serve as an excellent basis for uniform standards to protect consumers.

* * *

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.

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[3] See OCC Advisory Letter, 2003-2, Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices (Feb. 21, 2003); OCC Advisory Letter 2003-3, Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans (Feb. 21, 2003).

[4] See Bank Activities and Operations, Real Estate Lending and Appraisals, 69 Fed. Reg. at 1911 (Jan. 13, 2004).

## DESCRIPTION OF SUBPRIME MARKET

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."[5]

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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[5] 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.[6]

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.[7]

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.

[6] An April 2000 SMR Research study of 1998 HMDA data.

[7] 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"

In this section we discuss a number of practices that have been attacked as "predatory."[8] 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."[9]

***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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[8] 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).

[9] 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.[10] 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.[11] Misleading consumers about credit insurance would also violate the Federal Trade Commission Act and similar state laws.

Voluntary credit insurance helps to address an unmet demand for life and disability insurance. About 25% of all U.S. households do not have 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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[10] *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).

[11] 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. The CMC members are no longer offering this product. Other large lenders, however, have 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.[12]

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 . . .')."[13]

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.

Dispute Resolution Process

Recently a number of investors, including Fannie Mae, have indicated their refusal or hesitancy to purchase loans having mandatory arbitration provisions. This certainly stems in part from certain state high cost loan laws that regard such provisions are potentially predatory. While we disagree with that premise, a potential alternative provision that would provide immediate relief to consumers and some protection against the frenzy of class actions for lenders is a dispute resolution provision, that would part of the loan contract, that would require the borrower to notify the lender (or servicer) of a compliance defect in a loan, such as an incorrect disclosure or impermissible term, prior to instituting any action, and giving the lender or servicer an opportunity to correct the

[12] *Green Tree Fin. Corp. v. Randolph*, 531 U.S. 79, 90, 121 S.Ct. 513, 521 (2000).

[13] *Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265, 280, 115 S.Ct. 834, 843 (1995).

error. For its part, the lender (or servicer) would be incented to review the loan file to correct defects on its own.

For example, the provision could provide for a 60-day cure period for disclosure defects, including inaccurate disclosures, missing disclosures or late disclosures. For inaccurate disclosures, there could be a minimum adjustment amount of $200 for an error less than $200, and an adjustment of the actual amount of the error plus $50 for an error of $200 or more. For missing disclosures that the lender provides within 60 days after the closing, the account would be adjusted by $250. If the disclosure is provided within one year after the closing, the lender would adjust the account by $500. For late disclosures, if discovered within 60 days after the closing, the lender must adjust the account by $25. If the late disclosure is discovered within one year after the closing, the lender must adjust the account by $50.

If the lender fails to cure a defect brought to its attention and the borrower prevails in an action against the lender, the lender would owe a minimum adjustment amount of $2,000 plus attorneys' fees. If the lender has failed to provide the notice of right of rescission, the right to rescind would be extended to one year from the closing date. If the defect is willful and knowing, the borrower may bring an action, and if successful, the lender would have to make a minimum adjustment of $5,000 plus attorneys' fees.

If adopted as part of the loan contract, these remedies would benefit both consumers and lenders. Consumers would receive immediate compensation for compliance defects, without having to pursue an action, and in most cases, would receive damages in amounts exceeding the actual amount of the error. In addition, because of the incentive to the lender of responding quickly to the consumer, the consumer will be made whole in a matter of months, rather than years.

The lender would benefit from these provisions by not having to undergo the great expense of defending class action lawsuits over relatively minor defects. Giving the consumers the incentive to bring errors directly to the attention of the lender also offers the lender an additional means to monitor its disclosure compliance procedures and improve the accuracy of the service it offers future borrowers.

Finally, both consumers and lenders would benefit ultimately from implementation of such a provision because the reduction in lawsuits would decrease overall costs to lenders and thus allow them to offer loans at lower rates.

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 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

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, a real estate broker or home improvement contractor refers the borrower. 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.[14] All or part of the application fee may be used to pay for the credit report and appraisal. Compensation paid

[14] 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.[15] 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.[16] 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.

<u>Compensation to Lenders/Servicers</u>

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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[15] 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.

[16] 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.

<u>Compensation to Investors (Portfolio Lenders or Secondary Market Investors)</u>

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.

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United States General Accounting Office

GAO

Report to the Chairman and Ranking Minority Member, Special Committee on Aging, U.S. Senate

January 2004

# CONSUMER PROTECTION

# Federal and State Agencies Face Challenges in Combating Predatory Lending

GAO

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GAO-04-280

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**Highlights**

Highlights of GAO-04-280, a report to the Chairman and Ranking Minority Member, Special Committee on Aging, U.S. Senate

### Why GAO Did This Study

While there is no universally accepted definition, the term "predatory lending" is used to characterize a range of practices, including deception, fraud, or manipulation, that a mortgage broker or lender may use to make a loan with terms that are disadvantageous to the borrower. No comprehensive data are available on the extent of these practices, but they appear most likely to occur among subprime mortgages—those made to borrowers with impaired credit or limited incomes. GAO was asked to examine actions taken by federal agencies and states to combat predatory lending; the roles played by the secondary market and by consumer education, mortgage counseling, and loan disclosure requirements; and the impact of predatory lending on the elderly.

### What GAO Recommends

GAO suggests that Congress consider providing the Federal Reserve Board with the authority to routinely monitor and, as necessary, examine nonbank mortgage lending subsidiaries of financial and bank holding companies to ensure compliance with federal consumer protection laws applicable to predatory lending. Congress should also consider giving the Board specific authority to initiate enforcement actions under those laws against these nonbank mortgage lending subsidiaries.

www.gao.gov/cgi-bin/getrpt?GAO-04-280.

To view the full product, including the scope and methodology, click on the link above. For more information, contact David G. Wood at 202-512-8678 or woodd@gao.gov.

January 2004

# CONSUMER PROTECTION

## Federal and State Agencies Face Challenges in Combating Predatory Lending

### What GAO Found

While only one federal law—the Home Ownership and Equity Protection Act—is specifically designed to combat predatory lending, federal agencies have taken actions, sometimes jointly, under various federal consumer protection laws. The Federal Trade Commission (FTC) has played the most prominent enforcement role, filing 19 complaints and reaching multimillion dollar settlements. The Departments of Justice and Housing and Urban Development have also entered into predatory lending-related settlements, using laws such as the Fair Housing Act and the Real Estate Settlement Procedures Act. Federal banking regulators, including the Federal Reserve Board, report little evidence of predatory lending by the institutions they supervise. However, the nonbank subsidiaries of financial and bank holding companies—financial institutions which account for a significant portion of subprime mortgages—are subject to less federal supervision. While FTC is the primary federal enforcer of consumer protection laws for these entities, it is a law enforcement agency that conducts targeted investigations. In contrast, the Board is well equipped to routinely monitor and examine these entities and, thus, potentially deter predatory lending activities, but has not done so because its authority in this regard is less clear.

As of January 2004, 25 states, as well as several localities, had passed laws to address predatory lending, often by restricting the terms or provisions of certain high-cost loans; however, federal banking regulators have preempted some state laws for the institutions they supervise. Also, some states have strengthened their regulation and licensing of mortgage lenders and brokers.

The secondary market—where mortgage loans and mortgage-backed securities are bought and sold—benefits borrowers by expanding credit, but may facilitate predatory lending by allowing unscrupulous lenders to quickly sell off loans with predatory terms. In part to avoid certain risks, secondary market participants perform varying degrees of "due diligence" to screen out loans with predatory terms, but may be unable to identify all such loans.

GAO's review of literature and interviews with consumer and federal officials suggest that consumer education, mortgage counseling, and loan disclosure requirements are useful, but may be of limited effectiveness in reducing predatory lending. A variety of factors limit their effectiveness, including the complexity of mortgage transactions, difficulties in reaching target audiences, and counselors' inability to review loan documents.

While there are no comprehensive data, federal, state, and consumer advocacy officials report that the elderly have disproportionately been victims of predatory lending. According to these officials and relevant studies, older consumers may be targeted by predatory lenders because, among other things, they are more likely to have substantial home equity and may have physical or cognitive impairments that make them more vulnerable to an unscrupulous mortgage lender or broker.

GAO
Accountability • Integrity • Reliability
United States General Accounting Office
Washington, D.C. 20548

January 30, 2004

The Honorable Larry E. Craig
Chairman
The Honorable John Breaux
Ranking Minority Member
Special Committee on Aging
United States Senate

This report responds to your request that we evaluate issues related to predatory home mortgage lending. As you requested, this report reviews (1) federal laws related to predatory lending and federal agencies' efforts to enforce them, (2) actions taken by states to address predatory lending, (3) the secondary market's role in facilitating or inhibiting predatory lending, (4) how consumer education, mortgage counseling, and loan disclosures may deter predatory lending, and (5) the relationship between predatory lending activities and elderly consumers. This report includes a Matter for Congressional Consideration.

As agreed with your office, we plan no further distribution of this report until 30 days from its issuance date unless you publicly release its contents sooner. We will then send copies of this report to the Chairman and Ranking Minority Member of the Senate Committee on Banking, Housing, and Urban Affairs; the Chairman and Ranking Minority Member of the House Committee on Financial Services; the Secretary of the Department of Housing and Urban Development; the Secretary of the Department of the Treasury; the Chairman of the Federal Trade Commission; the Chairman of the Board of Governors of the Federal Reserve System; the Chairman of the Federal Deposit Insurance Corporation; the Comptroller of the Currency; the Director of the Office of Thrift Supervision; the Chairman of the National Credit Union Administration; and other interested parties. Copies will also be made available to others upon request. In addition, this report will be available at no charge on the GAO Web site at http://www.gao.gov.

This report was prepared under the direction of Harry Medina, Assistant Director. Please contact Mr. Medina at (415) 904-2000 or me at (202) 512-8678 if you or your staff have any questions about this report. Major contributors to this report are listed in appendix VI.

David G. Wood

David G. Wood
Director, Financial Markets
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# Executive Summary

## Purpose

Each year, millions of American consumers take out mortgage loans through mortgage brokers or lenders to purchase homes or refinance existing mortgage loans. While the majority of these transactions are legitimate and ultimately benefit borrowers, some have been found to be "predatory"—that is, to contain terms and conditions that ultimately harm borrowers. Loans with these features, often targeted at the elderly, minorities, and low-income homeowners, can strip borrowers of home equity built up over decades and cause them to lose their homes.

The Chair and Ranking Minority Member of the Senate Special Committee on Aging asked GAO to examine the efforts under way to combat predatory lending. GAO reviewed (1) federal laws related to predatory lending and federal agencies' efforts to enforce them, (2) actions taken by states to address predatory lending, (3) the secondary market's role in facilitating or inhibiting predatory lending, (4) how consumer education, mortgage counseling, and loan disclosures may deter predatory lending, and (5) the relationship between predatory lending activities and elderly consumers. The scope of this work was limited to home mortgage lending and did not include other forms of consumer loans. To address these objectives, GAO reviewed data and interviewed officials from federal, state, and local agencies and from industry and consumer advocacy groups; examined federal, state, and local laws; and reviewed relevant literature. At GAO's request, federal agencies identified enforcement or other actions they have taken to address predatory lending. GAO also obtained data from publicly available databases; the data were analyzed and found to be sufficiently reliable for this report. Chapter 1 provides the details of the scope and methodology of this report. The work was conducted between January 2003 and January 2004 in accordance with generally accepted government auditing standards.

## Background

While there is no uniformly accepted definition of predatory lending, a number of practices are widely acknowledged to be predatory. These include, among other things, charging excessive fees and interest rates, lending without regard to borrowers' ability to repay, refinancing borrowers' loans repeatedly over a short period of time without any economic gain for the borrower, and committing outright fraud or deception—for example, falsifying documents or intentionally misinforming borrowers about the terms of a loan.[1] These types of practices offer lenders that originate predatory loans potentially high returns even if borrowers default, since many of these loans require excessive up-front fees. No comprehensive data are available on the incidence of these practices, but banking regulators, consumer advocates, and industry participants generally agree that predatory loans are most likely to occur in the market for "subprime" loans. The subprime market serves borrowers who have limited incomes or poor or no credit histories, in contrast with the prime market, which encompasses traditional lenders and borrowers with credit histories that put them at low risk of default. Originators of subprime loans most often are mortgage and consumer finance companies but can also be banks, thrifts, and other institutions.

Serious data limitations make the extent of predatory lending difficult to determine. However, there have been a number of major settlements resulting from government enforcement actions or private party lawsuits in the last 5 years that have accused lenders of abusive practices affecting large numbers of borrowers. For example, in October 2002, Household International, a large home mortgage lender, agreed to pay up to $484 million to homeowners to settle states' allegations that it used unfair and deceptive lending practices to make mortgage loans with excessive interest and fees. In addition, the rate of foreclosures of subprime loans has increased substantially since 1990, far exceeding the rate of increase for subprime originations. Some consumer groups and industry observers have attributed this development, at least in part, to an increase in abusive lending, particularly of loans made without regard to borrowers' ability to repay. Additionally, groups such as legal services agencies have reported seeing an ever-greater number of consumers, particularly the elderly and minorities, who are in danger of losing their homes as a result of predatory lending practices.

## Results in Brief

Federal agencies have addressed predatory lending under a variety of federal laws, including the Home Ownership and Equity Protection Act (HOEPA), which was an amendment to the Truth in Lending Act (TILA) designed specifically to combat predatory lending, and other consumer protection laws such as the Federal Trade Commission Act (FTC Act), TILA generally, and the Real Estate Settlement Procedures Act (RESPA). The

[1]Throughout this report, the terms "predatory lending" and "abusive lending" are used to refer to such practices.

Federal Trade Commission (FTC) has played a prominent role because it is responsible for implementing and enforcing certain federal laws among lending institutions that are not supervised by federal banking regulators. As of December 2003, FTC reported that it had taken 19 enforcement actions against mortgage lenders and brokers for predatory practices, including some actions that have resulted in multimillion dollar settlements. The Department of Housing and Urban Development's (HUD) enforcement activities related to abusive lending have focused on criminal fraud in its Federal Housing Administration (FHA) loan insurance program. The federal banking regulators—the Federal Deposit Insurance Corporation (FDIC), Board of Governors of the Federal Reserve System (the Board), Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS), and National Credit Union Administration (NCUA)—report little evidence of predatory lending by the depository institutions that they supervise. However, concerns exist about nonbank mortgage lending companies that are owned by financial or bank holding companies, which have been involved in several notable enforcement actions involving allegations of abusive lending practices. While FTC has clear authority to conduct investigations and enforce consumer protection laws among these nonbank mortgage lending companies, as a law enforcement agency its role is to investigate possible violations rather than to act as a supervisory agency with routine monitoring and examination responsibilities. The Board may be better equipped to monitor and examine these subsidiaries' compliance with federal consumer protection laws and thus to deter predatory lending, but it does not have clear authority to do so.

According to a database that tracks state and local legislation, 25 states, 11 localities, and the District of Columbia have passed their own laws addressing predatory lending.[2] While these laws vary, most of them restrict the terms or provisions of mortgage loans originated within their jurisdictions. In addition, some states have strengthened the regulation and licensing of mortgage lenders and brokers, and state law enforcement agencies and banking regulators have taken a number of enforcement actions under state consumer protection and banking laws. Some federal regulators have asserted that federal law preempts some state predatory

[2]Information relating to state and local laws and their provisions is from a database maintained by Butera & Andrews, a Washington, D.C., law firm that tracks predatory lending legislation, and is current as of January 9, 2004. These laws only include state and local laws that placed actual restrictions on lending. For example, they do not include local ordinances that consisted solely of a resolution that condemned predatory lending.

lending laws for the institutions they regulate, stating that federally chartered lending institutions should be required to comply with a single uniform set of national regulations. Many state officials and consumer advocates, however, maintain that federal preemption interferes with the states' ability to protect consumers.

The secondary market for mortgage loans—which allows lenders and investors to sell and buy mortgages and mortgage-backed securities—provides lenders with an additional source of liquidity and may benefit borrowers by increasing access to credit and lowering interest rates. But the secondary market may also inadvertently serve to facilitate predatory lending, both by providing a source of funds for unscrupulous originators to quickly sell off loans with predatory terms and by reducing incentives for these originators to ensure that borrowers can repay their loans. Secondary market participants may use varying degrees of "due diligence"—a review and appraisal of legal and financial information—to avoid purchasing loans with abusive terms. Fannie Mae and Freddie Mac—which are relatively recent entrants in the subprime market—have due diligence processes that are designed, in part, to avoid purchasing loans that may have been harmful to consumers. Other firms may use due diligence not necessarily to avoid loans that may have harmed consumers but to avoid loans that are not in compliance with applicable law or that present undue financial or reputation risks. Some states have passed laws making secondary market buyers liable for violations by loan originators, although such laws may have the unintended consequence of reducing the availability of legitimate credit to consumers.

A number of federal, state, nonprofit, and industry-sponsored organizations offer consumer education initiatives designed to deter predatory lending by, among other things, providing information about predatory practices and working to improve consumers' overall financial literacy. GAO's review of literature and interviews with consumer and federal officials suggest that while tools such as consumer education, mortgage counseling, and disclosures are useful, they may be of limited effectiveness in reducing predatory lending. For instance, consumer education is hampered by the complexity of mortgage transactions and the difficulty of reaching the target audience. Similarly, unreceptive consumers and counselors' lack of access to relevant loan documents can hamper the effectiveness of mortgage counseling efforts, while the sheer volume of mortgage originations each year makes providing universal counseling difficult. And while efforts are under way to improve the federally required disclosures associated with mortgage loans, the complexity of mortgage transactions also hinders these efforts, especially given the lack of financial sophistication among many borrowers who are targeted by predatory lenders.

While there are no comprehensive data, government officials and consumer advocacy organizations have reported that elderly consumers have been disproportionately targeted and victimized by predatory lenders. According to these officials and organizations, elderly consumers appear to be favored targets for several reasons—for example, because they may have substantial equity in their homes or live on limited incomes that make them susceptible to offers for quick access to cash. Further, some seniors have cognitive or physical impairments such as poor eyesight, hearing, or mobility that may limit their ability to access competitive sources of credit. Most consumer financial education efforts seek to serve the general consumer population, but a few education initiatives have focused specifically on predatory lending and the elderly. Most legal assistance related to predatory lending aims at assisting the general population of consumers, although some is focused on elderly consumers in particular.

## Principal Findings

### Federal Agencies Have Taken Enforcement and Other Actions to Address Predatory Lending, but Face Challenges

Federal agencies and regulators have used a number of federal laws to combat predatory lending practices. Among the most frequently used laws—HOEPA, the FTC Act, TILA, and RESPA—only HOEPA was specifically designed to address predatory lending. Enacted in 1994, HOEPA places restrictions on certain high-cost loans, including limits on prepayment penalties and balloon payments and prohibitions against negative amortization. However, HOEPA covers only loans that exceed certain rate or fee triggers, and although comprehensive data are lacking, it appears that HOEPA covers only a limited portion of all subprime loans. The FTC Act, enacted in 1914 and amended on numerous occasions, authorizes FTC to prohibit and take action against unfair or deceptive acts or practices in or affecting commerce. TILA and RESPA are designed in part to provide consumers with accurate information about the cost of credit.

Other federal laws that have been used to address predatory lending practices include criminal fraud statutes that prohibit certain types of fraud sometimes used in abusive lending schemes, such as forgery and false statements. Also, the Fair Housing Act and Equal Credit Opportunity Act—which prohibit discrimination in housing-related transactions and the extension of credit, respectively—have been used in cases against abusive lenders that have targeted certain protected groups.

Using these or other authorities, federal agencies have taken a number of enforcement actions and other steps, such as issuing guidance and revising regulations.

- Among federal agencies, FTC has a prominent role in combating predatory lending because of its responsibilities in implementing and enforcing certain federal laws among lending institutions that are not depository institutions supervised by federal banking regulators. FTC has reported that it has filed 19 complaints—17 since 1998—alleging deceptive or other illegal practices by mortgage lenders or brokers and that some actions have resulted in multimillion dollar settlements. For example, in 2002 FTC settled a complaint against a lender charged with engaging in systematic and widespread deceptive and abusive lending practices. According to FTC staff, close to 1 million borrowers will receive about $240 million in restitution under the settlement.

- DOJ, which is responsible for enforcing certain federal civil rights laws, has filed an enforcement action on behalf of the FTC and identified two additional enforcement actions it has taken that are related to predatory mortgage lending practices. The statutes DOJ enforces only address predatory lending practices when they are alleged to be discriminatory.

- HUD has undertaken enforcement activities related to abusive lending that primarily focus on reducing losses to the FHA insurance fund, most notably violations of criminal fraud statutes and FHA regulations through "property flipping" schemes, which in some cases can harm borrowers by leaving them with mortgage loans that may far exceed the value of their homes.[3] HUD has also taken three enforcement actions in abusive mortgage lending cases for violations of RESPA's prohibitions on certain types of fees.

[3]HUD's FHA mortgage insurance program makes loans more readily available for low- and moderate-income families by providing mortgage insurance to purchase or refinance a home. Lending institutions such as mortgage companies and banks fund the loans.

- Federal banking regulators have stated that their monitoring and examination activities have uncovered little evidence of predatory lending in federally regulated depository institutions. Four of the five federal banking regulators reported taking no formal enforcement actions involving predatory mortgage lending against the institutions they regulate, while the fifth—OCC—reported that it has taken one formal enforcement action against a bank engaged in abusive mortgage lending. Regulators noted that they have taken informal enforcement actions to address questionable practices raised during the examination process and required their institutions to take corrective action.
- The banking regulators have also issued guidance to the institutions they supervise on avoiding direct or indirect involvement in predatory lending. In addition, the Board has made changes to its regulations implementing HOEPA that, among other things, increase the number of loans HOEPA covers. The Board also made changes to its regulations implementing the Home Mortgage Disclosure Act that make it easier to analyze potential patterns of predatory lending.

Federal agencies and banking regulators have coordinated their efforts to address predatory lending on certain occasions through participation in interagency working groups and through joint enforcement actions. For example, FTC, DOJ, and HUD coordinated to take an enforcement action against Delta Funding Corporation, with each agency investigating and bringing actions for violations of the laws within its jurisdiction.

Issues related to federal oversight and regulation of certain nonbank mortgage lenders may challenge efforts to combat predatory lending. Nonbank mortgage lending companies owned by financial or bank holding companies (nonbank mortgage lending subsidiaries), such as finance and mortgage companies, account for an estimated 24 percent of subprime loan orginations, according to HUD, and some have been the target of notable federal and state enforcement actions involving allegations of abusive lending.[4] FTC is the primary federal enforcer of consumer protection laws for these nonbank subsidiaries, but it is a law enforcement rather than supervisory agency. Thus, FTC's mission and resource allocations are focused on conducting investigations in response to consumer complaints and other information rather than on routine monitoring and examination

[4]These nonbank subsidiaries are owned by the financial holding companies or bank holding companies and are not the direct operating subsidiaries of the bank itself.

responsibilities. In contrast, the Board conducts periodic examinations of financial and bank holding companies and, under the Bank Holding Company Act, is authorized to monitor and examine the subsidiaries of a bank holding company under certain circumstances. However, this authority does not clearly extend to routine examinations of nonbank subsidiaries of these holding companies with regard to laws pertinent to predatory lending. In addition, the Board does not have specific authority under pertinent federal consumer protection laws to institute an enforcement action against a nonbank subsidiary of a financial or bank holding company. Granting the Board concurrent enforcement authority with the FTC for these nonbank subsidiaries of holding companies could help deter some predatory lending.

## Many States Have Passed Laws Addressing Predatory Lending, but Federal Agencies Have Preempted Some Statutes

In response to concerns about the growth of predatory lending and the limitations of existing laws, 25 states, the District of Columbia, and 11 localities have passed their own laws addressing predatory lending practices, according to a database that tracks such laws. Most of these laws regulate and restrict the terms and characteristics of high-cost loans—that is, loans that exceed certain rate or fee thresholds. While some state statutes follow the thresholds for covered loans established in HOEPA, many set lower thresholds in order to cover more loans than the federal statute. The statutes vary, but they generally cover a variety of predatory practices, such as balloon payments and prepayment penalties, and some include restrictions on such things as mandatory arbitration clauses that can restrict borrowers' ability to obtain legal redress through the courts.

Some states have also increased the regulation of and licensing requirements for mortgage lenders and brokers, in part to address concerns that some unscrupulous lenders and brokers have been responsible for lending abuses and that these entities have not been adequately regulated. For example, some states have increased the educational requirements that lenders and brokers must meet in order to obtain a license. In recent years, state law enforcement agencies and banking regulators have also taken a number of actions against mortgage lenders involving predatory lending. For example, an official from Washington State's Department of Financial Institutions reported that the department had taken several enforcement actions to address predatory lending, including one that resulted in a lender being ordered to return more than $700,000 to 120 Washington borrowers for allegedly deceiving them and charging prohibited fees.

Three federal banking regulators—NCUA, OCC, and OTS—have issued opinions stating that federal laws preempt some state predatory lending laws for the institutions that they regulate. The regulators note that such preemption creates a more uniform regulatory framework, relieves lending institutions of the burden of complying with a hodgepodge of state and federal laws, and avoids state laws that may restrict legitimate lending activities. State officials and consumer advocates that oppose preemption argue that federal laws do not effectively protect consumers against predatory lending practices and that federal regulators do not devote sufficient resources toward enforcement of consumer protection laws for the institutions they oversee.

## The Secondary Market May Benefit Consumers but Can Also Facilitate Predatory Lending

In 2002, an estimated 63 percent of subprime loans, worth $134 billion, were securitized and sold on the secondary market.[5] The existence of a secondary market for subprime loans has benefited consumers by increasing the sources of funds available to subprime lenders, potentially lowering interest rates and origination costs for subprime loans. However, the secondary market may also inadvertently facilitate predatory lending by providing a source of funds for unscrupulous originators, allowing them to quickly sell off loans with predatory terms. Further, originators of subprime mortgage loans generally make their profits from high origination fees, and the existence of a secondary market may reduce the incentive for these lenders to ensure that borrowers can repay.

Purchasers of mortgage loans undertake a process of due diligence designed to avoid legal, financial, and reputational risk. Prior to the sale, purchasers typically review electronic data containing information on the loans, such as the loan amount, interest rate, and credit score of the borrower. Purchasers also often physically review a sample of individual loans, including such items as the loan application and settlement forms. However, the degree of due diligence purchasers undertake varies. Fannie Mae and Freddie Mac—which are estimated to account for a relatively small portion of the secondary market for subprime loans—told us that they undertake a series of measures aimed at avoiding the purchase of

[5]Originators of mortgage loans—which can include banks, other depository institutions, and mortgage lenders that are not depository institutions—may keep the loans or sell them on the secondary market. Secondary market purchasers may then hold the loans or pool together a group of loans and issue a security that is backed by a pool of mortgages (a "mortgage-backed security").

loans with abusive characteristics that may have harmed borrowers. In contrast, according to some market participants, the due diligence of other secondary market purchasers of residential mortgages may be more narrowly focused on the creditworthiness of the loans and on their compliance with federal, state, and local laws. However, even the most stringent efforts cannot uncover some predatory loans. For example, due diligence by secondary market purchasers may be unable to uncover fraud that occurred during the loan underwriting or approval process, some excessive or unwarranted fees, or loan flipping.

Under some state and local legislation, purchasers of mortgages or mortgage-backed securities on the secondary market may be liable for violations committed by the originating lenders—referred to as "assignee liability" provisions. HOEPA contains such a provision for loans above certain thresholds, as do the antipredatory lending laws in at least eight states and the District of Columbia, according to a database that tracks state predatory lending laws. Assignee liability is intended to discourage secondary market participants from purchasing loans that may have predatory features and to provide an additional source of redress for victims of abusive lenders. However, according to some secondary market participants, assignee liability can also discourage legitimate lending activity. Secondary market purchasers that are unwilling to assume the potential risks associated with assignee liability provisions have stopped purchasing, or announced their intention to stop purchasing, mortgages originated in areas covered by such provisions. Credit rating agencies—whose decisions influence securitizers' ability to sell the securities—have asserted that assignee liability provisions can make it difficult for them to measure the risk associated with pools of loans. Assignee liability provisions of the Georgia Fair Lending Act were blamed for causing several participants in the mortgage lending industry to withdraw from the market, and the provisions were subsequently repealed.

## The Usefulness of Consumer Education, Counseling, and Disclosures in Deterring Predatory Lending May Be Limited

In response to widespread concern about low levels of financial literacy among consumers, federal agencies have conducted and funded financial education for consumers as a means of improving consumers' financial literacy and, in some cases, raising consumers' awareness of predatory lending practices. For example, FDIC sponsors a financial literacy program, MoneySmart, which is designed for low- and moderate-income individuals with little banking experience. Other federal agencies, including the Board, FTC, HUD, and OTS, engage in activities such as distributing educational literature, working with community groups, and providing institutions they regulate with guidance on encouraging financial literacy. Federal agencies have also taken some actions to coordinate their efforts to educate consumers about predatory lending. For example, in October 2003, the Interagency Task Force on Fair Lending, which consists of 10 federal agencies, published a brochure that alerts consumers to the potential pitfalls of home equity loans, particularly high-cost loans. A number of states, nonprofits, and trade organizations also conduct consumer financial education activities, which sometimes focus specifically on raising awareness about predatory lending.

While representatives of the mortgage lending industry and consumer groups have noted that financial education may make some consumers less susceptible to abusive lending practices, GAO's review of literature and interviews with consumer and federal officials suggest that consumer education by itself has limits as a tool for deterring predatory lending. First, mortgage loans are complex financial transactions, and many different factors—including the interest rate, fees, provisions of the loan, and situation of the borrower—determine whether a loan is in a borrower's best interests. Even an excellent campaign of consumer education is unlikely to provide less sophisticated consumers with enough information to properly assess whether a loan contains abusive terms. Second, predatory lenders and brokers tend to use aggressive marketing tactics that are designed to confuse consumers. Broad-based campaigns to make consumers aware of predatory lending may not be sufficient to prevent many consumers—particularly those who may be uneducated or unsophisticated in financial matters—from succumbing to such tactics. Finally, the consumers who are often the targets of predatory lenders are also some of the hardest to reach with educational information.

Prepurchase mortgage counseling—which can offer a "third party" review of a prospective mortgage loan—may help borrowers avoid predatory loans, in part by alerting consumers to predatory loan terms and practices. HUD supports a network of approximately 1,700 HUD-approved counseling agencies across the country and in some cases provides funding for their activities. While beneficial, the role of mortgage counseling in preventing predatory lending is likely to be limited. Borrowers do not always attend such counseling, and when they do, counselors may not have access to all of the loan documents needed to review the full final terms and provisions before closing. In addition, counseling may be ineffective against lenders and brokers engaging in fraudulent practices, such as falsifying applications or loan documents, that cannot be detected during a prepurchase review of mortgage loan documents.

Finally, disclosures made during the mortgage loan process, while important, may be of limited usefulness in reducing the incidence of predatory lending practices. TILA and RESPA have requirements covering the content, form, and timing of the information that must be disclosed to borrowers. However, industry and consumer advocacy groups have publicly expressed dissatisfaction with the current disclosure system. HUD issued proposed rules in July 2002 intended to streamline the disclosure process and make disclosures more understandable and timely, and debate over the proposed rules has been contentious. Although improving loan disclosures would undoubtedly have benefits, once again the inherent complexity of loan transactions may limit any impact on the incidence of predatory lending practices. Moreover, even a relatively clear and transparent system of disclosures may be of limited use to borrowers who lack sophistication about financial matters, are not highly educated, or suffer physical or mental infirmities. Finally, as with mortgage counseling, revised disclosure requirements would not necessarily help protect consumers against lenders and brokers that engage in outright fraud or that mislead borrowers about the terms of loans in the disclosure documents themselves.

## Predatory Lenders May Target Elderly Consumers

Consistent observational and anecdotal evidence, along with some limited data, indicates that, for a variety of reasons, elderly homeowners are disproportionately the targets of predatory lending. Abusive lenders tend to target homeowners who have substantial equity in their homes, as many older homeowners do. In addition, some brokers and lenders aggressively market home equity loans as a source of cash, particularly for older homeowners who may have limited incomes but require funds for major home repairs or medical expenses. Moreover, diseases and physical impairments associated with aging—such as declining vision, hearing, or mobility—can restrict elderly consumers' ability to access financial information and compare credit terms. Some older persons may also have diminished cognitive capacity, which can impair their ability to comprehend and make informed judgments on financial issues. Finally, several advocacy groups have noted that some elderly people lack social and family support systems, potentially increasing their susceptibility to unscrupulous lenders who may market loans by making home visits or offering other personal contact.

Because the elderly may be more susceptible to predatory lending, government agencies and consumer advocacy organizations have focused some of their education efforts on this population. For example, the

Justice Department offers on its Web site the guide "Financial Crimes Against the Elderly," which includes references to predatory lending. The Department of Health and Human Services' Administration on Aging provides grants to state and nonprofit agencies for programs aimed at preventing elder abuse, including predatory lending practices targeting older consumers. The AARP, which represents Americans age 50 and over, sponsors a number of financial education efforts, including a borrower's kit that contains tips for avoiding predatory lending.

Consumer protection and fair lending laws that have been used to address predatory lending do not generally have provisions specific to elderly persons, although the Equal Credit Opportunity Act does prohibit unlawful discrimination on the basis of age in connection with any aspect of a credit transaction. Federal and state enforcement actions and private class-action lawsuits involving predatory lending generally seek to provide redress to large groups of consumers. Little comprehensive data exist on the age of consumers involved in these actions, but a few cases have involved allegations of predatory lending targeting elderly borrowers. For example, FTC, six states, AARP, and private plaintiffs settled a case with First Alliance Mortgage Company in March 2002 for more than $60 million. An estimated 28 percent of the 8,712 borrowers represented in the class-action suit were elderly. The company was accused of using misrepresentation and unfair and deceptive practices to lure senior citizens and those with poor credit histories into entering into abusive loans. In addition, some nonprofit groups—such as the AARP Foundation Litigation, the National Consumer Law Center, and South Brooklyn Legal Services' Foreclosure Prevention Project—provide legal services that focus, in part, on helping elderly victims of predatory lending.

## Matters for Congressional Consideration

To enable greater oversight of and potentially deter predatory lending from occurring at certain nonbank lenders, Congress should consider making appropriate statutory changes to grant the Board of Governors of the Federal Reserve System the authority to routinely monitor and, as necessary, examine the nonbank mortgage lending subsidiaries of financial and bank holding companies for compliance with federal consumer protection laws applicable to predatory lending practices. Also, Congress should consider giving the Board specific authority to initiate enforcement actions under those laws against these nonbank mortgage lending subsidiaries.

## Agency Comments and Our Evaluation

GAO provided a draft of this report to the Board, DOJ, FDIC, FTC, HUD, NCUA, OCC, OTS, and the Department of the Treasury for review and comment. The agencies provided technical comments that have been incorporated where appropriate. In addition, the Board, DOJ, FDIC, FTC, HUD, and NCUA provided general comments, which are discussed in greater detail at the end of chapter 2. The written comments of the Board, DOJ, HUD, and NCUA are printed in appendixes II through V.

The Board commented that, while the existing structure has not been a barrier to Federal Reserve oversight, the approach recommended in our Matter for Congressional Consideration would likely be beneficial by catching some abusive practices that might not be caught otherwise. The Board also noted that the approach would pose tradeoffs, such as different supervisory schemes being applied to nonbank mortgage lenders based on whether or not they are part of a holding company, and additional costs. Because nonbank mortgage lenders that are part of a financial or bank holding company currently can be examined by the Board in some circumstances, they are already subject to a different supervisory scheme than other such lenders. We agree that the costs to the lenders and the Board would increase to the extent the Board exercised any additional authority to monitor and examine nonbank lenders, and believe that Congress should consider both the potential costs and benefits of clarifying the Board's authorities.

The FTC expressed concern that our report could give the impression that we are suggesting that Congress consider giving the Board sole jurisdiction—rather than concurrent jurisdiction with FTC—over nonbank subsidiaries of holding companies. Our report did not intend to suggest that the Congress make any change that would necessarily affect FTC's existing authority for these entities, and we modified the report to clarify this point.

DOJ commented that the report will be helpful in assessing the department's role in the federal government's efforts to develop strategies to combat predatory lending. DOJ disagreed with our inclusion in the report of "property or loan flips," which it said was a traditional fraud scheme but not a type of predatory lending. As we noted in our report, there is no precise definition of predatory lending. We incorporated a discussion of property flipping—quick resales of recently sold FHA properties—because HUD officials characterize some of these schemes as involving predatory practices that can harm borrowers. We included loan flipping—the rapid and repeated refinancing of a loan without benefit to the borrower—in our report because this is widely characterized in the literature and by federal, state, and nonprofit agency officials as a predatory lending practice.

FDIC noted that our Matter for Congressional Consideration focuses on nonbank subsidiaries of holding companies even though these entities comprise, according to HUD, only about 20 percent of all subprime lenders. We recognize that our Matter does not address all subprime lenders or other institutions that may be engaging in predatory lending, but believe it represents a potential step in addressing predatory lending among a significant segment of mortgage lenders. NCUA said that the report provides a useful discussion of the issues and the agency concurs with our Matter for Congressional Consideration. HUD, in its comment letter, described a variety of actions it has taken that it characterized as combating predatory lending, particularly with regard to FHA-insured loans.

# Introduction

In recent years, abuses in home mortgage lending—commonly referred to as "predatory lending"—have increasingly garnered the attention and concern of policymakers, consumer advocates, and participants in the mortgage lending industry.[1] Once relatively rare, government enforcement actions and private party lawsuits against institutions accused of abusive home mortgage lending have increased dramatically in the last 10 years. In 2002 alone, there were dozens of settlements resulting from accusations of abusive lending. In the largest of these, a major national mortgage lender agreed to pay up to $484 million to tens of thousands of affected consumers.

## The Nature and Attributes of Predatory Lending

Predatory lending is an umbrella term that is generally used to describe cases in which a broker or originating lender takes unfair advantage of a borrower, often through deception, fraud, or manipulation, to make a loan that contains terms that are disadvantageous to the borrower. While there is no universally accepted definition, predatory lending is associated with the following loan characteristics and lending practices:

- *Excessive fees.* Abusive loans may include fees that greatly exceed the amounts justified by the costs of the services provided and the credit and interest rate risks involved. Lenders may add these fees to the loan amounts rather than requiring payment up front, so the borrowers may not know the exact amount of the fees they are paying.
- *Excessive interest rates.* Mortgage interest rates can legitimately vary based on the characteristics of borrowers (such as creditworthiness) and of the loans themselves. However, in some cases, lenders may charge interest rates that far exceed what would be justified by any risk-based pricing calculation, or lenders may "steer" a borrower with an excellent credit record to a higher-rate loan intended for borrowers with poor credit histories.
- *Single-premium credit insurance.* Credit insurance is a loan product that repays the lender should the borrower die or become disabled. In the case of single- premium credit insurance, the full premium is paid all at once—by being added to the amount financed in the loan—rather than on a monthly basis. Because adding the full premium to the

[1] Throughout this report, the terms predatory lending and abusive lending are used interchangeably.

amount of the loan unnecessarily raises the amount of interest borrowers pay, single-premium credit insurance is generally considered inherently abusive.

- *Lending without regard to ability to repay.* Loans may be made without regard to a borrower's ability to repay the loan. In these cases, the loan is approved based on the value of the asset (the home) that is used as collateral. In particularly egregious cases, monthly loan payments have equaled or exceeded the borrower's total monthly income. Such lending can quickly lead to foreclosure of the property.

- *Loan flipping.* Mortgage originators may refinance borrowers' loans repeatedly in a short period of time without any economic gain for the borrower. With each successive refinancing, these originators charge high fees that "strip" borrowers' equity in their homes.

- *Fraud and deception.* Predatory lenders may perpetrate outright fraud through actions such as inflating property appraisals and doctoring loan applications and settlement documents. Lenders may also deceive borrowers by using "bait and switch" tactics that mislead borrowers about the terms of their loan. Unscrupulous lenders may fail to disclose items as required by law or in other ways may take advantage of borrowers' lack of financial sophistication.

- *Prepayment penalties.* Penalties for prepaying a loan are not necessarily abusive, but predatory lenders may use them to trap borrowers in high-cost loans.

- *Balloon payments.* Loans with balloon payments are structured so that monthly payments are lower but one large payment (the balloon payment) is due when the loan matures. Predatory loans may contain a balloon payment that the borrower is unlikely to be able to afford, resulting in foreclosure or refinancing with additional high costs and fees. Sometimes, lenders market a low monthly payment without adequate disclosure of the balloon payment.

Predatory lending is difficult to define partly because certain loan attributes may or may not be abusive, depending on the overall context of the loan and the borrower. For example, although prepayment penalties can be abusive in the context of some loans, in the context of other loans, they can benefit borrowers by reducing the overall cost of loans by reducing the lender's prepayment risk.

According to federal and industry officials, most predatory mortgage lending involves home equity loans or loan refinancings rather than loans for home purchases. Homeowners may be lured into entering refinance loans through aggressive solicitations by mortgage brokers or lenders that promise "savings" from debt consolidation or the ability to "cash out" a portion of a borrower's home equity. Predatory lending schemes may also involve home improvement contractors that work in conjunction with a lender. The contractor may offer to arrange financing for necessary repairs or improvements, and then perform shoddy work or fail to complete the job, while leaving the borrower holding a high-cost loan. Abuses in loan servicing have also increasingly become a concern. Abusive mortgage lenders or servicing agents may charge improper late fees, require unjustified homeowner's insurance, or not properly credit payments. In November 2003, the Federal Trade Commission (FTC) and the Department of Housing and Urban Development (HUD) reached a settlement with a large national mortgage servicer, Fairbanks Capital, after the company was accused of unfair, deceptive, and illegal practices in the servicing of mortgage loans. The settlement will provide $40 million to reimburse consumers.

Originating lenders or brokers that engage in abusive practices can make high profits through the excessive points and fees that they charge, particularly when borrowers make their payments regularly. Even when a loan enters foreclosure, the originator of a predatory loan may still make a profit due to the high up-front fees it has already collected. Moreover, a lender that sells a loan in the secondary market shortly after origination no longer necessarily faces financial risk from foreclosure.[2] Similarly, a mortgage broker that collects fees up front is not affected by foreclosure of the loan.

According to HUD and community groups, predatory lending not only harms individual borrowers but also can weaken communities and neighborhoods by causing widespread foreclosures, which reduce property values. Predatory lending also serves to harm the reputation of honest and legitimate lenders, casting them in the same suspicious light as those making unfair loans and thus increasing their reluctance to extend credit to the traditionally underserved communities that are often targeted by abusive lenders.

[2]As discussed in chapter 4, the secondary market is where existing mortgage loans and mortgage-backed securities are sold and purchased.

## Emergence of Subprime Mortgage Market

The market for mortgage loans has evolved considerably over the past 20 years. Among the changes has been the emergence of a market for subprime mortgage loans. Most mortgage lending takes place in what is known as the prime market, which encompasses traditional lenders and borrowers with credit histories that put them at low risk of default. In contrast, the subprime market serves borrowers who have poor or no credit histories or limited incomes, and thus cannot meet the credit standards for obtaining loans in the prime market.[3] It is widely accepted that the overwhelming majority of predatory lending occurs in the subprime market, which has grown dramatically in recent years. Subprime mortgage originations grew from $34 billion in 1994 to more than $213 billion in 2002 and in 2002 represented 8.6 percent of all mortgage originations, according to data reported by the trade publication *Inside B&C Lending*. Several factors account for the growth of the subprime market, including changes in tax law that increased the tax advantages of home equity loans, rapidly increasing home prices that have provided many consumers with substantial home equity, entry into the subprime market by companies that had previously made only prime loans, and the expansion of credit scoring and automated underwriting, which has made it easier for lenders to price the risks associated with making loans to credit-impaired borrowers.

Originating lenders charge higher interest rates and fees for subprime loans than they do for prime loans to compensate for increased risks and for higher servicing and origination costs. In many cases, increased risks and costs justify the additional cost of the loan to the borrower, but in some cases they may not. Because subprime loans involve a greater variety and complexity of risks, they are not the uniformly priced commodities that prime loans generally are. This lack of uniformity makes comparing the costs of subprime loans difficult, which can increase borrowers' vulnerability to abuse.

However, subprime lending is not inherently abusive, and certainly all subprime loans are not predatory. Although some advocacy groups claim that subprime lending involves abusive practices in a majority of cases, most analysts believe that only a relatively small portion of subprime loans

[3] There is no uniform definition across the lending industry for what characterizes a loan as subprime. Subprime loans are generally given to borrowers with credit scores that are below a certain threshold, but that threshold can vary according to the policies of the individual lender.

contain features that may be considered abusive. In addition, according to officials at HUD and the Department of the Treasury, the emergence of a subprime mortgage market has enabled a whole class of credit-impaired borrowers to buy homes or access the equity in their homes. At the same time, however, federal officials and consumer advocates have expressed concerns that the overall growth in subprime lending and home equity lending in general has been accompanied by a corresponding increase in predatory lending. For example, lenders and brokers may use aggressive sales and marketing tactics to convince consumers who need cash to enter into a home equity loan with highly disadvantageous terms.

Originators of subprime loans are most often mortgage and consumer finance companies, but can also be banks, thrifts, and other institutions. Some originators focus primarily on making subprime loans, while others offer a variety of prime and subprime loans. According to HUD, 178 lenders concentrated primarily on subprime mortgage lending in 2001. Fifty-nine percent of these lenders were independent mortgage companies (mortgage bankers and finance companies), 20 percent were nonbank subsidiaries of financial or bank holding companies, and the remainder were other types of financial institutions. Only 10 percent were federally regulated banks and thrifts.[4]

About half of all mortgage loans are made through mortgage brokers that serve as intermediaries between the borrower and the originating lender. According to government and industry officials, while the great majority of mortgage brokers are honest, some play a significant role in perpetrating predatory lending. A broker can be paid for his services from up-front fees directly charged to the borrower and/or through fees paid indirectly by the borrower through the lender in what is referred to as a "yield spread premium."[5] Some consumer advocates argue that compensating brokers this way gives brokers an incentive to push loans with higher interest rates and fees. Brokers respond that yield spread premiums in fact allow them to reduce the direct up-front fees they charge consumers.

[4]HUD annually identifies a list of lenders that specialize in either subprime or manufactured home lending. HUD occasionally updates data related to past years. The information provided here was based on data available as of November 7, 2003.

[5]A "yield spread premium" is a payment a mortgage broker receives from a lender based on the difference between the actual interest rate on the loan and the rate the lender would have accepted on the loan given the risks and costs involved. The higher the actual loan rate compared with the acceptable loan rate, the higher the yield spread premium.

## The Extent of Predatory Lending Is Unknown

Currently no comprehensive and reliable data are available on the extent of predatory lending nationwide, for several reasons. First, the lack of a standard definition of what constitutes predatory lending makes it inherently difficult to measure. Second, any comprehensive data collection on predatory lending would require access to a representative sample of loans and to information that can only be extracted manually from the physical loan files. Given that such records are not only widely dispersed but also generally proprietary, to date comprehensive data have not been collected.[6] Nevertheless, policymakers, advocates, and some lending industry representatives have expressed concerns in recent years that predatory lending is a significant problem. Although the extent of predatory lending cannot be easily quantified, several indicators suggest that it may be prevalent. Primary among these indicators are legal settlements, foreclosure patterns, and anecdotal evidence.

In the past 5 years, there have been a number of major settlements resulting from government enforcement actions and private party lawsuits accusing lenders of abusive lending practices affecting large numbers of borrowers. Among the largest of these settlements have been the following:

- In October 2002, the lender Household International agreed to pay up to $484 million to homeowners across the nation to settle allegations by states that it used unfair and deceptive lending practices to make mortgage loans with excessive interest and charges.

- In September 2002, Citigroup agreed to pay up to $240 million to resolve charges by FTC and private parties that Associates First Capital Corporation and Associates Corporation of North America (The

[6]One of the few studies that sought to quantify the extent of predatory lending was "Quantifying the Economic Cost of Predatory Lending," E. Stein, Coalition for Responsible Lending, July 25, 2001 (revised Oct. 30, 2001). We were not able to verify the reliability of the study's data, which were based on several sources. Other empirical data appears in a study by Freddie Mac on its automated underwriting system, "Automated Underwriting: Making Mortgage Lending Simpler and Fairer for America's Families," September 1996. The company evaluated a sample of 15,000 subprime mortgage loans originated by four financial institutions and provided preliminary estimates that between 10 and 35 percent of the borrowers who received these loans could have qualified for a loan in the prime market. Some consumer advocates have said these data suggest that some borrowers may be "steered" to high-cost loans even though they qualify for conventional loans with better terms. A Freddie Mac official told us that the data are insufficient to necessarily draw that conclusion.

Associates) engaged in systematic and widespread deceptive and abusive lending practices.[7] According to FTC staff, under the settlement close to 1 million borrowers will receive compensation for loans that misrepresented insurance products and that contained other abusive terms.

- In response to allegations of deceptive marketing and abusive lending, First Alliance Mortgage Company entered into a settlement in March 2002 with FTC, six states, and private parties to compensate nearly 18,000 borrowers more than $60 million dollars.

Further, between January 1998 and September 1999, the foreclosure rate for subprime loans was more than 10 times the foreclosure rate for prime loans.[8] While it would be expected that loans made to less creditworthy borrowers would result in some increased rate of foreclosure, the magnitude of this difference has led many analysts to suggest that it is at least partly the result of abusive lending, particularly of loans made without regard to the borrower's ability to repay. Moreover, the rate of foreclosures of subprime mortgage loans has increased substantially since 1990, far exceeding the rate of increase for subprime originations. A study conducted for HUD noted that while the increased rate in subprime foreclosures could be the result of abusive lending, it could also be the result of other factors, such as an increase in subprime loans that are made to the least creditworthy borrowers.[9]

In the early 1990s, anecdotal evidence began to emerge suggesting that predatory lending was on the rise. Legal services agencies throughout the country reported an increase in clients who were facing foreclosure as a result of mortgage loans that included abusive terms and conditions. These agencies noted that for the first time they were seeing large numbers of

[7]Citigroup acquired Associates First Capital Corporation and Associates Corporation of North America in November 2000 and merged The Associates' consumer finance operations into its subsidiary, CitiFinancial Credit Company.

[8]See HUD-Treasury Task Force on Predatory Lending, *Curbing Predatory Home Mortgage Lending: A Joint Report* (June 2000), 34-35. The report noted that from January 1998 through September 1999, foreclosure rates averaged 0.2 percent for prime mortgage loans and 2.6 percent for subprime mortgage loans.

[9]Harold L. Bunce, Debbie Gruenstein, Christopher E. Herbert, and Randall M. Scheessele, "Subprime Foreclosures: The Smoking Gun of Predatory Lending?" Paper presented at the U.S. Department of Housing and Urban Development conference "Housing Policy in the New Millennium," Crystal City, VA, October 2000.

consumers, particularly elderly and minority borrowers, who were facing the loss of homes they had lived in for many years because of a high-cost refinancing. Similar observations were also reported extensively at forums on predatory lending sponsored by HUD and the Department of the Treasury in five cities during 2000, at hearings held in four cities during 2000 by the Board of Governors of the Federal Reserve System (the Board), and at congressional hearings on the issue in 1998, 2001, 2002, and 2003.[10]

Federal officials and consumer advocates maintain that predatory lenders often target certain populations, including the elderly and some low-income and minority communities. Some advocates say that in many cases, predatory lenders target communities that are underserved by legitimate institutions, such as banks and thrifts, leaving borrowers with limited credit options. According to government officials and legal aid organizations, predatory lending appears to be more prevalent in urban areas than in rural areas, possibly because of the concentration of certain target groups in urban areas and because the aggressive marketing tactics of many predatory lenders may be more efficient in denser neighborhoods.[11]

## Emergence of Predatory Lending As Policy Issue

The federal government began addressing predatory home mortgage lending as a significant policy issue in the early 1990s. In 1994, the Congress passed the Home Ownership and Equity Protection Act (HOEPA), an amendment to the Truth in Lending Act that set certain restrictions on "high-cost" loans in order to protect consumers.[12] In 1998, as part of an

[10]Hearing on "Equity Predators: Stripping, Flipping and Packing Their Way to Profits," Special Committee on Aging, U.S. Senate, March 16, 1998. Hearing on "Predatory Mortgage Lending: The Problem, Impact and Responses," Committee on Banking, Housing, and Urban Affairs, U.S. Senate, July 26 and 27, 2001. Hearing on "Predatory Mortgage Lending Practices: Abusive Uses of Yield Spread Premiums," Committee on Banking, Housing, and Urban Affairs, U.S. Senate, January 8, 2002. Hearing on "Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit," Subcommittees on Financial Institutions and Consumer Credit and Housing and Community Opportunity, Committee on Financial Services, House of Representatives, November 5, 2003.

[11]A Rural Housing Institute report found that predatory lending did not appear to have infiltrated rural counties in Iowa as much as urban counties. However, the institute also noted there have been reports of many cases of predatory lending in rural areas of the country overall, with comparably severe effects on rural victims. See *Rural Voices*, Vol. 7, No. 2, Spring 2002, 4-5.

[12]See Pub. L. 103-325 §§ 151-158, 108 Stat. 2190-2198.

overall review of the statutory requirements for mortgage loans, HUD and the Board released a report recommending that additional actions be taken to protect consumers from abusive lending practices.[13] HUD and the Department of the Treasury formed a task force in 2000 that produced the report *Curbing Predatory Home Mortgage Lending*, which made several dozen recommendations for addressing predatory lending.[14, 15]

As discussed in chapters 2 and 3, a variety of federal, state, and local laws have been used to take civil and criminal enforcement actions against institutions and individuals accused of abusive lending practices. Various federal agencies have responsibilities for enforcing laws related to predatory lending. In addition, some state or local enforcement authorities—including attorneys general, banking regulators, and district attorneys—have used state and local laws related to consumer protection and banking to address predatory lending practices. In addition, many private attorneys and advocacy groups have pursued private legal actions, including class actions, on behalf of borrowers who claim to have been victimized by abusive lending.

## Objectives, Scope, and Methodology

Our objectives were to describe (1) federal laws related to predatory lending and federal agencies' efforts to enforce them; (2) the actions taken by the states in addressing predatory lending; (3) the secondary market's role in facilitating or inhibiting predatory lending; (4) how consumer education, mortgage counseling, and loan disclosures may deter predatory lending; and (5) the relationship between predatory lending activities and elderly consumers. The scope of this work was limited to home mortgage lending and did not include other forms of consumer loans.

To identify federal laws and enforcement activities related to predatory lending, we interviewed officials and reviewed documents from HUD, the

[13] Board of Governors of the Federal Reserve System and 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.

[14] HUD-Treasury Task Force on Predatory Lending, *Curbing Predatory Home Mortgage Lending: A Joint Report*, June 2000.

[15] During 2003, there were at least two bills introduced in Congress that addressed predatory or abusive lending practices—the Responsible Lending Act (H.R. 833, Feb. 13, 2003) and the Predatory Lending Consumer Protection Act of 2003 (S. 1928, Nov. 21, 2003).

Department of Justice (DOJ), the Department of the Treasury, the Federal Deposit Insurance Corporation (FDIC), FTC, the Board, the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS). We asked each agency to provide us with the enforcement actions they have taken that—in their assessment—were related to predatory home mortgage lending. We compiled and reviewed data on these enforcement actions and other steps these agencies have taken to address abusive lending practices. We also reviewed and analyzed federal laws that have been used to combat these practices.

To identify actions taken by states and localities, we reviewed and analyzed a publicly available database maintained by the law firm of Butera & Andrews that tracks state and municipal antipredatory lending legislation. We reviewed information related to this database and conducted interviews with the person who maintains it. In order to identify gaps in the completeness or accuracy of data, we compared data elements from this database and from three similar databases maintained by Lotstein Buckman, the National Conference of State Legislatures, and the Mortgage Bankers Association of America. We determined that the data were sufficiently reliable for use in this report. We also interviewed officials representing a wide range of state and local government agencies, lending institutions, and advocacy groups in a number of states and municipalities. In order to illustrate approaches taken in certain states with regard to predatory lending, we collected and analyzed additional information from two states, North Carolina and Ohio. We chose these states to illustrate the differing characteristics of two states' approaches to addressing predatory lending—particularly with regard to legislation restricting high-cost loans and tightening regulation of mortgage lenders and brokers. We also conducted meetings with the Conference of State Bank Supervisors and the National Association of Attorneys General that included representatives from several states. Additionally, we conducted interviews with OCC, OTS, and NCUA to understand their policies and processes on federal preemption of state antipredatory lending laws.

To describe the secondary market's role, we interviewed officials and reviewed documents from the Bond Market Association, the Securities Industry Association, Fannie Mae, Freddie Mac, a due diligence contractor, and two credit rating agencies. We also spoke with officials representing federal and state agencies, and with representatives of the lending industry and consumer groups. In addition, we reviewed and analyzed several local and state laws containing assignee liability provisions.

To describe the role of consumer education, mortgage counseling, and disclosures in deterring predatory lending, we interviewed officials from entities that engage in consumer financial education, including several federal and state agencies, industry trade groups, and local nonprofit organizations such as the Long Island Housing Partnership, the Greater Cincinnati Mortgage Counseling Service, and the Foreclosure Prevention Project of South Brooklyn Legal Services. We also reviewed and analyzed the materials these entities produce. Additionally, we conducted a literature review of studies that have evaluated the effectiveness of consumer education and homeownership counseling.

To describe the impact on older consumers, we conducted a literature review on predatory lending and the elderly and examined studies on financial exploitation of the elderly. We also examined certain enforcement activities and private party lawsuits in which elderly consumers may have been targeted by abusive lenders. We interviewed federal and state agencies that have addressed issues of financial abuse of the elderly, including the Department of Health and Human Services' Administration on Aging and the National Institute on Aging, as well as nonprofit groups that have addressed this issue, including AARP (formerly known as the American Association of Retired Persons).

In addressing all of the objectives, we met with a wide range of organizations that represent consumers, among them the National Community Reinvestment Coalition, the Coalition for Responsible Lending, the National Consumer Law Center, the Association of Community Organizations for Reform Now, and AARP. We also met with organizations representing various aspects of the mortgage lending industry, among them the American Financial Services Association, the Consumer Mortgage Coalition, the Coalition for Fair and Affordable Lending, America's Community Bankers, the National Association of Mortgage Brokers, the Mortgage Bankers Association of America, and the National Home Equity Mortgage Association.

We provided a draft of this report to the Board, DOJ, FDIC, FTC, HUD, NCUA, OCC, OTS, and the Department of the Treasury for review and comment. The agencies provided technical comments that have been incorporated, as appropriate, as well as general comments that are discussed at the end of chapter 2. The written comments of the Board, DOJ, HUD, and NCUA are printed in appendixes II through V. We conducted our work between January 2003 and January 2004 in accordance with generally accepted government auditing standards in Atlanta, Boston, New York, San Francisco, and Washington, D.C.

# Federal Agencies Have Taken Steps to Address Predatory Lending, but Face Challenges

While HOEPA is the only federal law specifically designed to combat predatory mortgage lending, federal agencies, including federal banking regulators, have used a number of federal consumer protection and disclosure statutes to take actions against lenders that have allegedly engaged in abusive or predatory lending.[1] These statutes have enabled agencies to file complaints on behalf of consumers over issues such as excessive interest rates and fees, deceptive lending practices, and fraud. FTC, DOJ, HUD, and federal banking regulators have taken steps to address predatory lending practices through enforcement and civil actions, guidance, and regulatory changes. In some cases, agencies have coordinated their efforts through joint enforcement actions and participation in interagency working groups or task forces. However, questions of jurisdiction regarding certain nonbank mortgage lenders may challenge efforts to combat predatory lending. While the Board has authority to examine many such nonbank mortgage lenders under certain circumstances, it lacks clear authority to enforce federal consumer protection laws against them.

## Federal Agencies Use a Variety of Laws to Address Predatory Lending Practices

As shown in figure 1, Congress has passed numerous laws that can be used to protect consumers against abusive lending practices. Federal agencies have applied provisions of these laws to seek redress for consumers who have been victims of predatory lending. Among the most frequently used laws are TILA, HOEPA, the Real Estate Settlement Procedures Act (RESPA), and the FTC Act.[2] Congress has also given certain federal agencies responsibility for writing regulations that implement these laws. For example, the Board writes Regulation Z, which implements TILA and HOEPA, and HUD writes Regulation X, which implements RESPA. Also, in some cases, DOJ has brought actions under criminal fraud statutes based on conduct that can constitute predatory lending.

[1]HOEPA amended various provisions of the Truth In Lending Act. In the context of this report, the term "federal banking regulators" refers to the Board, the federal supervisory agency for state-chartered banks that are members of the Federal Reserve System; OCC, which supervises national banks and their subsidiaries; FDIC, the federal regulator responsible for insured state-chartered banks that are not members of the Federal Reserve System; OTS, the primary federal supervisory agency for federally insured thrifts and their subsidiaries; and NCUA, which supervises federally insured credit unions.

[2]TILA, as amended, is codified at 15 U.S.C. §§ 1601 – 1667f (2000 & Supp 2003). The pertinent consumer protection provisions of the FTC Act are contained in 15 U.S.C. §§ 41 – 58 (2000). RESPA is codified at 12 U.S.C. §§ 2601 – 2617 (2000 & Supp 2003).

Figure 1: Federal Laws and Statutes Used to Address Lending Practices Generally Considered to be Predatory

| | Governing federal statute | | | | |
|---|---|---|---|---|---|
| Predatory lending practice | TILA | HOEPA[a] | RESPA | FTC Act | Title 18 of U.S. Code |
| Failure to disclose actual loan costs | ● | ● | ● | | |
| Prohibited fees and payments | | | ● | | |
| Lending without regard to ability to repay | | ● | | | |
| Loan flipping | | ● | | | |
| Fraud and deception | | | | ● | ● |
| Prohibited prepayment penalties | | ● | | | |
| Prohibited balloon payments | | ● | | | |

Source: GAO

[a]HOEPA covers only a limited portion of all subprime loans.

TILA, which became law in 1968, was designed to provide consumers with accurate information about the cost of credit. Among other things, the act requires lenders to disclose information about the terms of loans—including the amount being financed, the total finance charge, and information on the annual percentage rate—that can help borrowers understand the overall costs of their loans. TILA also provides borrowers with the right to cancel certain loans secured by a principal residence within 3 days of closing or 3 days of the time at which the final disclosure is made, whichever is later.[3]

[3]See 15 U.S.C. § 1635.

In 1994, Congress enacted the HOEPA amendments to TILA in response to concerns about predatory lending. HOEPA covers certain types of loans made to refinance existing mortgages, as well as home equity loans, that satisfy specific criteria.[4] HOEPA covers only a limited portion of all subprime loans, although there is no comprehensive data on precisely what that portion is.[5] The law is designed to limit predatory practices for these so-called "high-cost" HOEPA loans in several ways. First, it places restrictions on loans that exceed certain rate or fee thresholds, which the Board can adjust within certain limits prescribed in the law. For these loans, the law restricts prepayment penalties, prohibits balloon payments for loans with terms of less than 5 years, prohibits negative amortization, and contains certain other restrictions on loan terms or payments.[6] Second, HOEPA prohibits lenders from routinely making loans without regard to the borrower's ability to repay. Third, the law requires lenders to include disclosures in addition to those required by TILA for consumer credit transactions to help borrowers understand the terms of the high-cost loan and the implications of failing to make required payments. Each federal banking regulator is charged with enforcing TILA and HOEPA with respect to the depository institutions it regulates, and FTC is primarily responsible for enforcing the statutes for most other financial institutions, including independent mortgage lenders and nonbank subsidiaries of holding companies. In enforcing TILA and HOEPA, FTC has required violators to compensate borrowers for statutory violations. Under certain

[4]HOEPA covers closed-end refinancing loans and home equity loans with either (i) an annual percentage rate that exceeds the rate for Treasury securities with comparable maturities by more than a specified amount, or (ii) points and fees that exceed the greater of 8 percent of the loan amount or $400, which is adjusted annually for inflation. 15 U.S.C. § 1602(aa)(1), (3); see 12 C.F.R. § 226.32 (2003). HOEPA does not apply to purchase money mortgages (i.e., loans to purchase or construct a residence), open-end credit (i.e., a line of credit), and reverse mortgages. See, e.g., 15 U.S.C. § 1639.

[5]The Board has cited a study conducted for the American Financial Services Association that estimated that—using current triggers—HOEPA would have covered nearly 38 percent of subprime first mortgage loans originated by nine major national lenders from 1995-2000. See M. Staten and G. Elliehausen, "The Impact of The Federal Reserve Board's Proposed Revisions to HOEPA on the Number and Characteristics of HOEPA Loans" (July 24, 2001). In the past, the Board has also cited estimates from data from OTS that, using the current triggers, HOEPA would cover roughly 5 percent of all subprime loans, but the Board noted to us that this estimate may be conservative. See 65 Fed. Reg. at 81441.

[6]Negative amortization occurs when loan payment amounts do not cover the interest accruing on a loan, resulting in an increasing outstanding principal balance over time. See 15 U.S.C. § 1639(f).

circumstances, HOEPA provides for damages in addition to the actual damages a person sustains as a result of a creditor's violation of the act.[7]

RESPA, passed in 1974, seeks to protect consumers from unnecessarily high charges in the settlement of residential mortgages by requiring lenders to disclose details of the costs of settling a loan and by prohibiting certain other costs.[8] Among its provisions is a prohibition against kickbacks—payments made in exchange for referring a settlement service, such as lender payments to real estate agents for the referral of business. RESPA also prohibits unearned fees such as adding an additional charge to a third party fee when no or nominal services are performed. These practices can unjustly increase the costs of loans and the settlement process. HUD enforces RESPA, working closely with federal banking regulators and other federal agencies such as the FTC and the Department of Justice. HUD often brings joint enforcement actions with these agencies, using RESPA and the statutes enforced by the other federal agencies. In addition, the banking regulators may prohibit violations of RESPA in their own regulations.

The FTC Act, enacted in 1914 and amended on numerous occasions, provides the FTC with the authority to prohibit and take action against unfair or deceptive acts or practices in or affecting commerce. FTC has used the act to address predatory lending abuses when borrowers have been misled or deceived about their loan terms.[9]

Various criminal fraud statutes prohibit certain types of fraud sometimes used in abusive lending schemes, including forgery and false statements. DOJ and HUD have used these statutes to fight fraudulent schemes that have resulted in borrowers purchasing homes worth substantially less than their mortgage amounts or borrowers being unfairly stripped of the equity in their homes. HUD officials have described some of these fraudulent activities as constituting predatory lending.

[7]See Pub. L. No. 103-325 § 153(a), 15 U.S.C. § 1640(a).

[8]Among other things, RESPA requires the good faith disclosure of estimated settlement costs within 3 days after an application for a mortgage loan and, at or before settlement, a uniform settlement statement (HUD-1) that enumerates the final cost of the loan.

[9]Banking regulators are also authorized to enforce standards imposed pursuant to the FTC Act with respect to unfair or deceptive acts or practices by the institutions they supervise. See 12 U.S.C. § 57a(f).

The following other federal laws have been used to a lesser extent to address abusive lending:

- The Fair Housing Act prohibits discrimination based on race, sex, and other factors in housing-related transactions, and the Equal Credit Opportunity Act (ECOA) prohibits discrimination against borrowers in the extension of credit. Federal agencies have used both laws in cases against lenders that have allegedly targeted certain protected groups with abusive loans.
- The Home Mortgage Disclosure Act (HMDA) requires lenders to make publicly available certain data about mortgage loans. Federal agencies have used the data provided by HMDA to help identify possible discriminatory lending patterns, including those that involve abusive lending practices.
- The Community Reinvestment Act (CRA) requires that banking regulators consider a depository institution's efforts to meet the credit needs of its community—including low- and moderate-income neighborhoods—in examinations and when it applies for permission to take certain actions such as a merger or acquisition. An institution's fair lending record is taken into account in assessing CRA performance. CRA regulations state that abusive lending practices that violate certain federal laws will adversely affect an institution's CRA performance.[10]
- Also, federal banking regulators may rely on their supervisory and enforcement authorities under the laws they administer, as well as on the Federal Deposit Insurance Act, to enforce these consumer protections laws and ensure that an institution's conduct with respect to compliance with consumer protection laws does not affect its safety and soundness or that of an affiliated institution.
- Finally, FTC and the banking regulators can also use the Fair Debt Collection Practices Act and Fair Credit Reporting Act in enforcement

[10]On January 20, 2004, FDIC announced approval of a joint interagency notice of proposed rulemaking regarding the Community Reinvestment Act. The proposed rule would amend the act's regulations to expand and clarify the provision that an institution's Community Reinvestment Act evaluation is adversely affected when the institution has engaged in specified discriminatory, illegal, or abusive credit practices in connection with certain loans. FDIC said that the Board, OCC, and OTS were expected to announce their approval of the proposed rulemaking shortly.

actions related to predatory lending that involve violations of credit reporting and loan servicing provisions.

Although a number of federal laws have been used to protect borrowers from abusive lending or to provide them redress, not all potentially abusive practices are illegal under federal law. Enforcement officials and consumer advocates have stated that some lenders make loans that include abusive features but are designed to remain below the thresholds that would subject them to the restrictions of HOEPA. For loans not covered under HOEPA, certain lending practices many consider to be abusive are not, depending on the circumstances, necessarily a violation of any federal law. For example, it is not necessarily illegal to charge a borrower interest rates or fees that exceed what is justified by the actual risk of the mortgage loan. Nor is it *per se* illegal under federal law to "steer" a borrower with good credit who qualifies for a prime loan into a higher cost subprime loan.[11] Finally, with the exception of loans covered under HOEPA, there are no federal statutes that expressly prohibit making a loan that a borrower will likely be unable to repay.[12]

[11]Even in instances where charging high interest rates or fees or steering borrowers to subprime loans do not violate federal consumer protection statutes, imposing such rates and fees on a discriminatory basis against groups protected under the Fair Housing Act and ECOA could constitute violations of those laws.

[12]A pattern of making loans without regard to the ability of borrowers to repay can be considered a violation of the safety and soundness requirements imposed on federally insured depository institutions and could also reflect poorly on an institution's compliance with the Community Reinvestment Act. See OCC Advisory Letter 2003-2 (Guidance for National Banks to Guard Against Predatory and Abusive Lending Practices), February 21, 2003. For loans that are covered under HOEPA, making a loan without regard to a borrower's ability to repay is not prohibited unless it can be demonstrated that an institution has engaged in a "pattern or practice" of doing so. OCC in its recent rulemaking prohibited national banks or their operating subsidiaries from making consumer loans based predominantly on the foreclosure or liquidation value of a borrower's collateral. See 69 Fed. Reg. 1904 (Jan. 13, 2004).

## Federal Agencies Have Taken Some Enforcement Actions, but Banking Regulators Have Focused on Guidance and Regulatory Changes

FTC, DOJ, and HUD have taken enforcement actions to address violations related to abusive lending.[13] As of December 2003, FTC reported that the agency had taken 19 actions against mortgage lenders and brokers for predatory practices. DOJ has addressed predatory lending that is alleged to be discriminatory by enforcing fair lending laws in a limited number of cases. HUD's efforts have generally focused on reducing losses to the Federal Housing Administration (FHA) insurance fund, including implementing a number of initiatives to monitor lenders for violations of FHA guidelines.[14] HUD reported having taken a small number of actions to enforce RESPA and the Fair Housing Act in cases involving predatory lending.

Federal banking regulators stated that their monitoring and examination activities have revealed little evidence of predatory lending practices by federally regulated depository institutions. Accordingly, most banking regulators reported that they have taken no formal enforcement actions related to predatory mortgage lending abuses by the institutions they supervise. Regulators have addressed predatory lending primarily by issuing guidance to their institutions on guarding against direct or indirect involvement in predatory lending practices and by making certain changes to HOEPA and HMDA regulations. In addition, several federal agencies have coordinated certain efforts to pursue enforcement actions related to predatory lending and have shared information on their efforts to address fair lending and predatory lending.

[13]Most enforcement actions discussed in this chapter were civil judicial actions brought and settled by FTC, DOJ, and HUD.

[14]HUD's FHA mortgage insurance program makes loans more readily available for low- and moderate-income families by providing mortgage insurance to purchase or refinance a home. Lending institutions such as mortgage companies and banks fund the loans.

## FTC Has Played the Predominant Federal Role in Enforcement Actions Related to Predatory Lending

FTC is responsible for implementing and enforcing certain federal laws among lending institutions that are not supervised by federal banking regulators. FTC reported that between 1983 and 2003, it filed 19 complaints alleging deceptive or other illegal practices by mortgage lenders and brokers, 17 of them filed since 1998.[15] For a list of these FTC enforcement actions, see appendix I. As of December 2003, FTC had reached settlements in all but one of the cases. In most of these settlements, companies have agreed to provide monetary redress to consumers and to halt certain practices in the future. In some cases, the settlements also imposed monetary penalties that the companies have paid to the government. Among the recent enforcement actions related to predatory lending that the FTC identified are the following:

- *The Associates.* In 2002, FTC settled a complaint against Associates First Capital Corporation and Associates Corporation of North America (collectively, The Associates), as well as their successor, Citigroup. The complaint alleged that the lender violated the FTC Act and other laws by, among other things, deceiving customers into refinancing debts into home loans with high interest rates and fees and purchasing high-cost credit insurance. The settlement, along with a related settlement with private parties, provides for up to $240 million in restitution to borrowers.[16]
- *First Alliance.* In 2002, FTC, along with several states and private plaintiffs, settled a complaint against First Alliance Mortgage Company alleging that it violated federal and state laws by misleading consumers about loan origination and other fees, interest rate increases, and monthly payment amounts on adjustable rate mortgage loans. The company agreed to compensate nearly 18,000 borrowers more than $60

[15] FTC has also recently addressed abuses in the mortgage loan servicing industry. In November 2003, it announced settlements with Fairbanks Capital Holding Corp., its wholly owned subsidiary Fairbanks Capital Corp., and their founder and former CEO (collectively, Fairbanks) on charges that Fairbanks violated the FTC Act, RESPA, and other laws by failing to post consumers' mortgage payments in a timely manner and charging consumers illegal late fees and other unauthorized fees. The settlement will provide $40 million in redress to consumers. The case was jointly filed with HUD. *United States of America v. Fairbanks Capital Corp. et al.*, Civ. Action No. 03-12219-DPW (D. Mass.)(filed 11/12/03).

[16] Citigroup, Inc., acquired The Associates in a merger that was completed in November 2000. The FTC complaint named Citigroup and CitiFinancial Credit Company as successor defendants.

million in consumer redress and to refrain from making misrepresentations about future offers of credit.

- *Fleet Finance and Home Equity U.S.A.* In 1999, Fleet Finance, Inc., and Home Equity U.S.A., Inc., settled an FTC complaint alleging violations of the FTC Act, TILA, and related regulations. These violations included failing to provide required disclosures about home equity loan costs and terms and failing to alert borrowers to their right to cancel their credit transactions. To settle, the company agreed to pay up to $1.3 million in redress and administrative costs and to refrain from violating TILA in the future.

- *Operation Home Inequity.* In 1999, FTC conducted "Operation Home Inequity," a law enforcement and consumer education campaign that sought to curb abusive practices in the subprime mortgage lending market. FTC reached settlements with seven subprime mortgage lenders that had been accused of violating a number of consumer protections laws, including the FTC Act, TILA, and HOEPA. Six companies were required to pay $572,000 in consumer redress, and all lenders were required to adhere to future lending restrictions. FTC staff told us that the operation was intended in large part to increase consumers' awareness of predatory lending and to provide a deterrent effect by warning lenders that FTC is able and willing to take action against them.

FTC staff expressed their belief that the agency's enforcement actions over the years have been successful in deterring other lenders from engaging in abusive practices. However, in a congressional hearing in 2000 FTC had requested statutory changes that would improve its ability to enforce HOEPA. For example, FTC recommended that Congress expand HOEPA to prohibit the financing of lump-sum credit insurance premiums in loans covered by HOEPA and to give FTC the power to impose civil penalties for HOEPA violations.[17]

[17]Prepared statement of the Federal Trade Commission before the House Committee on Banking and Financial Services on "Predatory Lending Practices in the Subprime Industry," May 24, 2000. Since then, many mortgage lenders have said they are abandoning lump-sum credit insurance.

## DOJ Has Enforced Fair Lending Laws in Connection with Predatory Lending

DOJ's Housing and Civil Enforcement Section is responsible for enforcing certain federal civil rights laws, including the Fair Housing Act and ECOA. DOJ identified two enforcement actions it has taken related to predatory mortgage lending practices that it alleged were discriminatory.[18]

- *Delta Funding.* In 2000, DOJ, in cooperation with FTC and HUD, brought charges against Delta Funding Corporation, accusing the consumer finance company of violations of the Fair Housing Act, HOEPA, ECOA, RESPA, and related federal regulations.[19] Delta allegedly approved and funded loans that carried substantially higher broker fees for African American females than for similarly situated white males. Delta was also accused of violating certain consumer protection laws by paying kickbacks and unearned fees to brokers to induce them to refer loan applicants to Delta and by systematically making HOEPA loans without regard to borrowers' ability to repay. The settlement placed restrictions on the company's future lending operations and victims were compensated from previously established monetary relief funds.[20]
- *Long Beach Mortgage.* In 1996 DOJ settled a complaint alleging violations of the Fair Housing Act and ECOA against Long Beach Mortgage Company.[21] According to the complaint, the company's loan officers and brokers charged African American, Hispanic, female, and

[18]In addition to these cases, DOJ filed an amicus curiae brief in a private case, *Hargraves v. Capital City Mortgage Corp.*, Civ. Action No. 98-1021 (JHG/AK) (D DC), in which the department contended that certain alleged predatory lending practices violated the Fair Housing Act and ECOA. The case involved a mortgage lender that allegedly engaged in a pattern or practice of deceiving African American borrowers about the terms of their loans and other information, such as the total amount due. In addition, DOJ filed a complaint in *United States v. Action Loan*, Civ. Action No. 3:00CV-511-H (W.D. KY), which resulted from enforcement efforts by the FTC and HUD and involved allegations of predatory mortgage lending.

[19]*United States v. Delta Funding Corp.*, Civ. Action No. CV 00 1872 (E.D. N.Y. 2000).

[20]Two monetary relief funds totaling over $12 million were set up under a previous remediation agreement involving Delta and the New York State Banking Department.

[21]*United States v. Long Beach Mortgage Company*, Case No. 96-6159 (1996). Prior to December 1990, Long Beach Bank was a savings and loan association, chartered by the state of California. Between December 1990 and October 1994, Long Beach Mortgage Company operated under the name of Long Beach Bank as a federally chartered thrift institution. In 1999, Washington Mutual, a federally chartered thrift, acquired Long Beach Mortgage Company and owns it at the holding company level.

older borrowers higher loan rates than it charged other similarly situated borrowers. The company agreed to set up a $3 million fund to reimburse 1,200 consumers who had received Long Beach loans.[22]

Representatives from both FTC and DOJ have stated that their enforcement actions can be very resource intensive and can involve years of discovery and litigation. For example, FTC filed a complaint against Capitol City Mortgage Corporation in 1998 that is still in litigation more than 5 years later. FTC staff told us that because cases involving predatory lending can be so resource intensive, the agencies try to focus their limited resources on the cases that will have the most impact, such as those that may result in large settlements to consumers or that will have some deterrent value by gaining national exposure. Similarly, DOJ officials select certain discrimination cases, including those mentioned above, in part because of their broad impact.

## HUD's Enforcement Activities Focus on FHA Loans

HUD's enforcement and regulatory activity with regard to abusive mortgage lending comes primarily through its management of the FHA single-family mortgage insurance programs, its rule-making and enforcement authority under RESPA, and its enforcement of the Fair Housing Act.

Most of HUD's enforcement activities related to abusive lending have focused on reducing losses to the FHA insurance fund. Investigators from HUD's Office of the Inspector General have worked with investigators from U.S. Attorneys' Offices and the FBI in a joint law enforcement effort to target fraud in the FHA mortgage insurance program, which can result in defaults and thus in losses to the insurance fund.[23] The fraudulent activities sometimes involve property flipping schemes, which can harm borrowers by leaving them with mortgage loans that may far exceed the

[22]DOJ has also taken enforcement actions to address other practices, such as credit repair schemes, that do not involve abusive lending but that nonetheless serve to illegally strip homeowners of their equity.

[23]GAO has issued a number of reports on the FHA single-family insurance program, a high-risk program area. For example, see U.S. General Accounting Office, *Major Management Challenges and Program Risks: Department of Housing and Urban Development*, GAO-03-103 (Washington, D.C.: January 2003).

value of their homes.[24] Under certain circumstances, such activity can involve predatory lending practices. To address these crimes, investigators have presented evidence of false statements and other criminal fraud and deception. In addition, representatives from HUD told us that they have processes in place to ensure that lenders adhere to agency guidelines and make loans that satisfy FHA requirements. The Office of Lender Activities and Program Compliance approves, recertifies, and monitors FHA lenders and works with them to ensure compliance. If necessary, the office refers violating lenders to HUD's Mortgagee Review Board, which has the authority to take administrative actions such as withdrawing approval for a lender to make FHA-insured loans. HUD officials told us that the board has taken many administrative actions to address violations that could be indicative of predatory lending, such as charging excessive and unallowable fees, inflating appraisals, and falsifying documents showing income or employment. In an effort to address abusive property flipping schemes involving homes secured by FHA-insured loans, HUD issued a final rule in May 2003 that prohibits FHA insurance on properties resold less than 90 days after their previous sale.

HUD officials say that programs they have in place to improve the monitoring of FHA lenders also serve to deter predatory lending. For example, HUD's Credit Watch Program routinely identifies those lenders with the highest early default and insurance claim rates and temporarily suspends the FHA loan origination approval agreements of the riskiest lenders, helping to ensure that lenders are not making loans that borrowers cannot repay. Also, the Neighborhood Watch program provides information to FHA participants about lenders and appraisers whose loans have high default and FHA insurance claim rates. HUD told us that it has also taken a series of actions to better ensure the integrity of appraisals used to finance FHA insured loans. As of December 2003, HUD was in the final stages of issuing a rule that would hold lenders accountable for appraisals associated with loans they make.

[24]In property flipping schemes, properties are purchased and quickly resold at grossly inflated values. In some cases the inflated value is established by an interim sale to a "straw buyer" and then flipped to an unsuspecting purchaser. In other cases, first-time buyers who have been turned down for home loans because of poor credit or low income are targeted by flippers who arrange loans well in excess of the real value of the property using fabricated employment and deposit records. These schemes often involve many players, including mortgage lenders, mortgage brokers, underwriters, and home-improvement workers. Almost all flipping schemes involve false appraisals. While HUD categorizes property flipping as a predatory lending practice, not all federal agencies concur with this categorization.

HUD's Office of RESPA and Interstate Land Sales is responsible for handling complaints, conducting investigations, and taking enforcement actions related to RESPA. HUD has taken several enforcement actions related to RESPA's prohibition of kickbacks and referral fees, three of which related directly to abusive mortgage lending, as of December 2003.[25] Also, as discussed above, in November 2003 HUD and FTC jointly filed a case against and reached settlement with a mortgage loan servicing company charged with violations of the FTC Act, RESPA, and other laws.[26] HUD has also recently hired additional staff to enhance its RESPA enforcement efforts. Finally, in 2002, HUD issued a proposed rule designed to change the regulatory requirements of RESPA to simplify and potentially lower the costs of the home mortgage settlement process. According to HUD, as of December 2003, the final rule had been submitted to the Office of Management and Budget and was being reviewed.

HUD's Office of Fair Housing and Equal Opportunity is responsible for enforcing the Fair Housing Act. HUD identified one action—a letter of reprimand to a financial institution—related to enforcement of this act in a case involving predatory lending.

## Federal Banking Regulators Have Issued Guidance and Made Regulatory Changes

According to federal banking regulators and state enforcement authorities, federally regulated depository institutions—banks, thrifts, and credit unions—have not typically engaged in predatory lending practices. Federal banking regulators have systems in place to track customer complaints and reported that they have received few complaints related to predatory lending by the institutions they supervise. The regulators conduct routine examinations of these institutions and have the authority, in cases of suspected predatory lending, to enforce a variety of fair lending and consumer protection laws. Banking regulators noted that the examination process, which involves routine on-site reviews of lenders' activities, serves as a powerful deterrent to predatory lending by the institutions they examine.

[25] For example, a complaint filed jointly by HUD, FTC, and Illinois authorities against Mercantile Mortgage Company in 2002 alleged that for almost 3 years, a broker referred virtually every one of his loan customers to Mercantile in exchange for a fee as high as 10 percent. The other two cases involving RESPA include Delta Funding (2000) and Action Loan Company (2000).

[26] *United States of America v. Fairbanks Capital Corp.*, 03-12219-DPW (D. MA, filed Nov. 12, 2003).

Officials of OTS, FDIC, the Board, and NCUA said that they had taken no formal enforcement actions related to predatory mortgage lending against the institutions they regulate.[27] Officials at OCC said they have taken one formal enforcement action related to predatory mortgage lending to address fee packing, equity stripping, and making loans without regard to a borrower's ability to pay. In November 2003, the agency announced an enforcement action against Loan Star Capital Bank seeking to reimburse 30 or more borrowers for more than $100,000 in abusive fees and closing costs that violated the FTC Act, HOEPA, TILA, and RESPA.[28] The bank also was required to conduct a comprehensive review of its entire mortgage portfolio and to provide restitution to any additional borrowers who may have been harmed.

While most federal banking regulators stated that they have taken no formal enforcement actions, representatives from some said they had taken informal enforcement actions to address some questionable practices among their institutions. For example, OTS has examined institutions that may have charged inappropriate fees or violated HOEPA and resolved the problems by requiring corrective action as part of the examination process. In addition, most of the banking regulators have taken formal enforcement actions, including issuing cease-and-desist orders, in response to activities that violated fair lending and consumer protection laws but were not necessarily deemed to constitute "predatory lending."

## Guidance

Federal banking regulators have issued guidance to their institutions about both predatory lending and subprime lending in general. In February 2003, OCC issued two advisory letters related to predatory lending to the national banks and the operating subsidiaries it supervises. One letter provided specific guidelines for guarding against predatory lending practices during loan originations, and the other alerted institutions to the risk of indirectly

[27] Banking regulators have broad enforcement powers and can take formal actions (cease and desist orders, civil money penalties, removal orders, and suspension orders, among others) or informal enforcement actions (such as memoranda of understanding and board resolutions). Not all informal actions are publicly disclosed.

[28] *Matter of Clear Lake National Bank*, AA-EC03-25 (OCC Nov. 7, 2003). The lender that made the loans, Clear Lake National Bank of San Antonio, Texas, merged with another bank in April 2003 to become Lone Star Capital Bank, N.A. OCC brought the action under the enforcement authority provided by Section 8 of the Federal Deposit Insurance Act, 12 U.S.C. 1818.

engaging in predatory lending through brokered or purchased loans.[29] The advisory letters described loan attributes that are often considered predatory and established standards for policies and procedures for monitoring loan transactions to avoid making, brokering, or purchasing loans with such attributes. For example, the first letter stated that banks should establish underwriting policies and procedures to determine that borrowers have the capacity to repay their loans. The advisory letter also stated OCC's position that predatory lending will also affect a national bank's CRA rating. The advisories have also clarified ways in which predatory practices can create legal, safety and soundness, and reputation risks for national banks. For example, they laid out ways in which the origination or purchase of predatory loans may constitute violations of TILA, RESPA, HOEPA, the FTC Act, and fair lending laws. In addition, in January 2004, OCC issued a rule adopting antipredatory lending standards that expressly prohibit national banks from making loans without regard to the borrower's ability to repay and from engaging in unfair and deceptive practices under the FTC Act.[30]

In 1999 and 2001, the Board, FDIC, OCC, and OTS issued joint guidance to their institutions on subprime lending in general.[31] The guidance highlighted the additional risks inherent in subprime lending and noted that institutions engaging in such lending need to be aware of the potential for predatory practices and be particularly careful to avoid violating fair lending and consumer protection laws and regulations. The NCUA issued similar guidance to insured credit unions in 1999.[32] Federal banking

[29]OCC Advisory Letter 2003-2 (Guidance for National Banks to Guard Against Predatory and Abusive Lending Practices), February 21, 2003; and OCC Advisory Letter 2003-3 (Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans), February 21, 2003.

[30]69 Fed. Reg. 1904 (Jan. 13, 2004).

[31]The Board, FDIC, OCC and OTS, Interagency Guidance on Subprime Lending, March 1, 1999; and Expanded Guidance for Subprime Lending Programs, January 31, 2001. The 2001 guidance applies to institutions with subprime lending programs with an aggregate credit exposure greater than or equal to 25 percent of Tier 1 capital.

[32]NCUA Letter to Credit Unions No. 99-CU-05, Risk Based Lending, June 1999.

regulators have also previously issued guidance about abusive lending practices, unfair or deceptive acts or practices, and other issues related to predatory lending.[33]

## Regulatory Changes

The Board is responsible for issuing regulations that implement HOEPA and HMDA, two laws that play a role in addressing predatory lending. In December 2001, in response to concerns that HOEPA may not be adequately protecting consumers from abusive lending practices, the Board amended Regulation Z, which implements HOEPA, to

- lower the interest rate "trigger" that determines whether loans are covered under HOEPA in order to bring more loans under the protection of the law,[34]
- require that fees paid for credit insurance and similar debt protection products be included when determining whether loans are subject to HOEPA,
- prohibit creditors that make HOEPA loans from refinancing the loan within one year of origination with another HOEPA loan, unless the refinancing is in the borrower's interest, and
- clarify the prohibition against engaging in a "pattern or practice" of lending without regard to borrowers' ability to repay.[35]

In February 2002, the Board also made changes to Regulation C, which implements HMDA. The changes, which went into effect in January 2004, require lenders to provide additional data that may facilitate analyses of lending patterns that may be predatory. For example

[33]See OCC Advisory Letter 2000-7 (abusive lending practices); OCC Advisory Letter 2000-10, OCC Advisory Letter 2000-11, OTS Chief Executive Officers Letter 131, OTS Chief Executive Officers Letter 132, and NCUA Letter 01-FCU-03 (title loans and payday lending); OCC Bulletin 2001-47 (third-party relationships); and OCC Advisory Letter 2002-3 and FDIC Financial Institution Letter 57-2002 (unfair or deceptive acts or practices).

[34]The Board adjusted the annual percentage rate (APR) trigger from 10 to 8 percentage points above the rate for Treasury securities with comparable maturities. The change applies only to first lien mortgages; the subordinate lien mortgage APR trigger remained at 10 percent.

[35]66 Fed. Reg. 65604 (Dec. 20, 2001).

- if the costs to the borrower of financing a loan exceed a certain threshold determined by the Board, the lender must report the cost of the loan;[36]
- if an application or loan involves a manufactured home, the lender is required to identify that fact, in part to help identify predatory practices involving these types of homes; and
- if a loan is subject to HOEPA, the lender is required to identify that fact in order to give policymakers more specific information about the number and characteristics of HOEPA loans.[37]

Because HOEPA expressly grants the Board broad authority to issue rules to regulate unfair or deceptive acts and practices, some consumer advocacy organizations have argued that the Board should use its authority to do more to curb predatory lending.[38] For example, some consumer groups have called on the Board to use its rule-making authority to prohibit the financing of single-premium credit insurance—a product that is believed by many to be inherently predatory.[39] Under the McCarran Ferguson Act,[40] unless a federal statute is specifically related to the business of insurance, the federal law may not be construed to invalidate, impair, or supercede any state law enacted to regulate the business of insurance. Board officials say it is not clear the extent to which rules issued by the Board under HOEPA seeking to regulate the sale of single-premium credit insurance would be consistent with that standard. The Board has previously recommended that it would be more appropriate for Congress to address this issue through changes in law. Some consumer groups also have argued that the Board should increase the loan data reporting requirements of HMDA to help detect abusive lending. The

[36]More specifically, lenders are required to report the difference or spread between a loan's annual percentage rate (a value reflecting both the interest rate and certain fees associated with a loan) and the yield on a Treasury security of comparable maturity, for loans where this spread exceeds certain thresholds set by the Board. See, generally, 67 Fed. Reg. 7222 (Feb. 15, 2002) and 67 Fed. Reg. 43218 (June 27, 2002).

[37]*Id.*

[38]See 15 U.S.C. § 1639(l)(2).

[39]In its 2001 amendments to the HOEPA rules, the Board added single-premium credit insurance to HOEPA's fee trigger.

[40]See 15 U.S.C. § 1012.

Board has added certain loan pricing and other items to the HMDA reporting requirements, effective in January 2004, but did not add other data reporting requirements, such as the credit score of the applicant. Board officials said this is based on the belief that the need for additional loan data to ensure fair lending must be weighed against the costs and burdens to the lender of gathering and reporting the additional information.

## Agencies Have Coordinated on Enforcement Actions and Participated in Interagency Groups

Federal agencies have worked together to investigate and pursue some cases involving predatory lending. For example, FTC, DOJ, and HUD coordinated to take enforcement action against Delta Funding Corporation, with each agency investigating and bringing actions for violations of the laws under its jurisdiction. DOJ conducted its enforcement action against Long Beach Mortgage Company in coordination with OTS, which investigated the initial complaint in 1993 when the company was a thrift. Federal agencies have also coordinated with state authorities and private entities in enforcement actions. For example, in 2002, FTC joined six states, AARP, and private attorneys to settle a complaint against First Alliance Mortgage Company alleging that the company used deception and manipulation in its lending practices.

Federal regulators have also coordinated their efforts to address fair lending and predatory lending through working groups. For example

- In the fall of 1999 the Interagency Fair Lending Task Force, which coordinates federal efforts to address discriminatory lending, established a working group to examine the laws related to predatory lending and determine how enforcement and consumer education could be strengthened.[41] Because of differing views on how to define and combat predatory lending, the group was unable to agree on a federal interagency policy statement related to predatory lending in 2001. The Task Force then continued its efforts related to consumer education and published a brochure in 2003 to educate consumers about predatory lending practices.
- The five banking regulators have conducted additional coordination activities through the Federal Financial Institutions Examination

[41]The agencies that participated in the working group were OCC, OTS, FDIC, the Board, NCUA, DOJ, FTC, HUD, the Federal Housing Finance Board, and the Office of Federal Housing Enterprise Oversight.

Council's Task Force on Consumer Compliance.[42] The task force coordinates policies and procedures for ensuring compliance with fair lending laws and the Community Reinvestment Act, both of which have been identified as tools that can be used to address predatory lending. The council publishes a document that responds to frequently asked questions about community reinvestment, including how examiners should consider illegal credit practices, which may be abusive, in determining an institution's Community Reinvestment Act rating.

- In 2000, HUD and the Department of the Treasury created the National Task Force on Predatory Lending, which convened forums around the country to examine the issue and released a report later in the year.[43] The report made specific recommendations to Congress, federal agencies, and other stakeholders that were aimed at (1) improving consumer literacy and disclosure, (2) reducing harmful sales practices, (3) reducing abusive or deceptive loan terms and conditions, and (4) changing structural aspects of the lending market.

Some of the recommendations made in the HUD-Treasury task force report have been implemented. For example, as recommended in the report, the Board has adopted changes to HOEPA regulations that have increased the number of loans covered and added additional restrictions. In addition, as the report recommended, FTC and some states have devoted more resources in the past few years to actively pursuing high-profile enforcement cases. As discussed in chapter 5, federal and state agencies have also worked to improve one of the areas highlighted in the report: public awareness about predatory lending issues. Other recommendations made in the report have not been implemented, however. For example, Congress has not enacted legislation to expand penalties for violations of TILA, HOEPA, and RESPA or to increase the damages available to borrowers harmed by such violations. HUD and the Department of the Treasury told us that they have not formally tracked the status of the recommendations made in the report, although HUD officials said they are

[42]The Federal Financial Institutions Examination Council is a formal interagency body composed of representatives of each of the five federal banking regulators. The council was established in 1979 and is empowered to (1) prescribe uniform principles, standards, and report forms for the federal examination of financial institutions and (2) make recommendations to promote uniformity in the supervision of financial institutions.

[43]U.S. Department of the Treasury and U.S. Department of Housing and Urban Development, *Curbing Predatory Home Mortgage Lending: A Joint Report*, June 2000.

informally monitoring the recommendations in the report that relate to their agency. Officials at both agencies also noted that the report and its recommendations were the product of a previous administration and may or may not reflect the views of the current administration.

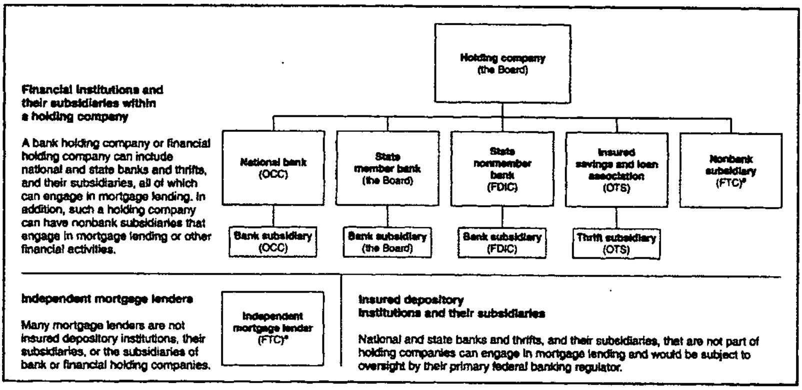
In addition to participating in interagency groups, agencies share information related to fair lending violations under statutory requirements and formal agreements. For example, since 1992 HUD and the banking regulators have had a memorandum of understanding stating that HUD will refer allegations of fair lending violations to banking regulators and a 1994 executive order requires that executive branch agencies notify HUD of complaints and violations of the Fair Housing Act. In addition, whenever the banking regulatory agencies or HUD have reason to believe that an institution has engaged in a "pattern or practice" of illegal discrimination, they are required to refer these cases to DOJ for possible civil action.

## Jurisdictional Issues Related to Nonbank Subsidiaries Challenge Efforts to Combat Predatory Lending

Jurisdictional issues related to the regulation of certain nonbank mortgage lenders may challenge efforts to combat predatory lending. Many federally and state-chartered banks and thrifts, as well as their subsidiaries, are part of larger financial holding companies or bank holding companies.[44] These holding companies may also include nonbank financial companies, such as finance and mortgage companies, that are subsidiaries of the holding companies themselves. These holding company subsidiaries are frequently referred to as affiliates of the banks and thrifts because of their common ownership by the holding company. As shown in figure 2, the federal regulators of federally and state-chartered banks and thrifts also regulate the subsidiaries of those institutions. For example, as the primary regulator for national banks, OCC also examines operating subsidiaries of those banks. On the other hand, federal regulators generally do not perform routine examinations of independent mortgage lenders and affiliated nonbank subsidiaries of financial and bank holding companies engaged in mortgage lending.

[44] A subsidiary of a bank, thrift, or credit union is controlled through partial or complete ownership by the institution. Federal laws and regulations set more specific requirements that dictate whether an institution is a subsidiary. For the purposes of this report, the term holding company refers to both (traditional) bank holding companies and bank holding companies that qualify as financial holding companies as defined by the Board.

Figure 2: Structure and Federal Oversight of Mortgage Lenders




Source: GAO.

Note: The primary federal agency for enforcement of the various federal laws used to combat abusive or predatory lending activities is shown in parentheses.

[a]FTC is responsible for enforcing federal laws for lenders that are not depository institutions but it is not a supervisory agency and does not conduct routine examinations.

Some disagreement exists between states and some federal banking regulators over states' authority to regulate and supervise the operating subsidiaries of federally chartered depository institutions. For example, OCC issued an advisory letter in 2002 noting that federal law provides the agency with exclusive authority to supervise and examine operating subsidiaries of national banks and that the states have no authority to regulate or supervise these subsidiaries.[45] Some representatives of state banking regulators expressed concerns to us about this because of the subsidiaries' potential involvement in predatory lending practices. OCC

[45]OCC Advisory Letter 2002-9 (Questions Concerning Applicability and Enforcement of State Laws: Contacts From State Officials, November 25, 2002.); see also 69 Fed. Reg. 1904 (Jan. 13, 2004).

has stated that the subsidiaries of the institutions it regulates do not play a large role in subprime lending and that little evidence exists to show that these subsidiaries are involved in predatory lending. But some state enforcement authorities and consumer advocates argue otherwise, citing some allegations of abuses at national bank subsidiaries. However, several state attorneys general have written that predatory lending abuses are "largely confined" to the subprime lending market and to non-depository institutions, not banks or direct bank subsidiaries.[46] OCC officials stated that the agency has strong monitoring and enforcement systems in place and can and will respond vigorously to any abuses among institutions it supervises.[47] For example, OCC officials pointed to an enforcement action taken in November 2003 that required restitution of more than $100,000 to be paid to 30 or more borrowers for fees and interest charged in a series of abusive loans involving small "tax-lien loans."

A second issue relates to the monitoring and supervision of certain nonbank subsidiaries of holding companies. As noted previously, many federally and state-chartered banks and thrifts, as well as their subsidiaries, are part of larger financial or bank holding companies.[48] These holding companies may also include nonbank subsidiaries, such as finance and mortgage companies, that are affiliates but not subsidiaries of the federally regulated bank or thrift. Although these affiliates engage in financial activities that may be subject to federal consumer protection and fair lending laws, unlike depository institutions they are not subject to routine supervisory examinations for compliance with those laws. While the Board has jurisdiction over these entities for purposes of the Bank Holding Company Act, it lacks authority to ensure and enforce their compliance.

[46]See Brief of Amicus Curiae State Attorneys General, *National Home Equity Mortgage Ass'n v. OTS*, Civil Action No. 02-2506 (GK) (D D.C.) (March 21, 2003) at 10-11.

[47]Another jurisdictional issue is uncertainty as to whether the FTC shares jurisdiction with federal banking regulators over bank subsidiaries that are not themselves banks (operating subsidiaries). While OCC maintains it has exclusive regulatory jurisdiction over the operating subsidiaries of national banks, FTC argues that a provision of the Gramm-Leach-Bliley Act provides for the two agencies to share jurisdiction. See Pub. L. No. 106-102 § 133(a). A federal district court has upheld FTC's interpretation. (See *Minnesota v. Fleet Mortg. Corp.*, 181 F. Supp. 2d 995 (D MN 2001)). We are not aware of any instance in which this matter has interfered with an FTC enforcement action.

[48]In addition to financial and bank holding companies, there are thrift holding companies, which can include thrifts and other financial institutions. Each thrift holding company is regulated and subject to examination by OTS. See 12 USC §1467a (b)(4).

with federal consumer protection and fair lending laws in the same way that the federal regulators monitor their depository institutions.

One reason for the concern about these entities is that nonbank subsidiaries of holding companies conduct a significant amount of subprime mortgage lending. Of the total subprime loan originations made by the top 25 subprime lenders in the first 6 months of 2003, 24 percent were originated by nonbank subsidiaries of holding companies. In addition, of the 178 lenders on HUD's 2001 subprime lender list, 20 percent were nonbank subsidiaries of holding companies. These types of subsidiaries have also been targets of some of the most notable federal and state enforcement actions involving abusive lending. For example, The Associates and Fleet Finance, which were both nonbank subsidiaries of bank holding companies, were defendants in two of the three largest cases involving subprime lending that FTC has brought.[49]

The Associates case illustrates an important aspect of the current federal regulatory oversight structure pertinent to predatory lending. The Board has authority under the Bank Holding Company Act to condition its approval of holding company acquisitions. The Board used this authority in connection with Citigroup's acquisition of European American Bank because of concerns about the subprime lending activities of The Associates, which Citigroup had acquired and merged into its CitiFinancial subsidiary. As a condition of approving the acquisition of European American Bank, the Board directed that an examination of certain subprime lending subsidiaries of Citigroup be carried out to determine whether Citigroup was effectively implementing policies and procedures designed to ensure compliance with fair lending laws and prevent abusive lending practices. However, the Board does not have clear authority to conduct the same type of monitoring outside of the Bank Holding Company Act approval process. Although the Board has the authority to monitor and

[49]Citigroup acquired The Associates in November 2000 and merged The Associates' consumer finance operations into its subsidiary, CitiFinancial Credit Company, a nonbank subsidiary of the holding company. In 1999, Fleet Finance, Inc., and its successor company, Home Equity U.S.A., Inc., agreed to pay $1.3 million to settle an FTC complaint alleging deceptive disclosures and TILA violations in conjunction with Fleet Finance, Inc., loans. At the time of the settlement, Fleet Finance had become Home Equity U.S.A., Inc. Both Fleet Finance, Inc., and Home Equity U.S.A., Inc., were nonbank subsidiaries of bank holding companies. At the time of the settlement, the bank holding company was Fleet Financial Group, Inc., which has been renamed FleetBoston Financial Corporation. Home Equity U.S.A., Inc., continues to operate as a nonbank subsidiary of FleetBoston Financial Corporation, a bank holding company.

perform routine inspections or examinations of a bank holding company, this authority apparently does not extend to routine examinations of nonbank subsidiaries of bank holding companies with regard to compliance with consumer protection laws. The Bank Holding Company Act, as amended by the Gramm-Leach-Bliley Act, authorizes the Board to examine a nonbank subsidiary for specific purposes, including "to monitor compliance with the provisions of (the Bank Holding Company Act) or any other Federal law that the Board has specific jurisdiction to enforce against such company or subsidiary." Federal consumer protection laws do not give the Board specific enforcement jurisdiction over nonbank subsidiaries.

For this reason, FTC is the primary federal agency monitoring nonbank subsidiaries' compliance with consumer protection laws. FTC is the primary federal enforcer of consumer protection laws for these nonbank subsidiaries, but it is a law enforcement rather than supervisory agency. Thus, FTC's mission and resource allocations are focused on conducting investigations in response to consumer complaints and other information rather than on routine monitoring and examination responsibilities. Moreover, as discussed elsewhere in this report, states vary widely in the extent to which they regulate practices that can constitute predatory lending.

The HUD-Treasury report on predatory lending argued that the Board should take more responsibility for monitoring nonbank subsidiaries of bank holding companies, in part to ensure that consumer protection laws are adequately enforced for these institutions. Similarly, in 1999, GAO recommended that the Board monitor the lending activities of nonbank mortgage lending subsidiaries of bank holding companies and consider examining these entities if patterns in lending performance, growth, or operating relationships with other holding company entities indicated the need to do so.[80] In its written response to GAO's recommendation, the Board said that while it has the general legal authority to examine these entities, it has neither the clear enforcement jurisdiction nor the legal responsibility for engaging in such activities, as Congress has directly charged FTC with primary responsibility over enforcement with regard to these entities.

[80]See U.S. General Accounting Office, *Large Bank Mergers: Fair Lending Review Could be Enhanced With Better Coordination*, GAO/GGD-00-16 (Washington, D.C.: Nov. 3, 1999), 20 and 47.

Among federal agencies, the Board is uniquely situated to monitor the activities of the nonbank mortgage lending subsidiaries of financial and bank holding companies by virtue of its role as the regulator of holding companies and its corresponding access to data (such as internal operating procedures, loan level data, and current involvement in subprime lending) that are not readily available to the public. In addition, the Board has extensive experience monitoring and analyzing HMDA data. The recent changes in HMDA reporting requirements will increase the Board's ability to effectively monitor nonbank mortgage lending subsidiaries of holding companies for lending abuses.

In contrast to the specific limits on the Board's examination authority, its authority to enforce the federal consumer protection laws against nonbank subsidiaries is somewhat less clear. The laws themselves specify the institutions subject to enforcement by the Board, but those institutions generally do not include nonbank subsidiaries. The Board has concluded that it must defer enforcement action at least where, as here, a statute specifically prescribes its enforcement jurisdiction to cover only certain entities and specifically grants enforcement authority for other entities to another agency.

## Conclusions

Under a number of laws, federal agencies have taken action to protect consumers from abusive lending practices. While FTC has taken a number of significant enforcement actions to battle abuses in the industry, its resources are finite and, as a law enforcement agency, it does not routinely monitor or examine lenders, including the mortgage lending subsidiaries of financial and bank holding companies.

Congress provided banking regulators with the authority to ensure compliance with consumer protection laws by the institutions they regulate, in part because it recognized the efficiencies of having banking regulators monitor for compliance with these laws while examining their institutions for safety and soundness. The Board is in a position to help ensure compliance with federal consumer protection laws by certain subsidiaries of financial and bank holding companies if it were clearly authorized to do so. While concerns about predatory lending extend well beyond the activities of the nonbank subsidiaries of holding companies, these entities represent a significant portion of the subprime mortgage market. Monitoring the mortgage lending activities of the nonbank subsidiaries would help the Board determine when it would be beneficial to conduct examinations of specific nonbank subsidiaries. The Board could then refer its findings to DOJ, HUD, or FTC or take its own enforcement action if a problem exists. Granting the Board concurrent enforcement authority—with the FTC—for these nonbank subsidiaries of holding companies would not diminish FTC's authority under federal laws used to combat predatory lending.

The significant amount of subprime lending among holding company subsidiaries, combined with recent large settlements in cases involving allegations against such subsidiaries, suggests a need for additional scrutiny and monitoring of these entities. The Board is in an optimal position to play a larger role in such monitoring but does not have clear legal authority and responsibility to do so for these entities with regard to monitoring compliance of consumer protection laws.

## Matters for Congressional Consideration

To enable greater oversight of and potentially deter predatory lending from occurring at certain nonbank lenders, Congress should consider making appropriate statutory changes to grant the Board of Governors of the Federal Reserve System the authority to routinely monitor and, as necessary, examine the nonbank mortgage lending subsidiaries of financial and bank holding companies for compliance with federal consumer protection laws applicable to predatory lending practices. Also, Congress should consider giving the Board specific authority to initiate enforcement actions under those laws against these nonbank mortgage lending subsidiaries.

## Agency Comments and Our Evaluation

GAO provided a draft of this report to the Board, DOJ, FDIC, FTC, HUD, NCUA, OCC, OTS, and the Department of the Treasury for review and comment. The agencies provided technical comments that have been incorporated, as appropriate. In addition, the Board, DOJ, FDIC, FTC, HUD, and NCUA provided general comments, which are discussed below. The written comments of the Board, DOJ, HUD, and NCUA are printed in appendixes II through V.

The Board commented that, while the existing structure has not been a barrier to Federal Reserve oversight, the approach recommended in our Matter for Congressional Consideration would likely be beneficial by catching some abusive practices that might not be caught otherwise. The Board also noted that the approach would pose tradeoffs, such as different supervisory schemes being applied to nonbank mortgage lenders based on whether or not they are part of a holding company. Because nonbank mortgage lenders that are part of a financial or bank holding company are already subject to being examined by the Board in some circumstances, they are already subject to a different supervisory scheme than other such lenders. For example, in its comments the Board noted that it may on occasion direct an examination of a nonbank lending subsidiary of a holding company when necessary in the context of applications that raise serious fair lending or compliance issues. Accordingly, we do not believe that clarifying jurisdiction as contemplated in the Matter would result in a significant departure from the current supervisory scheme for nonbank mortgage lenders. The Board also noted that that there could be some additional cost to the nonbank mortgage lending subsidiaries of financial or bank holding companies, as well as to the Board, if the Board were to exercise additional authority. We agree and believe that Congress should consider both the potential costs as well as the benefits of clarifying the Board's authorities.

The FTC expressed concern that our report could give the impression that we are suggesting that Congress consider giving the Board sole jurisdiction—rather than concurrent jurisdiction with FTC—over nonbank subsidiaries of holding companies. Our report did not intend to suggest that the Congress make any change that would necessarily affect FTC's existing authority for these entities and we modified our report to clarify this point. To illustrate the difference in regulatory and enforcement approaches, our draft report contrasted the Board's routine examination authority with the FTC's role as a law enforcement agency. In its comments, FTC noted that it uses a number of tools to monitor nonbank mortgage lenders, of which consumer complaints is only one. The agency also commented that a key difference between the FTC and the Board is that the Board has access to routine information to aid in its oversight as part of the supervisory process. Our report did not intend to suggest that the FTC's actions are based solely on consumer complaints, and we revised the report to avoid this impression.

DOJ commented that the report will be helpful in assessing the department's role in the federal government's efforts to develop strategies to combat predatory lending. DOJ disagreed with our inclusion in the report of "property or loan flips," which it characterized as a traditional fraud scheme rather than an example of predatory lending. As our report states, there is no precise definition of predatory lending. We included a discussion of efforts to combat "property flipping" because HUD officials told us that these schemes sometimes involve predatory practices that can harm borrowers. As we note in the report, while HUD categorizes property flipping as a predatory lending practice, not all federal agencies concur with this categorization. Distinct from property flipping is "loan flipping"—the rapid and repeated refinancing of a loan without benefit to the borrower. This practice is widely noted in literature and by federal, state, industry, and nonprofit officials as constituting predatory lending.

FDIC noted that our Matter for Congressional Consideration focuses on nonbank subsidiaries of financial and bank holding companies even though these entities comprise, according to HUD, only about 20 percent of all subprime lenders. We acknowledge that our Matter does not address all subprime lenders or institutions that may be engaging in predatory lending, but believe it represents a step in addressing predatory lending among a significant category of mortgage lenders. NCUA said that the report provides a useful discussion of the issues and that the agency concurs with our Matter for Congressional Consideration. HUD, in its comment letter, described a variety of actions it has taken that it characterized as combating predatory lending, particularly with regard to FHA-insured loans.

# States Have Enacted and Enforced Laws to Address Predatory Lending, but Some Laws Have Been Preempted

In part because of concerns about the growth of predatory lending and the limitations of existing state and federal laws, 25 states, the District of Columbia, and 11 localities had passed their own laws addressing predatory lending practices as of January 9, 2004.[1] Most of the state laws restrict the terms or provisions of certain high-cost loans, while others apply to a broader range of loans. In addition, some states have taken measures to strengthen the regulation and licensing of mortgage lenders and brokers, and some have used existing state consumer protection and banking laws to take enforcement actions related to abusive lending. However, regulators of federally chartered financial institutions have issued opinions stating that federal laws may preempt some state predatory lending laws and that nationally chartered lending institutions should have to comply only with a single uniform set of national standards. Many state officials and consumer advocates have opposed federal preemption of state predatory lending laws on the grounds that it interferes with the states' ability to protect consumers.

## States and Localities Have Addressed Predatory Lending through Legislation, Regulation, and Enforcement Actions

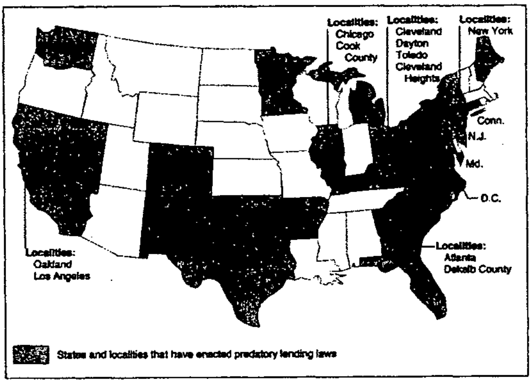
Since 1999, many states and localities have passed laws designed to address abusive mortgage lending by restricting the terms or provisions of certain loans. In addition, states have increased the registration or licensing requirements of mortgage brokers and mortgage lenders and have undertaken enforcement activities under existing consumer protection laws and regulations to combat abusive lending.

[1] Except where citations to provisions of state laws are provided, all information relating to state and local laws and their provisions is from a database maintained by Butera & Andrews, a Washington, D.C., law firm that tracks predatory lending legislation. These laws include only state and local laws that place actual restrictions on lending and do not include, for example, local ordinances that consist solely of a resolution that condemned predatory lending. As noted in chapter 1, we took measures to verify the reliability of these data.

## A Growing Number of States and Localities Have Passed Laws to Address Abusive Lending

According to the database of state laws, as of January 9, 2004, 25 states and the District of Columbia had passed laws that were specifically designed to address abusive lending practices.[2] (See fig. 3.) These laws were motivated, at least in part, by growing evidence of abusive lending and by concerns that existing laws were not sufficient to protect consumers against abusive lending practices.

Figure 3: States and Localities That Have Enacted Predatory Lending Laws




Source: Butera & Andrews.

[2]North Carolina enacted the first state law (N.C. Gen. Stat. 24-1-.1E[1999]) in 1999; it took effect on July 1, 2000. Nearly all the other state laws were enacted between 2001 and 2003.

Based on our review of the database of state laws, the predatory lending statutes in 20 of the 25 states regulate and restrict the terms and characteristics of certain kinds of "high-cost" or "covered" mortgage loans that exceed certain interest rate or fee triggers.[3] Some state laws, such as those in Florida, Ohio, and Pennsylvania, use triggers that are identical to those in the federal HOEPA statute but add provisions or requirements, such as restrictions on refinancing a loan under certain conditions.[4] Other state laws, such as those of Georgia, New Jersey and North Carolina, use triggers that are lower than those in HOEPA and therefore cover more loans than the federal legislation.[5] Some states design their triggers to vary depending on the amount of the loan. For example, in New Mexico and North Carolina, covered loans greater than $20,000 are considered high cost if the points and fees on the loan exceed 5 percent of the total loan amount (North Carolina) or equal or exceed it (New Mexico). In these states, loans for less than $20,000 are considered high cost if the points and fees exceed either 8 percent of the total or $1,000.[6] In the remaining 5 states, the predatory lending laws apply to most mortgage loans; there is no designation of loans as high cost. For example, West Virginia's law in effect generally prohibits lenders from charging prepayment penalties on any loans and restricts points and fees to either 5 or 6 percent, depending on whether the loan includes a yield spread premium.[7] Michigan's law prohibits the financing of single-premium credit insurance into loans.[8]

According to the database, common provisions in state laws are designed to address the following:

- *Lending without regard to the ability to repay.* Restrictions on the making of loans without regard to the borrower's ability to repay the loan, sometimes referred to as asset-based lending.

[3]Massachusetts has imposed similar restrictions on high-cost loans, but it was done through regulatory changes rather than legislation.

[4]See, e.g., Fla. Stat. Ann. §§ 494.0079, 494.00791 (2003); Ohio Rev. Code Ann. §§ 1394; Ohio Rev. Code Ann. § 1349.25 (2003); 63 PA Stat. § 456.503 (2003).

[5]See GA Code Ann. § 7-6A-2(2003); N.J. Stat. Ann. § 46:10B-24 (West 2003); N.C. Gen. Stat. § 24-1.1E (2003).

[6]N.C. Gen. Stat. § 24-1-1E; N.M. Stat. Ann § 58-21A-3 (2003).

[7]W. VA. Code §§ 46A-3-110, 31-17-8 (2003).

[8]See Mich. Comp. Laws § 445.1634 (2003).

- *Prepayment penalties.* Limitations on the amount of a prepayment penalty, terms under which a penalty can be assessed, or both.

- *Balloon payments.* Prohibitions on loans with balloon payments or restrictions on their timing.

- *Negative amortization.* Prohibitions on loans where regularly scheduled payments do not cover the interest due.

- *Loan flipping.* Restrictions or prohibitions on the repeated refinancing of certain loans within a short period of time if the refinancing will not benefit the borrower.

- *Credit counseling.* Requirements that borrowers either receive or are notified of the availability of loan counseling.

- *Arbitration clauses.* Restrictions on mandatory arbitration clauses, which limit a borrower's right to seek redress in court. Some laws prohibit mandatory arbitration clauses altogether, while others require compliance with certain standards, such as those set by a nationally recognized arbitration organization.

- *Assignee liability.* Provisions that expressly hold purchasers or securitizers of loans liable for violations of the law committed by the originator, under certain conditions. (See ch. 4 for more information on assignee liability.)

In addition, according to the database we reviewed, 11 cities and counties have passed laws of their own designed to address predatory lending since 2000.[9] Some local laws are similar to state laws in that they define high-cost loans and restrict their provisions, such as in Los Angeles, California. Other localities, such as Oakland, California, have passed resolutions prohibiting lenders that engage in predatory lending practices from doing business with the locality.

[9]In some cases, these laws were enacted but pending litigation stayed enforcement.

## Some States Have Increased the Regulation of Lenders and Brokers and Undertaken Enforcement Activities to Combat Predatory Lending

In general, states have regulated mortgage lenders and brokers, although to varying degrees. Some state officials told us that because of concerns that unscrupulous mortgage lenders and brokers were not adequately regulated and were responsible for lending abuses, some states have increased their regulation or licensing requirements of lenders and brokers. As part of their licensing requirements, states sometimes require that these companies establish a bond to help compensate victims of predatory lenders or brokers that go out of business, and some states also require that individuals working for or as mortgage lenders and brokers meet certain educational requirements.

Some states have also reorganized their agencies' operations to better address abuses by lenders and brokers. For example, an official with the Kansas Office of the State Banking Commissioner told us that in 1999 the Kansas legislature created the Division of Consumer and Mortgage Lending, which provides additional staff for examination and enforcement activities. Similarly, an official from the Idaho Department of Finance told us that the state created the Consumer Finance Bureau in 2000 to oversee and conduct routine examinations of mortgage brokers and mortgage lenders.

State law enforcement agencies and banking regulators have also taken a number of actions in recent years to enforce existing state consumer protection and banking laws in cases involving predatory lending. For example, an official from the Washington Department of Financial Institutions reported that it has taken several enforcement actions in recent years to address predatory lending. In one such action, a California mortgage company that allegedly deceived borrowers and made prohibited charges was ordered to return more than $700,000 to 120 Washington State borrowers. According to officials of the Conference of State Bank Supervisors, states reported that in addressing predatory lending they have usually relied on general state consumer protection laws in areas such as fair lending, licensing, and unfair and deceptive practices. In some states, consumer protection statutes do not apply to financial institutions, so state banking regulators, rather than the attorneys general, typically initiate enforcement activities. Because allegations of predatory practices often involve lending activities in multiple states, states have sometimes cooperated in investigating alleged abuses and negotiating settlements. For example, in 2002 a settlement of up to $484 million with Household Finance Corporation resulted from a joint investigation begun by the attorneys general and financial regulatory agencies of 19 states and the

District of Columbia. State agencies have also conducted investigations in conjunction with the federal government.

## Activities in North Carolina and Ohio Illustrate State Approaches to Predatory Lending

States have varied in their approaches to addressing predatory lending issues. We reviewed legislative and enforcement activities related to predatory lending in two states, North Carolina and Ohio, to illustrate two different approaches.

### Impact of North Carolina's Laws on High-Cost Loans and Licensing of Brokers and Originators Remains Uncertain

North Carolina has enacted two separate laws to address concerns about predatory lending. In 1999, the legislature passed a law that attempted to curb predatory lending by prohibiting specific lending practices and restricting the terms of high-cost loans.[10] In 2001, North Carolina supplemented its predatory lending law by adopting legislation that required the licensing of mortgage professionals (mortgage lenders, brokers, and loan officers), defined a number of prohibited activities related to the making of residential mortgages, and enhanced the enforcement powers of the banking commissioner.[11]

According to the North Carolina Commissioner of Banks, the North Carolina laws applicable to predatory lending were the product of a consensus of banks, mortgage bankers and brokers, nonprofit organizations, and other stakeholders and were intended to address lending abuses that were not prohibited by federal statutes and regulations. Among other things, the 1999 legislation, known as the North Carolina Anti-Predatory Lending Law, imposes limitations specific to both "high-cost"

[10] N.C. Session Law 1999-332.

[11] N.C. Sessions Laws 2001-393 and 2001-399.

loans and other "consumer home loans."[12] North Carolina's predatory lending law did not restrict initial interest rates but instead focused on prohibiting specific lending practices and restricting the terms of high-cost loans. In conjunction with other North Carolina laws, the 1999 legislation contains four key features. First, it bans prepayment penalties for all home loans with a principal amount of $150,000 or less. Second, it prohibits loan flipping—refinancings of consumer home loans that do not provide a reasonable, net tangible benefit to the borrower. Third, it prohibits the financing of single-premium credit life insurance. Finally, it sets a number of restrictions on high-cost loans, including making loans without regard to borrowers' ability to repay; financing points, fees, and any other charges payable to third parties; or setting up loans with balloon payments. Further, the law prohibits home improvement contract loans under which the proceeds go directly to the contractor, and requires that borrowers receive financial counseling prior to closing.

Although the North Carolina predatory lending law governs the practices of lenders and mortgage brokers, some groups questioned whether it provided for effective enforcement. Specifically, concerns were focused on the lack of state licensing and oversight of all segments of the mortgage lending profession, including mortgage brokers and bankers. Additionally, some critics asserted that the statute provided the state banking commissioner with limited and uncertain authority to enforce the predatory lending provisions. As a result, even before the predatory lending legislation passed, stakeholders worked on a measure to fill the gaps left by the state's predatory lending law.

[12]The North Carolina predatory lending law defines a high-cost loan as a home loan of $300,000 or less that has one or more of the following characteristics: (1) points, fees (excluding certain amounts specified in the law), and other charges totaling more than 5 percent of the borrowed amount if the loan is $20,000 or more, or the lesser of 8 percent of the amount borrowed or $1,000 if the loan is less than $20,000; (2) an interest rate that exceeds by more than 10 percent per annum the yield on comparable Treasury bills; or (3) a prepayment penalty that could be collected more than 30 months after closing or that is greater than 2 percent of the amount prepaid. According to the North Carolina Commissioner of Banks, the $300,000 cap is based on the presumption that those able to borrow $300,000 or more are able to adequately protect themselves. "Consumer home loans" are loans in which (i) the borrower is a natural person, (ii) the debt is incurred by the borrower primarily for personal, family, or household purposes, and (iii) the loan is secured by a mortgage or deed of trust upon real estate upon which there is located or there is to be located a structure or structures designed principally for occupancy of from one to four families which is or will be occupied by the borrower as the borrower's principal dwelling.

North Carolina's second statute, the Mortgage Lending Act, was signed into law on August 29, 2001. Prior to the act, some mortgage banking firms and all mortgage brokerages domiciled in the state had been required to register with the state's banking regulator, but individual loan originators were not. The Mortgage Lending Act imposed licensing requirements on all mortgage bankers and brokers, including individuals who originate loans, and added continuing education and testing requirements for mortgage loan officers. The provisions of the act mean that individuals as well as firms are now subject to regulatory discipline. According to the North Carolina Commissioner of Banks, the act has been effective in reducing the number of abusive brokers and individual loan originators. The commissioner noted that a large number of applications for licenses have been denied because the applicants did not meet basic requirements or did not pass the required background check.

Studies on the impact of North Carolina's Anti-Predatory Lending Law have offered conflicting conclusions. For example, one study found an overall decline in subprime mortgages and concluded that any reductions in predatory lending had been attained at the expense of many legitimate loans.[13] Some have pointed to this evidence as suggesting that the law has reduced legitimate credit to those who most need it. Another study found a reduction in subprime originations but attributed the decline to a reduction in loans with abusive or predatory terms.[14] Consumer advocates and state officials have cited this study as evidence that the law has worked as intended.

Our review of the five studies available on the impact of the North Carolina predatory lending law suggested that data limitations and the lack of an accepted definition of predatory lending make determining the law's impact difficult. For example, information about borrowers' risk profiles, the pricing and production costs of the loans, and the lenders' and borrowers' behaviors was not available to the study researchers. In addition, the extent to which any potential reductions in predatory loans

[13]Elliehausen and Staten, *Regulation of Subprime Mortgage Products: An Analysis of North Carolina's Predatory Lending Law*, Georgetown University School of Business (November 2002).

[14]Quercia, Stegman, and Davis, *The Impact of North Carolina's Anti-Predatory Lending Law: A Descriptive Assessment*, Center for Community Capitalism, The Frank Hawkins Kenan Institute of Private Enterprise, University of North Carolina at Chapel Hill (June 25, 2003).

can be attributed to the Mortgage Lending Act as opposed to the Anti-Predatory Lending Law is unclear. Additional experience with the North Carolina laws may be needed in order to properly assess them.

## Ohio Has Preempted Local Laws and Taken Action to Regulate Mortgage Brokers

In February 2002, the Ohio legislature enacted a law with the purpose of bringing Ohio law into conformance with HOEPA.[15] Among other things, the legislation preempted certain local predatory lending ordinances. The law was passed in response to an ordinance enacted in the city of Dayton, which was designed to fight predatory lending by regulating mortgage loans originated in that city. Proponents of the state law argued that regulating lenders is a state rather than municipal function and that lending rules should be uniform throughout the state. Some advocates argued that the state law prevents cities from protecting their citizens from abusive lending practices.

The Ohio law imposes certain restrictions on high-cost loans as defined by HOEPA. These include additional restrictions on credit life or disability insurance beyond those imposed by HOEPA. The law also prohibits the replacement or consolidation of a zero- interest rate or other low-rate loan made by a governmental or nonprofit lender with a high-cost loan within the first 10 years of the low-rate loan unless the current holder of the loan consents in writing to the refinancing.[16] Because the purpose of this law was to bring Ohio's law into conformance with HOEPA, the law applies only to loans that qualify as mortgage loans subject to HOEPA. Thus, like predatory lending laws in some other states, the Ohio law applies to relatively few loans.

In May 2002, the Ohio legislature passed another piece of legislation, designed in part to address abusive lending—the Ohio Mortgage Broker Act—that imposed requirements on the state's mortgage brokers and loan officers.[17] Among other things, this law required state examination, education, and licensing of loan officers, and prohibited brokers from engaging in certain deceptive or fraudulent practices. It also required that

[15]See Ohio Rev. Code. Ann. § 1349.32 (2003).

[16]Ohio Rev. Code Ann. § 1349.27 (2002).

[17]See Ohio. Rev. Code Ann. §§ 1322.01 - 1322.12 (2003).

mortgage brokers and loan officers receive continuing education and take prelicensing competency tests.

In the act adopting HOEPA standards, the Ohio legislature also established a Predatory Lending Study Committee, which was charged with investigating the impact of predatory lending practices on the citizens and communities of Ohio.[18] The study committee consisted of 15 members, including representatives from state agencies, consumer groups, and the lending industry. The act required the committee to submit a report to the governor and legislators by the end of June 2003. The committee reached consensus on two major issues. First, it recommended that all appraisers in the state be licensed and subject to criminal background checks, and second, it recommended increased enforcement of the Ohio Mortgage Broker Act. The Division of Financial Institutions, which is responsible for enforcing the Ohio Mortgage Broker Act, has hired additional staff to ensure compliance with the law. The report and recommendations have been forwarded to the governor and the committee suggested that the Ohio General Assembly consider all recommendations.

Other local ordinances have been passed in Ohio to address predatory lending. One of these ordinances, passed in November 2002 by the Toledo City Council to regulate mortgage lending practices, was challenged, and its enforcement stayed, because of the state HOEPA law passed in February 2002.[19] One provision of that ordinance prohibited making an abusive loan by "taking advantage of a borrower's physical or mental infirmities, ignorance or inability to understand the terms of the loan." This provision drew criticism from the mortgage industry, which said the language was vague and difficult to comply with. For example, one secondary market participant noted that it would be nearly impossible to assess borrowers' mental capabilities for loans they did not originate in the first place. Violating the law was made a criminal offense, and convicted offenders could not receive city contracts or conduct other business with the city.

[18]2002 Ohio Laws HB 386 § 5.

[19]Ordinance No. 271-03. As of November 17, 2003, the City of Toledo was temporarily enjoined from enforcing application, enforcement, or other effectuation of this ordinance as a result of a lawsuit asserting that the ordinance is preempted by the Home Ownership and Equity Protection Act of Ohio. *AFSA v. City of Toledo, Ohio*, No. C10200301547 (Lucas County).

## Regulators Have Determined That Federal Law Preempts Some State Predatory Lending Laws, but Views on Preemption Differ

Significant debate has taken place as to the advantages and disadvantages of state and local predatory lending laws. In several cases, regulators of federally supervised financial institutions have determined that federal laws preempt state predatory lending laws for the institutions they regulate. In making these determinations, two regulators—OCC and OTS—have cited federal law that provides for uniform regulation of federally chartered institutions and have noted the potential harm that state predatory lending laws can have on legitimate lending. Representatives of the lending industry and some researchers agree with the federal banking regulators, arguing that restrictive state predatory lending laws may ultimately hurt many borrowers by reducing the supply of lenders willing to make subprime loans, creating undue legal risks for legitimate lenders, and increasing the costs of underwriting mortgage loans. Moreover, industry representatives have said that most predatory lending practices are already illegal under federal and state civil and criminal laws and that these laws should simply be more stringently enforced. In contrast, many state officials and consumer advocates are opposed to federal preemption of state predatory lending laws. They maintain that federal laws related to predatory lending are insufficient, and thus preemption interferes with their ability to protect consumers in their states, particularly from any potential abuses by the subsidiaries of federally chartered institutions.

### OCC, OTS, and NCUA Have Determined That Federal Law Preempts Some State Predatory Lending Laws

Because both the federal and state governments have roles in chartering and regulating financial institutions, questions can arise as to whether a federal statute preempts particular state laws.[20] Affected parties may seek guidance from federal agencies requesting their views on whether a particular federal statute preempts a particular state law; in these instances, the agency may issue an advisory opinion or order on the issue. Because the courts are ultimately responsible for resolving conflicts between federal and state laws, these advisory opinions and orders are subject to court challenge and review. As of November 2003, one or more federal regulators had determined that federal laws preempted the predatory mortgage lending laws of the District of Columbia and five

[20] See U.S. General Accounting Office, *Role of the Office of Thrift Supervision and Office of the Comptroller of the Currency in the Preemption of State Law*, GAO/GGD/OGC-00-51R (Washington, D.C.: Feb. 7, 2000) for additional information on federal preemption of state banking laws.

states—Georgia, New Jersey, New Mexico, New York, and North Carolina. (See table 1.)

**Table 1: Preemption Determinations Issued by OCC, OTS, and NCUA Related to Predatory Mortgage Lending Laws**

| OCC | OTS | NCUA |
|---|---|---|
| Georgia (2003) | Georgia (2003) | Georgia (2002) |
| | New York (2003) | New York (2000) |
| | New Mexico (2003) | North Carolina (2002) |
| | New Jersey (2003) | District of Columbia (2003) |

Source: GAO.

Preemption of state law is rooted in the U.S. Constitution's Supremacy Clause, which provides for the supremacy of federal law. Over the years, the courts have developed a substantial body of precedent that has guided the analysis of whether any particular federal law or regulation overrides or preempts state law. The courts' analysis of whether federal law preempts state law has fundamentally centered on whether Congress intended for the federal law or regulation to override state law, either from the face of the statute itself (express preemption) or from the structure and purpose of the statute (implied preemption.) In their preemption opinions, OCC, OTS, and NCUA have cited a variety of legislation and legal precedents. Since 1996, OTS has had regulations in place that describe its preemption of state lending laws.[21] In January 2004, OCC issued a rule amending its regulations in a similar manner, clarifying what types of state laws federal law preempts in the context of national bank lending.[22] OCC stated that it issued the rule in response to the number and significance of the questions that have arisen with respect to the preemption of state laws and to reduce uncertainty for national banks that operate in multiple states. In its rulemaking, OCC stated that it was seeking to provide more comprehensive standards regarding the applicability of state laws to lending, deposit taking, and other authorized activities of national banks. The regulations

[21]12 C.F.R § 560.2(a).

[22]69 Fed. Reg. 1904 (Jan. 13, 2004).

list examples of the types of state statutes that are preempted (such as laws regulating credit terms, interest rates, and disclosure requirements) and examples of the types of state laws that would not be preempted (such as laws pertaining to zoning, debt collection, and taxation). When OCC first proposed these rules, one news article stated that it "triggered a flood of letters and strong reactions from all corners of the predatory lending debate." States and consumer groups were critical of the proposal. In contrast, the Mortgage Bankers Association of America and some large national banking companies wrote comment letters in support of OCC's proposed rules.

## Views Differ on the Implications of Federal Preemption of State Predatory Lending Laws

Federal banking regulators point out that preemption of states' antipredatory lending laws applies only to institutions chartered by the agency issuing the preemption order. For example, OTS's preemption opinion served to preempt New Jersey's predatory lending statute for federally chartered thrifts but did not affect the statute's applicability to independent mortgage companies, national banks, and state-chartered banks and thrifts. In preempting the New Jersey Home Ownership Security Act of 2002, OTS's Chief Counsel noted that requiring federally chartered thrifts to comply with a hodgepodge of conflicting and overlapping state lending requirements would undermine Congress's intent that federal savings institutions operate under a single set of uniform laws and regulations that would facilitate efficiency and effectiveness.[23] Federal banking regulators have said that they have found little to no evidence of predatory lending by the institutions they regulate, pointing out that federally supervised institutions are highly regulated and subject to comprehensive supervision.[24] They have also noted that they have issued guidance and taken numerous other steps to ensure that their institutions do not engage in predatory lending. Further, OCC has stated that state predatory lending laws, rather than reducing predatory lending among federally supervised institutions, can actually restrict and inhibit legitimate lending activity. The lending industry has generally supported preemption. For example, the Mortgage Bankers Association of America has argued

[23] Office of Thrift Supervision, P-2003-5, Preemption of New Jersey Predatory Lending Act (July 22, 2003).

[24] Several state law enforcement authorities have also said that predatory lending generally occurs outside of banks and direct bank subsidiaries. See Brief of Amicus Curiae State Attorneys General, *National Home Equity Mortgage Ass'n v. OTS*, Civil Action No. 02-2506 (GK) (D D.C.) (March 21, 2003) at 10-11.

that uniformity in lending regulations is central to an efficient and effective credit market.

In contrast, many state officials and consumer advocates have opposed federal preemption of state predatory lending laws, for several reasons. First, they contend that state predatory lending laws are necessary to address gaps in relevant federal consumer protection laws. For example, one state official said that the predatory lending legislation adopted by his state was more focused and effective than the provisions of the Federal Trade Commission Act. In addition, opponents of preemption claim that federal regulators may not devote the necessary resources or have the willingness to enforce federal consumer protection laws relevant to predatory lending by federally chartered institutions and their subsidiaries. In response to OCC's and OTS's statements that there is no evidence of predatory lending among subsidiaries of federally regulated depository institutions, opponents of preemption noted that there are several cases in which allegations of abusive lending practices involving some of these subsidiaries have been raised.[25]

[25] For example, see *Comments on OCC Working Paper*, Center for Responsible Lending, 7-10, October 6, 2003, http://www.predatorylending.org/pdfs/CRLCommentsonOCCWorkingPaper.pdf.

# The Secondary Market May Play a Role in Both Facilitating and Combating Predatory Lending

By providing lenders with an additional source of liquidity, the secondary market can benefit borrowers by increasing the availability of credit and, in general, lowering interest rates. While a secondary market for prime mortgage loans has existed for decades, a relatively recent secondary market for subprime loans now offers these potential benefits to subprime borrowers as well. However, the secondary market may also serve to facilitate predatory lending, as it can provide a source of funds for unscrupulous originators that quickly sell off loans with predatory terms. Secondary market participants may use varying degrees of due diligence to avoid purchasing loans with abusive terms. In addition, some states have enacted legislation with assignee liability—potentially holding purchasers liable for violations of abusive lending laws that occurred in the loan origination. However, extending liability to secondary market purchasers may cause lenders and other secondary market participants, such as credit rating agencies, to withdraw from the market, as occurred in Georgia.

## The Development of a Secondary Market for Subprime Loans Can Benefit Consumers

Originators of mortgage loans—which can include banks, other depository institutions, and mortgage lenders that are not depository institutions—may keep the loans or sell them in the secondary market. Secondary market purchasers may then hold the loans in their own portfolio or may pool together a group of loans and issue a mortgage-backed security that is backed by a pool of such loans. The securitization of mortgage loans became common during the 1980s and, by the 1990s, had become a major source of funding in the prime mortgage market. According to the Office of Federal Housing Enterprise Oversight, by the end of 2002 more than 58 percent of outstanding U.S. single-family residential mortgage debt was financed through securitization. Two government-sponsored enterprises—Fannie Mae and Freddie Mac—represented nearly 40 percent of the amount securitized.[1]

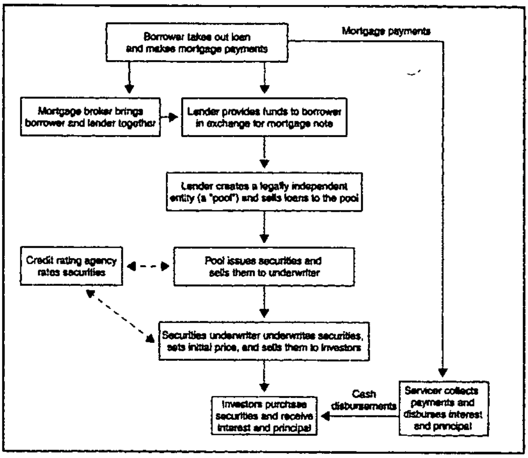
The securitization of subprime mortgage loans did not become common until the mid-1990s. The development of a secondary market for these loans has been an important factor in the growth of subprime lending, expanding subprime lenders' access to funds and thus increasing the availability of subprime credit. The trade journal *Inside B&C Lending* estimated that in 2002 approximately 63 percent of new subprime

[1]A government-sponsored enterprise (GSE) is a congressionally chartered, publicly owned corporation established and accorded favored regulatory treatment to increase access to the capital market for specific economic sectors, including housing.

mortgages, representing $134 billion, were securitized. The originators of subprime loans are often nonbank mortgage and finance companies. As secondary market participants—such as the Wall Street investment firms that have been the major underwriters for subprime securities—have grown more willing to purchase these instruments, subprime originators have gained access to an important source of liquidity that has allowed them to make more subprime loans.

As shown in figure 4, the process of securitization starts with borrowers obtaining mortgages either directly from a lender or through a broker. The lender then creates a pool—a separate legal entity that purchases the mortgages and issues securities based on them. The lender hires a credit rating agency, which has no direct financial interest in the deal, to confirm the value of the securities based on the expected return and risks of the underlying mortgages. At the same time, the lender hires an underwriter to sell the securities to investors. The value of the securities is based exclusively on the mortgages themselves and is separate from the financial condition of the original lender. Finally, a servicer is hired to collect mortgage payments from the borrowers and disburse interest and principal payments to the investors. The process described above is for securitizations performed via private conduits—that is, without the participation of government-sponsored enterprises.

Figure 4: Steps in the Securitization of Residential Mortgages




Source: GAO.

Note: This chart represents the process for fully private securitizations and not for government-sponsored enterprises.

Freddie Mac and Fannie Mae are relatively recent entrants into the subprime market; Freddie Mac began purchasing subprime loans in 1997 and Fannie Mae in 1999. Both companies have moved slowly and have limited their purchases to the segment of the subprime market with the most creditworthy of subprime loans. At present, the companies are believed to represent a relatively small portion of the overall secondary market for subprime loans. The exact portion they represent is not clear, but a study conducted for HUD estimated that the companies purchased about 14 percent of the subprime loans originated in 2002.[2] Both Fannie Mae and Freddie Mac have stated publicly that they plan on expanding their role in the subprime market in the future. In part, this may be a result of the affordable housing goals that HUD set for the GSEs in October 2000, which increased the goals for loans made to low- and moderate-income borrowers.[3] HUD recommended that the GSEs consider enhancing their roles in the subprime market—which often serves low- and moderate-income borrowers—to help standardize mortgage terms in that market and potentially reduce interest rates for subprime borrowers. While the GSEs are currently believed to represent a small portion of the secondary market for subprime lending, some market observers believe their share will grow.

The growth of the secondary market for subprime loans has potentially benefited some consumers. By providing subprime lenders with a new source of liquidity, these lenders face lower funding costs and reduced interest rate risk, in part because the supply of lenders willing to make loans to borrowers with impaired credit has increased. Many analysts say that, as a result, mortgage loans are now available to a whole new population of consumers and interest rates on subprime loans made by reputable lenders have fallen. In addition, increased securitization of subprime lending may lead to more uniform underwriting of subprime loans, which could further reduce origination costs and interest rates to consumers.

[2]K. Temkin, J. Johnson, D. Levy, "Subprime Markets, the Role of GSEs, and Risk-Based Pricing," prepared by The Urban Institute for the U.S. Department of Housing and Urban Development, March 2002. Other estimates of the GSEs' share of securitization of the subprime market have varied, in part because—as noted earlier—there is no consistent industry definition of what constitutes subprime.

[3]The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 requires Fannie Mae and Freddie Mac to meet annual percent-of-business housing goals established by HUD for three categories: low- and moderate-income, underserved, and special affordable. HUD set the following goals for 2001 through 2003: low- and moderate-income—50 percent of the total number of units financed; underserved—31 percent of the total number of units financed; and special affordable—20 percent of the total number of units financed.

## The Secondary Market for Subprime Loans Can Facilitate Predatory Lending

While the development of a secondary market for subprime loans may have benefits for borrowers, it can also provide a source of funds for unscrupulous originators that quickly sell off loans with predatory terms. The secondary market can complicate efforts to eliminate predatory lending by separating ownership of a loan from its originator. This separation can undermine incentives to reduce risk in lending and create incentives that may increase the attractiveness of making loans with predatory terms. As noted earlier, some originators of subprime mortgage loans make their profits from high origination fees. The existence of a market that allows originating lenders to quickly resell subprime loans may reduce the incentive these lenders have to ensure that borrowers can repay. Further, lenders often market their products through brokers that do not bear the risks associated with default, as brokers are compensated in up-front fees for the loans they help originate. Some lenders and state officials told us that unscrupulous brokers sometimes deceive originating lenders regarding borrowers' ability to repay. Even if deceived, lenders who originate the loans and then sell them in the secondary market ultimately may not bear the risk of a loan default. Taken together, these circumstances can undermine efforts to combat predatory lending practices.

Market forces provide some incentives to deter secondary market purchasers from purchasing predatory loans because these loans create both credit and reputation risk.[4] However, predatory loans do not in all cases create unusual financial risks or losses for secondary market purchasers. For example, in most states loan purchasers are generally not liable for damages that may have resulted from the origination of abusive loans that they purchased, mitigating much of the legal risk of buying loans that may have violated laws addressing predatory lending. Moreover, loans with predatory features may carry very high interest rates and have barriers to prepayment, which may more than compensate for the increased credit risks associated with subprime loans.

However, investors' insistence on the use of credit enhancements in the securitization process may offset or mitigate the incentives to engage in predatory lending of originators who sell loans to the secondary market.

[4]Reputation risk is the current and prospective impact on a company's earnings and capital arising from negative public opinion from other market participants. This risk may expose a misbehaving originator or lender to litigation, financial loss, and a decline in its customer base if its behavior injures its customers or clients.

Credit enhancements, which refer to a variety of approaches used to reduce the credit risk of an obligation, are common in securitization transactions, in part because of concerns that originators may try to pass on lower-quality loans. Because the price investors will pay for securities is based on risk as well as return, sellers use the enhancements to lower the risk and thus raise the price of securities. For example, the securities may be overcollateralized by ensuring that the value of the collateral backing the securities—in the case of mortgage backed securities, the face value of the loans—exceeds the value of the securities being offered for sale. The difference provides a "cushion" or reserve against possible credit losses and permits a higher loss rate on the total mortgage pool without endangering payments to the owners of the securities. Securitizers can also include recourse provisions in their loan purchases that require sellers to take back loans in the event of borrower default. As a result of these factors, the degree to which originators of loans sold in the secondary market—including loans with abusive terms—are insulated from credit risks associated with those loans varies, and the profits from selling the loans may vary with the costs of credit enhancement.

## Due Diligence Can Help Purchasers Avoid Predatory Loans, but Efforts Vary among Secondary Market Participants

Secondary market purchasers of residential mortgage loans undertake a process of due diligence designed to minimize legal, financial, and reputation risk associated with the purchase of those loans. Due diligence can play an important role in avoiding the purchase of abusive loans, but cannot necessarily identify all potentially abusive loans. Officials of Fannie Mae and Freddie Mac—which, as noted previously, are relatively recent entrants in the subprime market—are also concerned about risks but say that their due diligence processes are also designed to avoid purchasing loans that may have been harmful to consumers. Other firms' due diligence is not necessarily specifically intended to avoid loans that may have harmed consumers but rather to avoid purchasing loans that are not in compliance with applicable law or that present undue financial or reputation risks.[5]

[5]OCC has issued guidelines stating that national banks are expected to undertake appropriate due diligence to avoid purchasing predatory loans. See OCC Advisory Letter 2003-3 (*Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans*), February 21, 2003.

## Due Diligence May Deter the Purchase of Some Predatory Loans but Has Limitations

Loans purchased in the secondary market are usually not purchased individually but rather as a pool of many loans. Purchasers or securitizers of residential mortgage loans try to ensure that the loans in a particular pool are creditworthy and in compliance with law. Purchasers perform a general background and financial review of the institutions from which they purchase loans. In addition, secondary market purchasers of loans nearly always conduct due diligence, or a review and appraisal of confidential legal and financial information related to the loans themselves. Before or after the sale, purchasers may review electronic data containing information on the loans, such as the loan amount, interest rate, and borrower's credit score. Purchasers also may physically review a sample of individual loans, including items such as the loan applications and settlement forms.

Some industry representatives and federal agencies say that appropriate due diligence can play an important role in deterring predatory lending. Participants in the secondary market have an interest in not purchasing loans that may be considered predatory because such loans can create unwarranted legal, financial, and reputation risk. For example, if such loans violate relevant municipal, state, or federal laws, purchasing them could, in some cases, expose the buyers to legal risks such as lawsuits, fines, and penalties. Moreover, predatory loans may be more likely to go into default, increasing financial risk without a commensurate increase in expected returns. In addition, many industry officials told us that reputation risk is a major reason why they want to avoid purchasing predatory loans. Firms involved in the securitization process do not want to be associated with predatory lending activity that could affect their relationships with other firms, community groups, and government agencies.

Due diligence reviews for residential mortgage loans are designed to determine the financial characteristics of the loans and to ensure compliance with applicable federal, state, and municipal laws, including those designed to prohibit predatory lending. The reviews also can be designed to detect loans that have potentially abusive terms but are not necessarily violating any law. For example, an electronic review of loan data can flag characteristics such as interest rates that appear excessive but are nonetheless legal. A loan-level file review, in which a purchaser reviews the physical loan origination documents, offers access to more information and can highlight items such as points and fees and the borrower's capacity to repay. While nearly all purchasers of loans use due diligence to check for legal compliance, purchasers set their own guidelines for what other loan characteristics meet their standards.

While due diligence in the secondary market is important, the role that it can play in deterring predatory lending by performing due diligence is limited. For one thing, more than one-third of all new subprime loans are not securitized in the first place but are held in the portfolio of the originating lender and thus do not face securitizers' due diligence reviews. In addition, even the most thorough due diligence will not necessarily catch all abusive loans or abusive lending practices. For example:

- Due diligence may not detect fraud in the underwriting or approving of a mortgage. For instance, if a mortgage broker includes false information in a loan application to ensure that a borrower meets an originator's income requirements, the process of due diligence may not detect it.[6]
- The data tapes used for loan reviews do not include point and fee information.[7] Thus, securitizers typically cannot detect excessive or unwarranted fees prior to purchasing a loan without a loan-level review.
- Loan flipping (repeated refinancings) can be difficult to detect because loan files do not necessarily include information on previous refinancings.

## Fannie Mae and Freddie Mac Appear to Perform Extensive Due Diligence to Avoid Buying Loans with Abusive Terms

Fannie Mae and Freddie Mac have relatively strict criteria for the loans they purchase, particularly subprime loans. As noted, both companies limit their purchases to the most creditworthy subprime loans. In April 2000, Fannie Mae issued guidelines to sellers of subprime loans that set criteria designed to help the GSE avoid purchasing loans with abusive features. For example, the guidelines state that Fannie Mae's approved lenders may not "steer" a borrower who qualifies for a standard loan to a higher cost

[6]Some securitizers have begun to use fraud detection software as part of their due diligence of residential mortgage loans. Such software analyzes specific data fields within a loan file and looks for characteristics and inconsistencies that may signal fraud in the appraisal, loan application, or loan itself. In some cases, a fraud review can also be incorporated as part of the regular due diligence process.

[7]A prepurchase financial due diligence review may not look at point and fee data because the risks and returns to the loan purchaser depend not on payments that were made at origination but rather on future payments by the homeowner. However, a review of points and fees is often done during a subsequent loan-level file review.

product, may not make loans without regard to the borrower's ability to repay, and may not in most instances charge more than 5 percent of the loan amount in points and fees. Freddie Mac issued similar guidelines to its sellers and servicers in December 2000. Further, both companies, like other secondary market purchasers, rely on a system of representations and warranties, under which sellers contractually agree to buy back loans they sell that turn out not to meet the terms of the contract.

Fannie Mae and Freddie Mac officials told us that they undertake a series of measures aimed at avoiding the purchase of loans with predatory characteristics. Approved sellers and servicers undergo a background check and operational review and assessment that seeks, in part, to determine whether lenders are able to comply with their guidelines. Fannie Mae and Freddie Mac also require that special steps, such as additional due diligence measures, be taken in purchasing subprime loans. For example, Fannie Mae requires that subprime loans be originated using the company's automated desktop underwriting system, which helps ensure that borrowers are not being steered to a more expensive loan than they qualify for.[8] Fannie Mae officials say that the automated desktop underwriting system also facilitates traditional lenders that serve subprime borrowers.

In addition, both companies said that they undertake extensive and costly due diligence that goes well beyond simple legal compliance and is aimed at avoiding loans that may potentially be considered abusive or detrimental to the borrower. Both companies use an outside contractor to conduct their loan-level due diligence reviews on subprime loans. The contractor has a standard "script" that reviews a large number of data elements related to legal compliance and creditworthiness. However, the contractor told us that Fannie Mae and Freddie Mac add elements to the script to make the review more stringent with regard to identifying potentially abusive practices. For example, Freddie Mac requires the contractor to check whether the lender has gathered evidence of a borrower's income information directly or relied on self-verification, which can raise uncertainty about a borrower's capacity to repay. In addition, the

[8]Fannie Mae and Freddie Mac officials note that their antipredatory lending policies and compliance measures are only one element in their efforts to fight predatory lending. For example, both companies also have special programs that provide appropriately priced loans to credit-impaired borrowers and other consumers who tend to be targeted by predatory lenders; support homebuyer education and counseling for at-risk individuals; and have special loan programs designed for borrowers who have been targeted or victimized by predatory lenders.

contractor told us that Fannie Mae and Freddie Mac are more likely than other firms to reject or require a repurchase if evidence exists that the loan may involve a predatory practice—even if the loan is otherwise legally compliant.

## Other Purchasers Vary in the Extent of Their Due Diligence

According to industry representatives, all purchasers of mortgage loans undertake a process of due diligence, but the process can vary in its degree of stringency and comprehensiveness. For example, while most firms typically pull a sample of loans for a loan-level file review, companies may review anywhere between a few percent and 100 percent of the loans. In addition, companies vary in terms of the data elements they choose to review. Some firms review prior loans made to the borrower in an effort to detect loan flipping, while others do not. Further, some companies may be more willing than others to purchase loans that are considered questionable in terms of legal compliance, creditworthiness, or other factors.

As noted earlier, loans that have harmed consumers and that may be deemed "predatory" by some observers are not necessarily against the law, nor do they necessarily increase the risk of the loan.[9] Industry officials told us that while securities firms are concerned with the reputation risk that may come with purchasing abusive loans, the primary function of their due diligence is to ensure compliance with the law and to protect investors by ensuring that loans are creditworthy.[10]

[9]One example would be steering borrowers to higher-cost loans than is justified by their credit histories. This practice is often considered abusive but is not *per se* a violation of federal law, nor does it necessarily increase credit risk to the lender.

[10]Reputation risk can also be an issue for *sellers* of loans to the secondary market. Regularly selling loans that later create risks and costs for secondary market purchasers may close off the seller's access to the secondary market.

## Assignee Liability May Help Deter Predatory Lending but Can Also Have Negative Unintended Consequences

Some states have enacted predatory lending laws that have assignee liability provisions under which purchasers of secondary market loans may be liable for violations committed by the originators or subject to a defense by the borrower against collecting the loan. Assignee liability is intended to discourage secondary market participants from purchasing loans that may have predatory features and to provide an additional source of redress for victims of abusive lenders. However, depending on the specific nature of the provision, assignee liability may also have unintended consequences, including reducing access to or increasing the cost of secondary market capital for legitimate loans. For example, assignee liability provisions of a predatory lending law in Georgia have been blamed for causing several participants in the mortgage lending industry to withdraw from the market, and the provisions were subsequently repealed.

### Several States Hold Secondary Purchasers Liable for Predatory Lending Violations

Antipredatory lending laws in several states have included some form of assignee liability. Typically, with assignee liability, little or no distinction is made between the broker or lender originating a loan that violates predatory lending provisions and the person who purchases or securitizes the loans. Under these provisions, secondary market participants that acquire loans may be liable for violations of the law committed by the original lenders or brokers whether or not the purchasers were aware of the violations at the time they bought the loans. Further, borrowers can assert the same defenses to foreclosure against both originating lenders and entities in the secondary market that hold the loans (the assignees). Depending on the specific provisions of the law, assignees may have to pay monetary damages to aggrieved borrowers.

As of December 2003, at least nine states and the District of Columbia had enacted predatory lending laws that expressly included assignee liability provisions, though the nature of these provisions varies greatly, according to the database of state and local legislation we reviewed. Other states have passed predatory lending laws that do not explicitly provide for assignee liability, but debate has occurred in some of these states about whether assignee liability can be asserted anyway under existing laws or legal principles. The federal HOEPA statute includes an assignee liability provision, but, as noted in chapter 2, only a limited number of subprime loans are covered under HOEPA.

Assignee liability can take a variety of forms. For example, an assignee can be held liable only in defensive claims (defense to foreclosure actions and to claims regarding monies owed on a loan) or can also be assessed for damages directly, including punitive damages.[11] Similarly, some laws include "safe harbor provisions," under which assignee liability may not arise if the assignee has taken certain measures to avoid obtaining a high-cost loan. For example, under New Jersey law, no assignee liability arises if the assignee demonstrates, by a preponderance of evidence, that a person exercising reasonable due diligence could not determine that the mortgage was a high-cost home loan.[12] However, many secondary market participants told us that the value of these safe harbor provisions is limited, in part because of difficulties in demonstrating compliance with safe harbor standards. For example, some secondary market participants say that the New Jersey law does not adequately define what constitutes "reasonable" due diligence.

## Assignee Liability May Help Combat Predatory Lending but May Also Hinder Legitimate Lending

The issue of whether to include assignee liability provisions in state and local predatory lending laws has been highly controversial, because such provisions can potentially both confer benefits and cause problems. Assignee liability has two possible primary benefits. First, holding purchasers and securitizers of loans liable for abusive lending violations provides them with an incentive not to purchase predatory loans in the first place. If secondary market participants took greater action—through policy decisions or stricter due diligence—to avoid purchasing potentially abusive loans, originators of predatory loans would likely see a steep decline in their access to secondary market capital. Second, under some forms of assignee liability, consumers who have been victimized by such lenders may have an additional source of redress. In some cases, originators of abusive loans that have been sold in the secondary market are insolvent or cannot be located, leaving victims dependent on assignees for relief from foreclosure or other redress.

[11] Under New York's law, an assignee seeking to enforce a loan against a borrower in default or in foreclosure is subject to the borrower's claims and defenses to payment that the borrower could assert against the original lender. See NY Banking Law § 6-l (2003). Under Maine's law, an assignee may be subject to all claims and defenses that the borrower may assert against the creditor of the mortgage. See Maine Rev. Stat. Ann. Title 9-A § 8-209 (2003).

[12] See, e.g., N.J. Stat. Ann. § 46:10B-27 (West 2003); see also, 815 Ill. Comp. Stat. 137/135 (2003).

However, assignee liability provisions may also have the serious if unintended consequence of discouraging legitimate secondary market activity. Secondary market participants say that because they do not originate the loans they purchase, even the most stringent due diligence process cannot ensure that all loans comply with applicable law. In addition, some secondary market participants state that assignee liability provisions require them to make subjective determinations about whether the loans are in compliance with law, and this ambiguity can create legal and financial risk. These factors, industry participants say, can actually end up harming consumers by raising the costs of ensuring compliance with the law and thus increasing the cost of loans to borrowers. Further, if secondary market participants are not willing to risk having to assume liability for violations committed by originators, they may pull out of the market altogether, reducing the availability and increasing the costs of legitimate subprime credit. Finally, if states' predatory lending laws have different terms and provisions regarding assignee responsibilities, the secondary market as a whole could become less efficient and liquid, further increasing rates on legitimate subprime mortgages.

Credit rating agencies have been among the secondary market players that have expressed concern about assignee liability provisions in state predatory lending laws. When a residential mortgage-backed security is created from a pool of loans, an independent credit rating agency examines the security's underlying loans and assigns it with a credit rating, which represents an opinion of its general creditworthiness. Credit rating agencies need to monetize (measure) the risk associated with the loans underlying a security in order to assign a credit rating. Because assignee liability can create additional legal and financial risks, the major credit rating agencies typically review new predatory lending legislation to assess whether they will be able to measure that risk adequately to rate securities backed by loans covered under the law.

We talked with representatives of two major credit rating agencies, firms that issue mortgage-backed securities, and the GSEs Fannie Mae and Freddie Mac to better understand how specific assignee liability provisions might affect their ability to conduct secondary market transactions. In general, the representatives told us that the most problematic assignee liability provisions for secondary market participants are those with two characteristics:

- *Ambiguous language*. Credit rating agencies and other secondary market players seek clear and objective descriptions of the loans covered by the statutes and the specific actions or omissions that constitute a violation. For example, some participants cited concerns about an ordinance enacted in Toledo, Ohio, that prohibited taking advantage of a borrower's "physical or mental infirmities" but did not define what constituted such infirmities.[13] Secondary market participants noted that without objective criteria, there is no way to ensure that an originator has complied adequately with the law.

- *Punitive Damages.* Under some assignee liability provisions, the potential damages a borrower can receive are restricted to the value of the loan, while other provisions allow for punitive damages, which are not necessarily capped. Secondary market participants say that the potential for punitive damages can make it very difficult to quantify the risk associated with a security.

## Georgia's Statute Illustrates Possible Effects of Assignee Liability Provisions

According to officials of industry and consumer advocacy organizations, the Georgia Fair Lending Act, which became effective on October 1, 2002, was one of the strictest antipredatory lending laws in the nation.[14] It banned single-premium credit insurance and set restrictions on late fees for all mortgage loans originated in the state and, for a special category of "covered loans," prohibited refinancing within 5 years after consummation of an existing home loan unless the new loan provided a "tangible net benefit" to the borrower. The act also created a category of "high-cost loans" that were subject to certain restrictions, including limitations on prepayment penalties, prohibitions on balloon payments, and prohibitions on loans that were made without regard to the borrower's ability to repay.

[13]City of Toledo Ordinance No. 291-02 (Oct. 4, 2002).

[14]The Georgia Fair Lending Act is codified at GA Code Ann. §§ 7-6A-1 *et. seq.* OTS, NCUA, and OCC have determined that the Georgia law does not apply to the institutions they supervise because it is preempted by federal law. See Office of Thrift Supervision, P-2003-1, Preemption of Georgia Fair Lending Act (Jan. 21, 2003); National Credit Union Administration, 02-0649, Applicability of Georgia Fair Lending Act to Federal Credit Unions (July 29, 2002); National Credit Union Administration, 03-0412, NCUA Preemption of the Georgia Fair Lending Act (Nov. 10, 2003); and *OCC Preemption Determination and Order*, Docket No. 03-17 (July 30, 2003). Because Georgia law contains a parity provision under which its state-chartered banks are treated similarly to national banks, Georgia's Commissioner of Banking and Finance ruled that Georgia-chartered banks also are not subject to the Fair Lending Act. See *Declaratory Ruling: Effect of Preemption of Georgia Fair Lending Act by the OCC on July 30, 2003* (Aug. 5, 2003).

The act also included fairly strict assignee liability. Secondary market participants that purchased high-cost loans were liable for violations of the law committed by the originator of the loans they purchased, while purchasers of covered loans were subject to borrower defenses and counterclaims based on violations of the act. The act also expressly made mortgage brokers and loan servicers liable for violations. Remedies available to borrowers included actual damages, rescission of high-cost loans, attorney fees, and punitive damages. Most of the violations were civil offenses, but knowing violations constituted criminal offenses.

Shortly after the Georgia Fair Lending Act took effect, several mortgage lenders announced that they would stop doing business in the state due to the increased risk they would incur. In addition, several secondary market participants stated their intention to cease doing business in Georgia. In January 2003, the credit rating agency Standard & Poor's announced it would stop rating mortgage-backed securities in Georgia because of the uncertainty surrounding potential liability under the act. Standard & Poor's decision extended to securitizations of virtually all loans in the state, not just those of covered or high-cost loans. The company said that because the act did not provide an unambiguous definition of which loans were covered (and therefore subject to assignee liability), it could not adequately assess the potential risk to securitizers. In addition, the company said that it was concerned about an antiflipping provision that did not adequately define what constituted the "net tangible benefit" to borrowers that certain refinancings had to provide. The two other major credit rating agencies, Moody's and Fitch, also said that the law would limit their ability to rate mortgage-backed securities in Georgia.

In response to these events, the Georgia legislature amended the Georgia Fair Lending Act on March 7, 2003. The amendments eliminated the category of "covered home loans" and the restrictions that had existed for that category of loans. In addition, the amendments greatly reduced the scope of assignee liability under the law, restricting such liability to "high-cost" loans, and then only when the assignee is unable to show that it has exercised reasonable due diligence to avoid purchasing them. In addition, the amendments capped the amount of damages an assignee can face and prohibited assignee liability in class-action lawsuits. Once these amendments were passed, credit rating agencies announced that they would once again rate securities backed by mortgage loans originated in Georgia, and lenders said they would continue to do business in the state. Advocates of the original Georgia law argued that the legislature overreacted to actions by some members of the lending industry, and many activists said that Standard & Poor's and others had engaged in an orchestrated effort to roll back the Georgia Fair Lending Act. Industry representatives said that the response by lenders and others was a reasonable response to a statute that created unacceptable risks of legal liability for lenders and assignees.

Policymakers and industry representatives have frequently cited the events in Georgia as a lesson in what can happen when secondary market participants are held liable for violations by the original lender. Industry representatives assert that assignee liability creates undue risks to the secondary market, or makes assessing risks difficult, and ultimately reduces borrowers' access to credit. In the case of Georgia, however, it is unclear whether the problem was assignee liability itself or the scope and characteristics of the specific assignee liability provisions contained in the original law. Georgia's original law created concern in large part because of perceived ambiguities in defining which loans were subject to assignee liability and because assignees' liability was subject to unlimited punitive damages. Not all states with antipredatory lending statutes that include assignee liability provisions have had lenders and credit agencies threaten to withdraw from the market to the same extent, largely because these laws generally cap an assignee's liability, create a safe harbor, or contain less ambiguous language. The challenge to states that choose to impose assignee liability is to craft provisions that may serve their purpose of deterring predatory lending and providing redress to affected borrowers without creating an undue adverse effect on the legitimate lending market.

# The Usefulness of Consumer Education, Counseling, and Disclosures in Deterring Predatory Lending May Be Limited

A number of federal, state, nonprofit, and industry-sponsored organizations offer consumer education initiatives designed to deter predatory lending by, among other things, providing information about predatory practices and working to improve consumers' overall financial literacy. While consumer education efforts have been shown to have some success in increasing consumers' financial literacy, the ability of these efforts to deter predatory lending practices may be limited by several factors, including the complexity of mortgage transactions and the difficulty of reaching the target audience. Similarly, unreceptive consumers and counselors' lack of access to relevant loan documents can hamper the effectiveness of mortgage counseling efforts, while the sheer volume of mortgage originations each year makes universal counseling difficult. While efforts are under way to improve the federally required disclosures associated with mortgage loans, their potential success in deterring predatory lending is likewise hindered by the complexity of mortgage transactions and by the lack of financial sophistication among many borrowers who are the targets of predatory lenders.

## Many Consumer Education and Mortgage Counseling Efforts Exist, but Several Factors Limit Their Potential to Deter Predatory Lending

In response to widespread concern about low levels of financial literacy among consumers, federal agencies such as FDIC, HUD, and OTS have conducted and funded initiatives designed in part to raise consumers' awareness of predatory lending practices. In addition, a number of states, nonprofits, and trade organizations have undertaken consumer education initiatives. Prepurchase mortgage counseling—which can include a third party review of a prospective mortgage loan—may also help borrowers avoid predatory loans, in part by alerting them to the characteristics of predatory loans. In some circumstances, such counseling is required. However, a variety of factors limit the potential of these tools to deter predatory lending practices.

## Some Federal Agencies Have Initiatives to Promote Awareness of Predatory Lending

A number of federal agencies and industry trade groups have advocated financial education for consumers as a means of improving consumers' financial literacy and addressing predatory lending. The Department of the Treasury, as well as consumer and industry groups, have identified the lack of financial literacy in the United States as a serious, widespread problem.[1] Studies have shown that many Americans lack a basic knowledge and understanding of how to manage money, use debt responsibly, and make wise financial decisions.[2] As a result, some federal agencies have conducted or funded programs and initiatives that serve to educate and inform consumers about personal financial matters. For example:

- FDIC sponsors MoneySmart, a financial literacy program for adults with little or no banking experience and low to moderate incomes. FDIC officials told us that the program, in effect, serves as one line of defense against predatory lending. The MoneySmart curriculum addresses such topics as bank services, credit, budgeting, saving, credit cards, loans, and homeownership. MoneySmart is offered free to banks and others interested in sponsoring financial education workshops.
- The Federal Reserve System's Community Affairs Offices issue media releases and distribute consumer education publications to financial institutions, community organizations, and to consumers directly. These offices also have hosted conferences and forums on financial education and predatory lending and have conducted direct outreach to communities targeted by predatory lenders.

[1]The Fair and Accurate Credit Transactions Act of 2003 (Pub. L. No. 108-159), which was enacted on December 4, 2003, addresses financial literacy in a number of its provisions. Among other things, it establishes a financial literacy and education commission consisting of representatives of FTC, the federal banking regulators, HUD, the Department of the Treasury, and other federal agencies.

[2]See National Endowment for Financial Education, "Financial Literacy in America: Individual Choices, National Consequences," report based on the symposium "The State of Financial Literacy in America: Evolutions and Revolutions," October 2002 (Greenwood Village, Colorado, 2002), 1 and 6; Maude Toussaint-Comeau and Sherrie L.W. Rhine, "Delivery of Financial Literacy Programs," Policy Studies, Consumer Issues Research Series, Consumer and Community Affairs Division, Federal Reserve Bank of Chicago (2000), 1; Marianne A. Hilgert, Jeanne M. Hogarth, and Sondra Beverly, "Household Financial Management: The Connection between Knowledge and Behavior," *Federal Reserve Bulletin*, July 2003, 309 and 311.

- OTS and NCUA have worked with community groups on financial literacy issues and have disseminated financial education materials, including literature on predatory lending issues, to their respective regulated institutions.

- HUD has developed and distributed a brochure titled *Don't Be a Victim of Loan Fraud: Protect Yourself from Predatory Lenders*, which seeks to educate consumers who may be vulnerable to predatory lending, especially the elderly, minorities, and low-income homeowners.

- Federal banking regulators give positive consideration in Community Reinvestment Act performance reviews to institutions for providing financial education to consumers in low- and moderate-income communities.

- OCC issued an advisory letter in 2001 providing detailed guidance for national banks, encouraging them to participate in financial literacy initiatives and specifying a range of activities that banks can provide to enhance their customers' financial skills, including support for educational campaigns that help borrowers avoid abusive lending situations.[3]

- FTC and DOJ disseminate information designed to raise consumers' awareness of predatory lending practices, particularly those involving fraudulent acts. Brochures and other consumer materials are distributed on the agencies' Web sites, as well as through conferences and seminars, local consumer protection agencies, consumer credit counselors, state offices, and schools. FTC has also supported public service announcements on radio and television, including Spanish-speaking media.

Some of these initiatives are general financial education programs that do not specifically address predatory home mortgage lending, some address predatory lending practices as one of a number of topics, and a few focus specifically on predatory lending. Some of these initiatives are directed to a general audience of consumers, while others are directed toward low-income or other communities that are often the targets of predatory lenders. A number of different media have been used to deliver the messages, including print and online materials, speeches and spot

[3]OCC Advisory Letter 2001-1, Financial Literacy, January 16, 2001.

announcements, and materials for the hearing- and visually impaired. In some cases, consumer financial education materials have been produced in a variety of languages, including Arabic, Chinese, Korean, and Spanish. Federal agencies' consumer education campaigns typically take place in partnership with other entities, including community and nonprofit groups and state and local agencies.

Federal agencies have taken some actions to coordinate their efforts related to educating consumers about predatory lending. For example, in October 2003, the Interagency Task Force on Fair Lending, which consists of 10 federal agencies, published a brochure that alerts consumers to potential pitfalls of home equity loans, particularly high-cost loans. The brochure *Putting Your Home on the Loan Line is Risky Business* describes common predatory lending practices and makes recommendations to help borrowers avoid them.

## State Agencies, Nonprofits, and Industry Organizations Have Also Initiated Consumer Education Efforts

Some state agencies have also sponsored consumer education initiatives that address predatory lending. For example, the Connecticut Department of Banking offers an educational program in both English and Spanish that partners with neighborhood assistance groups and others to promote financial literacy and educate consumers on the state's antipredatory lending statute. The Massachusetts Division of Banks maintains a toll-free mortgage hotline to assist homeowners about potentially unethical and unlawful lending practices. The hotline helps consumers determine whether loan terms may be predatory and directs them to other sources of information and assistance. The New York State Banking Department distributes educational materials, including a video, that describe predatory lending practices. The department has also conducted educational outreach programs to community groups on the issue.

Nonprofits provide a significant portion of consumer financial education on predatory lending, sometimes with support from federal, state, or local agencies. These efforts include both general financial literacy programs with a predatory lending component and initiatives that focus specifically on predatory lending issues. For example, the National Community Reinvestment Coalition, with funding support from HUD, distributes a training module to help communities across the country educate consumers about predatory lending.

Some industry trade organizations and companies also have consumer education initiatives related to predatory lending:

- Freddie Mac has developed the CreditSmart program in partnership with universities and colleges. CreditSmart is a curriculum on credit education that is available online and has been used in academic programs and in community workshops, seminars, and credit education campaigns. Freddie Mac also helps fund and promote the "Don't Borrow Trouble" campaign, a comprehensive public education campaign with counseling services that is designed to help homeowners avoid falling victim to predatory lenders. The campaign uses brochures, mailings, posters, public service announcements, transit ads, and television commercials. Its media toolkit and marketing consultant services have been provided to the U.S. Conference of Mayors for use in local communities.

- Fannie Mae supports financial literacy programs through its Fannie Mae Foundation, which sponsors homeownership education programs that focus on improving financial skills and literacy for adult students and at-risk populations, such as new Americans and Native Americans. Fannie Mae also offers a Web-based tool that allows home-buyers to compare loan products and prices.

- The Jump$tart Program for Personal Financial Literacy, sponsored by a coalition of corporations, industry associations—such as the Insurance Education Foundation and the American Bankers Association Education Foundation—and several government and nonprofit agencies, includes a series of modules covering topics such as managing debt and shopping for credit that are designed to improve the personal financial literacy of young adults.

- The Mortgage Bankers Association of America, a trade association representing mortgage companies and brokers and the real estate finance industry, disseminates a package of information describing some common warning signs of mortgage fraud and predatory lending, a consumer's bill of rights, and appropriate contacts for consumers who believe they have been victimized by predatory lenders.

- The National Association of Mortgage Brokers makes presentations to first-time homebuyers to educate them on the mortgage process and credit reports, among other topics.

- The American Financial Services Association's Education Foundation develops educational materials designed to improve consumers' use of credit and overall financial literacy.

## Mortgage Counseling Can Warn Borrowers of Predatory Lending and Can Offer a "Third Party" Review of Proposed Mortgage Loans

Mortgage counseling can be part of general "homeownership counseling" for new homeowners but may also be offered prior to a refinancing. It gives borrowers an opportunity to receive personalized advice from a disinterested third party about a proposed mortgage or other loan. In addition to providing general advice about the mortgage process and loan products, counselors typically review the terms of proposed loans for potentially predatory characteristics. Studies evaluating the impact of homeownership counseling have found that it helps homeowners maintain ownership of their homes and avoid delinquencies, particularly when the counseling is provided one on one.[4] HUD supports a network of approximately 1,700 approved counseling agencies across the country. The agencies provide a wide variety of education and counseling services, including homebuyer education and prepurchase counseling. HUD makes grant funds available to some of these agencies, and a portion of these funds has been earmarked exclusively for counseling for victims of predatory lending.

A number of state antipredatory lending laws, such as those in New Jersey and North Carolina, require some lenders to document that a borrower has received counseling before taking out certain types of high-cost loans. In a few cases, however, borrowers may waive their right to receive such counseling. Several states, including Colorado, New York, and Pennsylvania, require lenders to provide notice to borrowers of certain loans that mortgage counseling is available and encourage them to seek it.

[4]See, for example, Abdighani Hirad and Peter M. Zorn, "A Little Knowledge is a Good Thing: Empirical Evidence of the Effectiveness of Pre-Purchase Homeownership Counseling," in *Low-Income Homeownership: Examining the Unexamined Goal*, ed. Nicolas P. Retsinas and Eric S. Belsky (Washington, D.C.: Brookings Institution Press and Harvard University Joint Center on Housing Studies, 2001), 2.

## A Variety of Factors May Limit the Effectiveness of Consumer Education and Mortgage Counseling in Deterring Predatory Lending

In testimony before Congress and elsewhere, representatives of the Mortgage Bankers Association, the Consumer Mortgage Coalition, and other industry organizations have promoted the view that educated borrowers are more likely to shop around for beneficial loan terms and avoid abusive lending practices. In searching the literature for studies on the effectiveness of consumer financial education programs, we found evidence that financial literacy programs may produce positive changes in consumers' financial behavior.[5] However, none of the studies measured the effectiveness of consumer information campaigns specifically on deterring predatory lending practices.

### Limitations of Consumer Education

The majority of federal officials and consumer advocates we contacted said that while consumer education can be very useful, it is unlikely to play a substantial role in reducing the incidence of predatory lending practices, for several reasons:

- First, mortgage loans are complex financial transactions, and many different factors—including the interest rate, fees, specific loan terms, and borrower's situation—determine whether the loan is in a borrower's best interests. Mortgage loans can involve dozens of different documents that are written in highly technical language. Even an excellent campaign of consumer education is unlikely to provide less sophisticated consumers with enough information to properly assess whether a proffered loan contains abusive terms.
- Second, abusive lenders and brokers may use high-pressure or "push marketing" tactics—such as direct mail, telemarketing, and door-to-door contacts—that are unfair, deceptive, or designed to confuse the consumer. Broad-based campaigns to make consumers aware of predatory lending may not be sufficient to prevent many consumers—particularly those who may be uneducated or unsophisticated in financial matters—from succumbing to aggressive sales tactics.
- Third, the consumers who are often the targets of predatory lenders are also some of the hardest to reach with educational information. Victims of predatory lending are often not highly educated or literate and may

[5] See for example, B. Douglas Bernheim, Daniel M. Garrett, and Dean M. Maki, *Education and Saving: The Long-Term Effects of High School Financial Curriculum Mandates* (Cambridge, Mass.: National Bureau of Economic Research, 1997), 29-30.

not read or speak English. Further, they may lack access to information conveyed through the Internet or traditional banking sources, or they may have hearing or visual impairments or mobility problems.

## Limitations of Mortgage Counseling

Consumer education campaigns have encouraged borrowers to seek counseling before entering into a mortgage loan, particularly a subprime refinancing loan. However, unreceptive consumers, lack of access to loan documents, fraudulent lending practices, and the uneven quality of counseling services can affect the success of these counseling efforts. For instance, some consumers may simply not respond to counseling. Officials at HUD have noted that not all first-time homebuyers avail themselves of prepurchase counseling, and that some consumers who do attend counseling sessions ignore the advice and information given to them. Further, counselors may not have access to loan documents containing the final terms of the mortgage loan. Although lenders are required to provide a good-faith estimate of the mortgage terms, they are not required to provide consumers with the final and fixed terms and provisions of a mortgage loan until closing.[6] Moreover, predatory lenders have been known to manipulate the terms of a mortgage loan (sometimes called "bait and switch") so that the terms of the actual loan vary substantially from that contained in the good faith estimate.

In addition, counseling may be ineffective against lenders and brokers that engage in fraudulent practices, such as falsifying applications or loan documents, that cannot be detected during a prepurchase review of mortgage loan documents. Finally, the quality of mortgage counseling can vary because of a number of factors. For example, one federal official cited an instance of a mortgage company conducting only cursory telephone counseling in order to comply with mandatory counseling requirements.

Although some states have mandated counseling for certain types of loans, serious practical barriers would exist to instituting mandatory prepurchase mortgage counseling nationally. HUD officials have noted that instituting a mandatory counseling program for most regular mortgage transactions nationwide would be an enormous and difficult undertaking that might not

[6]For example, TILA requires federal lenders to make certain disclosures on mortgage loans within 3 business days after the receipt of a written application. It also requires a final disclosure statement at the time of closing that includes the contract sales price, principal amount of the new loan, interest rate, broker's commission, loan origination fee, and mortgage and hazard insurance, among other things.

be cost-effective. Lenders originated about 10 million mortgage loans in 2002 in the United States. The cost of providing counseling for all or many of these loans would be high, and it is unclear who would or should be responsible for paying it. In addition, there is a need for trained, qualified counselors, according to federal officials and representatives of consumer and advocacy groups, and currently no system exists for effectively training large numbers of counselors while maintaining quality control.

HUD requires counseling for its reverse mortgages. These mortgages allow homeowners to access the equity in their home through a lender, who makes payments to the owner.[7] Borrowers who receive a home equity conversion mortgage insured through FHA must attend a consumer information session given by a HUD-approved housing counselor. Mandatory counseling for reverse mortgages may be reasonable because these products are complex and subject to abuse. However, reverse mortgages are also relatively uncommon; only approximately 17,610 HUD-insured reverse mortgages were originated in fiscal year 2003.

## Disclosures, Even If Improved, May Be of Limited Use in Deterring Predatory Lending

Federally mandated mortgage disclosures, while helpful to some borrowers, may be of limited usefulness in reducing the incidence of predatory lending practices. TILA and RESPA have requirements concerning the content, form, and timing of information that must be disclosed to borrowers. The goal of these laws is to ensure that consumers obtain timely and standardized information about the terms and cost of their loans. Federal agencies, advocacy groups, and the mortgage industry have said that mortgage disclosures are an important source of information for borrowers, providing key information on loan terms and conditions and enabling borrowers to compare mortgage loan products and costs. Representatives of the lending industry in particular have said that disclosures can play an important role in fighting predatory lending, noting that clear, understandable, and uniform disclosures allow borrowers to understand the terms of their mortgage loans and thus make more informed choices when shopping for a loan.

However, industry and advocacy groups have publicly expressed dissatisfaction with the current scheme of disclosures as mandated by TILA and RESPA. A 1998 report by the Board and HUD concluded that

[7]The loan is not repaid in full until the homeowner permanently moves out of the home, passes away, or other specified events have occurred.

consumers cannot easily understand current disclosures, that disclosures are often provided too late in the lending process to be meaningful, that the information in disclosures may differ significantly from the actual final loan terms, and that the protections and remedies for violations of disclosure rules are inadequate.[8]

Improving the disclosure of pertinent information has been part of efforts under way over the last few years to streamline and improve the real estate settlement process. HUD issued proposed rules in July 2002 to simplify and improve the process of obtaining home mortgages and reduce settlement costs for consumers. HUD stated that the proposed changes to its RESPA regulations would, among other things, "make the good faith estimate [settlement cost disclosure] firmer and more usable, facilitate shopping for mortgages, make mortgage transactions more transparent, and prevent unexpected charges to consumers at settlement."[9] Debate over the proposed rules, which as of December 2003 were still under review, has been contentious. Industry groups claim that the proposal would help fight predatory lending by helping consumers understand loan costs up front and thus enable consumers to compare products, or comparison shop. Several advocacy organizations and an industry group say the proposed rules would still allow unscrupulous mortgage originators to hide illegal or unjustified fees.

Although streamlining and improving mortgage loan disclosures could help some borrowers better understand the costs and terms of their loans, such efforts may play only a limited role in decreasing the incidence of predatory lending practices. As noted above, mortgage loans are inherently complex, and assessing their terms requires knowing and understanding many variables, including interest rates, points, fees, and prepayment penalties. Brokers and lenders that engage in abusive practices may target vulnerable individuals who are not financially sophisticated and are therefore more susceptible to being deceived or defrauded into entering into a loan that is clearly not in their interests. Even a relatively clear and transparent system of disclosures may be of limited use to borrowers who lack sophistication about financial matters, are not highly educated, or suffer physical or mental infirmities. Moreover, as with prepurchase counseling, revised

[8]Board of Governors of the Federal Reserve System and the 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* (Washington, D.C.: July 1998).

[9]See 67 Fed. Reg. 49134 (Jul. 29, 2002).

disclosure requirements would not necessarily help protect consumers against lenders and brokers that engage in outright fraud or that mislead borrowers about the terms of a loan in the disclosure documents themselves.

# Elderly Consumers May Be Targeted for Predatory Lending

Although little data is available on the incidence of predatory lending among the elderly, government officials and consumer advocacy organizations have reported consistent observational evidence that elderly consumers have been disproportionately victimized by predatory lenders.[1] Abusive lenders are likely to target older consumers for a number of reasons, including the fact that older homeowners are more likely to have substantial equity in their homes and may be more likely to have diminished cognitive function or physical impairments that an unscrupulous lender may try to exploit. Most educational material and legal activity related to predatory lending targets the general population rather than elderly borrowers in particular. Some federal agencies and nonprofit organizations provide consumer education materials on predatory lending that specifically target the elderly.

## A Number of Factors Make Elderly Consumers Targets of Predatory Lenders

Nearly all federal, state, and consumer advocacy officials with whom we spoke offered consistent observational and anecdotal information that elderly consumers have disproportionately been victims of predatory lending. Little hard data exist on the ages of victims of predatory lending or on the proportion of victims who are elderly. Nonetheless, several factors explain why unscrupulous lenders may target older consumers and why some elderly homeowners may be more vulnerable to abusive lenders, including higher home equity, a greater need for cash to supplement limited incomes, and a greater likelihood of physical impairments, diminished cognitive abilities, and social isolation.

On average, older homeowners have more equity in their homes than younger homeowners, and abusive lenders could be expected to target consumers who have substantial home equity.[2] By targeting these owners, unscrupulous lenders are more easily able to "strip" the equity from a borrower's home by including unjustified and excessive fees into the cost

[1] No clear agreement exists on the age at which someone is considered "elderly." While we do not designate any specific age in this report with reference to the terms "older" or "elderly," we are generally referring to persons over the age of 65.

[2] For example, a study by the Board found that in 1997, some 55 percent of the homeowners who had fully paid off their mortgage were 65 years of age or older. See Glenn B. Canner, Thomas A. Durkin, and Charles A. Luckett, "Recent Developments in Home Equity Lending," *Federal Reserve Bulletin*, April 1998, 241-51. Borrowers may have substantial equity in their homes but still not qualify for a prime loan because their capacity to repay the loan is limited or their credit score is beneath a certain threshold.

of the home equity loan.[3] Federal officials and consumer groups say that abusive lenders often try to convince elderly borrowers to repeatedly refinance their loans, adding more costs each time. "Flipping" loans in this way can over time literally wipe out owners' equity in their homes.

In addition, some brokers and lenders aggressively market home equity loans as a source of cash, particularly for older homeowners who have limited cash flows and can use money from a home equity loan for major home repairs or medical expenses. In the overall marketplace it is common, and can be advantageous, to tap into one's home equity when refinancing. However, unscrupulous brokers and lenders can take advantage of an elderly person's need for cash to steer borrowers to loans with highly unfavorable terms.

Further, diseases and physical impairments associated with aging can make elderly borrowers more susceptible to abusive lending. For example, declining vision, hearing, or mobility can restrict elderly consumers' ability to access financial information and compare credit terms. In such situations potential borrowers may be susceptible to the first lender to offer what seems to be a good deal, especially if the lender is willing to visit them at home or provide transportation to the closing. Physical impairments like poor hearing and vision can also make it difficult for older borrowers to fully understand loan documents and disclosures.

Similarly, while many older persons enjoy excellent mental and cognitive capacity, others experience the diminished cognitive capacity and judgment that sometimes occurs with advanced age. Age-related dementias or mental impairments can limit the capacity of some older persons to comprehend and make informed judgments on financial issues, according to an expert in behavioral medicine at the National Institute on Aging. Furthermore, a report sponsored by the National Academy of Sciences on the mistreatment of elderly persons reported that they may be more likely to have conditions or disabilities that make them easy targets for financial abuse and they may have diminished capacity to evaluate proposed courses of action. The report noted that these impairments can

[3]For example, a loan might be offered to a borrower who owns a home worth $100,000 and owes $20,000 from a previous mortgage. An abusive lender might refinance the loan for $25,000 (providing the borrower with a $5,000 "cashout") but then charge fees of $15,000, which are financed into the loan. The borrower then would owe $40,000, but might not be aware of the excessive fees that were charged because the monthly repayment schedule had been spread over a much longer period of time.

make older persons more vulnerable to financial abuse and exploitation.[4] Representatives of legal aid organizations have said that they frequently represent elderly clients in predatory lending cases involving lenders that have taken advantage of a borrower's confusion and, in some cases, dementia.

Finally, both the National Academy of Sciences report and representatives of advocacy groups we spoke with noted that elderly people—particularly those who live alone—may feel isolated and lonely, and may lack support systems of family and friends who could provide them with advice and assistance in obtaining credit. Such individuals may simply be more willing to discuss an offer for a home equity loan made by someone who telephones or knocks on their door, makes personal contact, or makes an effort to gain their confidence. These personalized marketing techniques are common among lenders and brokers that target vulnerable individuals for loans with abusive terms.

Federal officials, legal aid services, and consumer groups have reported that home repair scams targeting elderly homeowners are particularly common. Elderly homeowners often live in older homes and are more likely to need someone to do repairs for them. The HUD-Treasury report noted that predatory brokers and home improvement contractors have collaborated to swindle older consumers. A contractor may come to a homeowner's door, pressure the homeowner into accepting a home improvement contract, and arrange for financing of the work with a high-cost loan. The contractor then does shoddy work or does not finish the agreed-on repairs, leaving the borrower to pay off the expensive loan.

The result of lending abuses, such as losing a home through foreclosure, can be especially severe for the elderly. The National Academy of Sciences report noted that losing financial assets accumulated over a lifetime can be devastating to an elderly person, and that replacing them is generally not viable for those who are retired or have physical or mental disabilities. The financial losses older people can suffer as a result of abusive loans can result in the loss of independence and security and a significant decline in quality of life. Moreover, older victims of financial exploitation may be

[4]Richard J. Bonnie and Robert B. Wallace, eds., "Elder Mistreatment: Abuse, Neglect, and Exploitation in an Aging America," Panel to Review Risk and Prevalence of Elder Abuse and Neglect, National Research Council (Washington, D.C.: National Academies Press, 2003), 393.

more likely to become dependent on social welfare services because they lack the funds to help compensate them for their financial losses.

Elderly consumers represent just one of several classes of people that predatory lenders appear to target. The HUD-Treasury task force report noted that many predatory lenders also specifically target minority communities. Consumer advocacy and legal aid organizations have reported that elderly African American women appear to be a particular target for predatory lenders. This population may be targeted by predatory lenders at least in part because of their relatively low literacy levels—the result of historical inequalities in educational opportunities—which, as discussed earlier, may increase vulnerability to abusive lending.[5]

## Some Education and Enforcement Efforts Focus on Elderly Consumers

Because elderly people appear to be more susceptible to predatory lending, government agencies and consumer advocacy organizations have focused some educational efforts and legal assistance on this population. Several booklets, pamphlets, and seminars are aimed at helping inform elderly borrowers about predatory lending. In addition, while most legal activities related to predatory lending practices are designed to assist the general population of consumers, some have focused on elderly consumers in particular.

### Federal and Nonprofit Agencies Sponsor Some Financial Education Efforts Targeted at Older Consumers

Consumer financial education efforts of government and nonprofit agencies and industry associations generally seek to serve the general consumer population rather than target specific subpopulations. However, some federal and nonprofit agencies have made efforts to increase awareness about predatory lending specifically among older consumers. For example:

- DOJ has published a guide entitled *Financial Crimes Against the Elderly*, which includes references to predatory lending. In 2000, the

[5]For example, about 25 percent of elderly black Americans had graduated from high school in 1992, compared with about 58 percent of elderly white Americans, and about 67 percent of elderly black Americans were reported to have had fewer than 9 years of formal education. See Robert Joseph Taylor and Shirley A. Lockery, "Socio-Economic Status of Older Black Americans: Education, Income, Poverty, Political Participation and Religious Involvement," *African American Research Perspectives* 2 (1): 3-4.

agency cosponsored a symposium that addressed, among other topics, financial exploitation of the elderly.

- OTS has produced an educational training video addressing financial abuse of the elderly.
- The U.S. Department of Health and Human Services' Administration on Aging provides grants to state and nonprofit agencies for programs aimed at preventing elder abuse, including predatory or abusive lending practices against older consumers. Supported activities include senior legal aid programs, projects to improve financial literacy among older consumers, and financial educational materials directed at senior citizens.
- FTC publishes a number of consumer information products related to predatory lending and home equity scams that discuss abusive practices targeted at the elderly.
- AARP, which represents more than 35 million Americans age 50 and over, offers a borrowers' kit containing consumer tips for avoiding predatory lenders, supports a toll-free number to call for assistance regarding lending issues, and distributes fact sheets on predatory lending. Some of these materials are provided in Spanish and in formats accessible to the hearing- and visually impaired. AARP also provides information on its Web site that is designed to educate older Americans on predatory lending issues. In addition, the organization has conducted focus groups of older Americans to gather data on their borrowing and shopping habits in order to better develop strategies for preventing older people from becoming the victims of predatory lending.
- The National Consumer Law Center has developed a number of consumer materials aimed in part at helping elderly consumers recover from abusive loans, including a brochure titled *Helping Elderly Homeowners Victimized by Predatory Mortgage Loans*.

## Some Legal Assistance Is Aimed Specifically at Helping Older Victims of Predatory Lending

Federal consumer protection and fair lending laws that have been used to address predatory lending do not generally have provisions specific to elderly persons. For example, age is not a protected class under the Fair Housing Act, which prohibits discrimination in housing-related transactions. In addition, HMDA—which requires certain financial institutions to collect, report, and disclose data on loan applications and originations—does not require lenders to report information about the age of the applicant or borrower. However, ECOA does specifically prohibit unlawful discrimination on the basis of age in connection with any aspect of a credit transaction. In the case against Long Beach Mortgage Company noted earlier, the lender was accused of violating ECOA by charging elderly borrowers, among other protected classes, higher loan rates than it charged other similarly situated borrowers.

Federal and state enforcement actions and private class-action lawsuits involving predatory lending generally seek to provide redress to large groups of consumers. Little hard data exist on the age of consumers involved in these actions, but a few cases have involved allegations of predatory lending targeting elderly borrowers. For example, FTC, six states, AARP, and private plaintiffs settled a case with First Alliance Mortgage Company in March 2002 for more than $60 million. According to AARP, an estimated 28 percent of the 8,712 borrowers represented in the class-action suit were elderly. The company was accused of using misrepresentation and unfair and deceptive practices to lure senior citizens and those with poor credit histories into entering into abusive loans. The company used a sophisticated campaign of telemarketing and direct mail solicitations, as well as a lengthy sales presentation that FTC said was designed to mislead consumers in general and elderly consumers in particular about the terms of its loans.

Some nonprofit groups provide legal services focused on helping elderly victims of predatory lending:

- The AARP Foundation Litigation, which conducts litigation to benefit Americans 50 years and older, has been party to 7 lawsuits since 1998 involving allegations of predatory lending against more than 50,000 elderly borrowers. Six of these suits have been settled, and the other is pending.
- The National Consumer Law Center has a "Seniors Initiative" that seeks to improve the quality and accessibility of legal assistance with consumer issues for vulnerable older Americans. One focus of the initiative is preventing abusive lending and foreclosure. The center publishes a guide for legal advocates to help them pursue predatory lending cases, and has been involved in litigation related to cases of predatory lending against senior citizens.

- Some local legal aid organizations that help victims of predatory lending have traditionally served older clients. For example, the majority of clients assisted by South Brooklyn Legal Services' Foreclosure Prevention Project are senior citizens.

The limited number of education and enforcement efforts related to predatory lending that specifically target older consumers—as opposed to the general population—is not necessarily problematic. Given limited resources, the most efficient and effective way to reach various subpopulations, including the elderly, is often through general education and information campaigns that reach broad audiences. Similarly, enforcement actions and private lawsuits that seek to curb the activities of the worst predatory lenders in general are likely to aid the elderly borrowers that these lenders may be targeting.

Appendix I

# FTC Enforcement Actions Related to Predatory Lending

| Primary defendant | Date of settlement[a] | Federal laws cited | Alleged unfair or deceptive practices |
|---|---|---|---|
| Capital City Mortgage Corporation[b] | (litigation ongoing) | FTC Act, TILA, ECOA, Fair Debt Collection Practices Act | Using deception/misrepresentation to manipulate borrowers into loans, ECOA recordkeeping and notice violations, unfair and deceptive loan servicing violations |
| OSI Financial Services, Inc., and Mark Diamond[c] | November 2003 | FTC Act | Using deception/misrepresentation to charge excessive loan fees |
| First Alliance Mortgage Company[d] | March 2002 | FTC Act, TILA | Using deception/misrepresentation to charge excessive loan fees |
| Associates First Capital Corporation, Associates Corporation of North America, Citigroup Inc., and CitiFinancial Credit Company | September 2002 | FTC Act, TILA, ECOA, FCRA | Using deception/misrepresentation to manipulate borrowers into loans, packing undisclosed products (insurance) into loans, unfair debt collection |
| Mercantile Mortgage Company, Inc.[e] | July 2002 | FTC Act, TILA, HOEPA, RESPA, Credit Practices Rule | Using deception/misrepresentation to manipulate borrowers into loans, illegal kickbacks, HOEPA disclosure violations, taking unlawful security interests |
| Action Loan Company, Inc.[f] | August 2000 | FTC Act, TILA, RESPA, Credit Practices Rule, ECOA, FCRA | Packing undisclosed products (insurance) into loans, kickbacks for the referral of loans, ECOA violation for failing to meet requirements upon adverse actions, taking unlawful security interest |
| FirstPlus Financial Group, Inc. | August 2000 | FTC Act, TILA | Using deception/misrepresentation to manipulate borrowers into home equity loans, TILA disclosure violations |
| Nu West, Inc. | July 2000 | FTC Act, TILA, HOEPA | HOEPA disclosure violations, right of rescission violations |
| Delta Funding Corporation and Delta Financial Corporation[g] | March 2000 | HOEPA, RESPA, ECOA, Fair Housing Act | Pattern or practice of asset-based lending and other HOEPA violations, paying kickbacks and unearned fees to brokers, intentionally charging African American females higher loan prices than similarly situated white males |
| Fleet Finance, Inc. and Home Equity USA, Inc. | October 1999 | FTC Act, TILA | Failure to provide, or provide accurately, (1) timely disclosures of the costs and terms of home equity loans and/or (2) information to consumers about their rights to cancel their credit transactions |
| Barry Cooper Properties | July 1999 | FTC Act, HOEPA | Pattern or practice of asset-based lending and other HOEPA violations |
| Capitol Mortgage Corporation | July 1999 | FTC Act, TILA, HOEPA | HOEPA disclosure violations, right of rescission violations |
| CLS Financial Services, Inc. | July 1999 | FTC Act, HOEPA | Pattern or practice of asset-based lending and other HOEPA violations |
| Granite Mortgage, LLC and others | July 1999 | FTC Act, TILA, HOEPA | Pattern or practice of asset-based lending and other HOEPA violations |

(Continued From Previous Page)

| Primary defendant | Date of settlement[a] | Federal laws cited | Alleged unfair or deceptive practices |
|---|---|---|---|
| Interstate Resource Corporation | July 1999 | FTC Act, HOEPA | HOEPA disclosure violations |
| LAP Financial Services, Inc. | July 1999 | FTC Act, TILA, HOEPA | Pattern or practice of asset-based lending and other HOEPA violations, right of rescission violations |
| Wasatch Credit Corporation | July 1999 | FTC Act, TILA, HOEPA | Pattern or practice of asset-based lending and other HOEPA violations, right of rescission violations |
| R.A. Walker and Associates | July 1991 | FTC Act | Using deception/misrepresentation to convince borrowers to transfer title to defendant |
| Nationwide Mortgage Corporation | May 1988 | FTC Act, TILA | Using deception/misrepresentation to manipulate borrowers into unaffordable loans with balloon payments |

Source: FTC.

Note: In addition to the cases listed, FTC has also recently addressed abuses in the mortgage loan servicing industry. In November 2003, it announced settlements with Fairbanks Capital Holding Corp., its wholly owned subsidiary Fairbanks Capital Corp., and their founder and former CEO (collectively, Fairbanks) on charges that Fairbanks violated the FTC Act, RESPA, and other laws by failing to post consumers' mortgage payments in a timely manner and charging consumers illegal late fees and other unauthorized fees. The settlement will provide for $40 million in redress to consumers. The case was jointly filed with HUD. *United States of America v. Fairbanks Capital Corp. et al.*, Civ. Action No. 03-12219-DPW (D. Mass.)(filed 11/12/03).

[a]In some cases, the date of settlement listed is the date of the press release announcing the settlement.

[b]DOJ filed an amicus curiae brief in a private suit alleging discrimination in violation of the ECOA and Fair Housing Act, which was joined with the FTC case, but settled separately.

[c]The state of Illinois was also a plaintiff in this case.

[d]The states of Arizona, California, Massachusetts, Florida, New York, Illinois, AARP, and private attorneys were also plaintiffs in this case.

[e]HUD and the state of Illinois were also plaintiffs in this case. Violations of Illinois state law were also claimed.

[f]HUD was also a plaintiff in this case, and DOJ formally filed the complaint on behalf of FTC and HUD.

[g]DOJ and HUD were also plaintiffs in this case.

Appendix II

# Comments from the Board of Governors of the Federal Reserve System

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

EDWARD M. GRAMLICH
MEMBER OF THE BOARD

January 16, 2004

Mr. David G. Wood
Director, Financial Markets and
Community Investment
General Accounting Office
Washington, DC 20548

Dear Mr. Wood:

This is in response to your request for the Federal Reserve Board's comments on the draft GAO report entitled Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending. Predatory mortgage lending has been an important issue of concern to federal and state regulators, consumer advocates, members of Congress and others.[1] The increase in responsible subprime lending in recent years has generally benefited consumers by making credit available to borrowers who may not have otherwise qualified for loans. But as the draft report notes, it is widely accepted that predatory lending occurs most often in connection with subprime loans albeit in a small portion of that market.

As the report notes, there is no precise definition of predatory lending in any federal statute. The term in common parlance, however, is generally used to describe cases in which a broker or lender takes unfair advantage of a borrower, often through deception or fraud to make a loan that is not in the borrower's interest. As the report explains, while there are no Federal statutes that specifically define and address "predatory" lending, a number of consumer protection statutes address various practices that occur in abusive lending.

The draft report contains a number of findings and a recommendation to Congress that focuses on enforcement of these existing Federal consumer protection statutes. To enable greater oversight of, and potentially deter predatory lending at, certain nonbank lenders, the report recommends that the Congress consider making certain statutory changes. The changes would grant the Board the clear authority to routinely monitor and, as necessary, examine the nonbank mortgage lending subsidiaries of bank and financial holding companies for compliance with federal consumer protection laws that may relate to predatory lending practices. Further, the draft report recommends that Congress consider

[1] The scope of the report was limited to home mortgage lending.

Mr. David G. Wood
Page 2

giving the Board specific authority to undertake enforcement actions under those laws against nonbank mortgage lending subsidiaries of bank and financial holding companies.

The Board currently has the general legal authority to monitor and examine nonbank subsidiaries of bank and financial holding companies, but primary responsibility for enforcement of existing federal consumer protection statutes with respect to these nonbank subsidiaries is specifically granted to the FTC. The report concludes, however, that the FTC's mission and resource allocation are directed primarily at conducting investigations based on consumer complaints rather than routine monitoring. The report finds that the Federal Reserve System is better equipped to monitor and examine the nonbank subsidiaries of bank holding companies, apparently by virtue of our role as holding company regulator, and, thus, potentially deter predatory lending activities; and finds that Congress consider giving the Federal Reserve clear and direct authority to do so.

The Federal Reserve regularly conducts examinations of state member banks for compliance with a number of federal consumer protection laws. Examinations of nonbank subsidiaries for compliance with specific statutes are not routinely conducted. Nevertheless, examiners assess consumer compliance risk across the broad range of a banking organization's activities to determine its impact on the organization's overall risk profile and to identify appropriate supervisory activities. In addition, the Board may on occasion direct an examination of a nonbank lending subsidiary of a holding company when necessary in the context of applications to expand in which serious fair lending or compliance issues are raised.[2]

Although it may be useful to clarify jurisdictional issues in this area, the existing structure has not been a barrier to Federal Reserve oversight. There could be some value in the approach the report is recommending in that it is likely that some abusive practices could be caught that might not be otherwise; however, the selection of either concurrent or exclusive jurisdiction over this population of nonbank entities poses tradeoffs. Changing the federal law expressly to give the Federal Reserve exclusive or even joint enforcement authority for nonbank mortgage lending subsidiaries would result in one supervisory scheme being applied to that group of entities (with attendant costs) and a different supervisory scheme under the sole jurisdiction of the FTC being applied to the same type of nonbank companies not affiliated with a bank. Providing for concurrent jurisdiction between the Federal Reserve and the FTC would subject these nonbank subsidiaries within holding companies to potentially greater oversight than similar entities that are not holding

[2] For example, in connection with Citigroup's application to acquire European American Bank (which the Board approved on July 2, 2001), the Board directed that an examination of certain subprime lending subsidiaries of Citigroup be carried out to determine whether Citigroup is effectively implementing policies and procedures designed to ensure compliance with fair lending laws and to prevent abusive lending practices.

Mr. David G. Wood
Page 3

company subsidiaries without any indication that affiliates of a bank act more often in a predatory manner than creditors that are not affiliated with a bank. Moreover, any jurisdictional change contemplated by the report would increase costs to the Federal Reserve and thus to the taxpayer, in much the same way as would increasing the FTC's responsibilities in this regard.

As the report illustrates, the challenges of combating predatory lending are difficult and complex. Finding solutions to these challenges merits careful attention by Congress to a broad range of approaches.

Sincerely,

Edward Gramlich

# Comments from the Department of Justice

**U. S. Department of Justice**

Civil Rights Division

*Office of the Assistant Attorney General*

*Washington, D.C. 20035*

JAN 1 4 2004

Mr. Harry Medina, Assistant Director
Financial Markets and Community Investments
United States General Accounting Office
301 Howard Street, Suite 1200
San Francisco, CA 94105-2252

Dear Mr. Medina:

Thank you for the opportunity to review the draft of the General Accounting Office (GAO) report entitled "*CONSUMER PROTECTION: Federal and State Agencies Face Challenges in Combating Predatory Lending, GAO-04-280.*" Representatives of the Department of Justice's (DOJ) Criminal Division, and the Civil Rights Division reviewed this draft report. This letter constitutes the DOJ's formal comments and I request that it be included in the final report.

The extensive effort that your staff has put into this report and the opportunity to work with them on this important issue is appreciated. The Civil Rights Division would like to comment on several aspects of the draft report as follows.

<u>Highlights one-pages</u> (First paragraph, 8th line):

a reference to the Equal Credit Opportunity Act should be added after the reference to the Fair Housing Act

<u>Executive Summary</u>

(Page 7, second bullet): This truncated explanation is a bit misleading and does not fully summarize the discussion in the text. We would suggest adding the language in bold: "DOJ, which is responsible for enforcing certain federal civil rights laws, **filed two of these enforcement actions on behalf of the FTC and** identified two **additional** enforcement action it has taken that were related to predatory lending practices. **The statutes DOJ enforces only address predatory lending practices when they also are** alleged to be discriminatory.

(page 12, first paragraph, line 7): Including DOJ in this list of federal agencies is a bit misleading, because all the other listed agencies have regulatory powers and we do not. We would suggest omitting DOJ from the list on line 7, and adding a reference to DOJ at the beginning of the next sentence, which would then read "Federal agencies, **including these agencies and the DOJ**, have also taken some actions to coordinate their efforts related to educating consumers about predatory lending.

Body of the Report

(Page 19, 2nd paragraph). The third sentence should be clarified to read as follows: DOJ has addressed predatory lending **that is alleged to be discriminatory** by enforcing fair lending laws in a limited number of cases.

(Page 22, first bullet). Last sentence should be clarified to read: "The settlement placed restrictions on the company's future lending operations and referred victims were **compensated from** to previously established monetary relief funds.

(Page 22, footnote 31). Last sentence should be corrected to read: "In addition, ~~according to~~ DOJ **filed complaints in both** U.S. v. Action Loan, Civ . Action No. 3:00CV-511-H (W.D. KY), **and U.S. v. Franklin Acceptance Corp., Civil No. 99-CV-2435 (E.D. Pa.), cases involving** ~~which involved~~ allegations of predatory mortgage lending that resulted from ~~a joint~~ enforcement efforts ~~between DOJ and~~ by the FTC. **HUD was also involved in the Action Loan case.**

(Page 30, bullet at bottom of page): The referenced working group had the dual purpose of strengthening enforcement and consumer education from the beginning and the consumer education subcommittee never stopped meeting, so several clarifications should be made, as follows:

-- In the fourth line, the end of that sentence should read "...determine where **how enforcement and consumer education** could be strengthened."

-- In the seventh line, the phrase "and stopped meeting" should be deleted.

-- In the eighth line, the beginning of that sentence should be changed to read: "The Task Force ~~then focused specifically on issues~~ **continued it efforts** related to consumer education ..."

(Page 72, last bullet): The referenced brochures and consumer materials are also available on our website (www.usdoj.gov/crt/housing), and this fact should be listed, as the website is one of our primary means of distributing information about our work.

The Criminal Division comments are as follows:

The GAO report purports to address the problem of "predatory lending," for which there is no commonly accepted definition. In attempting to define the term, Page 3

the GAO uses examples of the kinds of practices which it associates with "predatory lending." The problem with this is that some of the GAO's examples are not what is commonly thought of as predatory lending practices. A substantial portion of the report discusses property or loan flips, which is a traditional fraud scheme but not a type of predatory lending that deserves discussion in this report. The Criminal Division's main objection to the report is the misleading way that GAO has defined predatory lending and the DOJ's enforcement efforts.

In conclusion, the Department of Justice would like to commend the GAO analysts who worked on this report. DOJ representatives met with them on several occasions and they worked diligently to analyze all aspects of this issue in a constructive manner. Their observations and conclusions will be most helpful in assessing the Department's role in the federal government's efforts to develop strategies regarding the important issue of predatory lending.

Sincerely,

Wan J. Kim
Deputy Assistant Attorney General

cc: Julie Wellman, Audit Liaison, Criminal Division

Appendix IV

# Comments from the Department of Housing and Urban Development

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-8000

January 16, 2004

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

Mr. David G. Wood
Director
Financial Markets and Community Investment
United States General Accounting Office
Washington, DC 20548

Dear Mr. Wood:

The Department appreciates the opportunity to comment on the draft GAO Report entitled: Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending (GAO-04-280). Our substantive comments will cover two areas of particular importance to HUD: the FHA Mortgage Insurance Programs and RESPA.

HUD agrees that there is no common definition of predatory lending in the context of the provision of mortgage credit. However, HUD is aggressively attacking abusive and deceptive lending practices in FHA insured lending, which we feel targets the behavior most indicative of predatory lending. Action by HUD and the Federal Housing Administration (FHA) to eliminate these practices is significant because it impacts over one million loans that FHA insures each year, including a substantial number of first time and minority buyers who use FHA and the exemplary influence FHA exerts on the marketplace.

To protect FHA borrowers and set industry examples, FHA has developed a series of new requirements specifically targeting lending practices indicative of predatory lending. To this end, the following have been published as final rules:

- 24 CFR Part 203, Anti-Flipping Rule. The rule prohibits FHA insurance on a property resold within 90 days of the previous sale and also prohibits sale of a property by anyone other than the owner of record. Effective June 2003.
- 24 CFR Part 200, Appraiser Qualifications for Placement on FHA Single Family Appraiser Roster. The rule establishes the changes designed to strengthen the licensing and certification requirements for placement on the FHA appraiser roster. Effective June 2003.
- 24 CFR Part 5 § 5.801, Electronic Submissions of Audited Financial Statements. The rule allows HUD to accept electronic submissions of lenders' financial audits to identify and remove noncompliant lenders more quickly. Effective September 2002.

www.hud.gov espanol.hud.gov

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- 24 CFR Part 200 and 203, Single Family Mortgage Insurance: Section 203(k) Consultant Placement and Removal Procedures. The rule establishes placement and removal procedures for HUD's roster of 203(k) consultants. Effective September 2002.

- 24 CFR Part 200, Nonprofit Organization Participation in Certain FHA Single Family Activities: Placement and Removal Procedures (Nonprofit Roster). The rule establishes placement and removal procedures for HUD's Nonprofit Organizations Roster. Effective July 2002.

Additional rules for program participants have been proposed. These proposed rules include:

- Lender Accountability for Appraisals. This rule holds lenders accountable for the appraisal validity. (Proposed Rule published January 2003)

- Revision to FHA Credit Watch/Termination Initiative. Revises Credit Watch to capture underwriting lenders; prevents a lender from opening a new branch within the area covered by the proposed termination. (Proposed Rule published April 2003)

The Department is in the process of developing other rules that will tighten the requirements relating to becoming an FHA-approved mortgagee, serving as a loan officer for an FHA insured mortgage, and maintaining approved status as a lender. In addition, rules are being developed to increase HUD control over false and misleading advertising, to limit the number of FHA insured loans a nonprofit may have outstanding, to strengthen the qualifications of owners/officers of FHA-approved lending institutions, and to define the duties and responsibilities of loan correspondents and underwriting lenders.

In addition to establishing more stringent procedures for participating in FHA insured programs, the Department is taking aggressive action concerning mortgagees who demonstrate poor performance through early claim and default rates. The Department has created the Credit Watch Program by which the Department tracks quarterly the default rates for the 25,000 offices that originate FHA loans and terminates those operations where the default rate exceeds twice that of the local jurisdiction. In addition to being used to protect the integrity of the FHA insurance funds and sanction those lenders who demonstrate imprudent or possible abusive lending practices, the default rates of these lenders are published on the Web and thereby serve as a source of information by which other lenders and interested parties can judge a lender's performance.

FHA also produces Neighborhood Watch, a web-based software application, for HUD oversight of lenders and lender self-monitoring. Neighborhood Watch complements the Credit Watch Termination initiative by providing FHA approved lenders with statistical views of their performance. As a self-policing tool it has enabled lenders to monitor their performance in comparison to other lenders, take corrective actions within their own organizations, and/or sever relationships with poorly-performing business partners.

FHA has created a companion program for appraisers, known as "Appraiser Watch," to target appraisers for review. Appraiser Watch uses traditional risk factors – such as loan volume, loan performance, and loan type – to compare appraisers across peer groups and identify appraisers for review. There are about 25,000 FHA-approved appraisers (about the same number as lender offices).

As stated before, FHA is aggressively policing its participants and imposing significant sanctions on mortgagees found to be violating procedures or otherwise engaged in abusive or deceptive behavior. To demonstrate the effectiveness of the Department's emphasis on program monitoring and enforcement, the following table shows the increase in activity on recent years:

| Sanctions | FY 1998-2000 | FY 2001-2003 |
|---|---|---|
| On-site Monitoring Review | 2,297 | 2,777 |
| Sanctions by MRB | 128 | 137 |
| Withdrawn by MRB | 28 | 36 |
| Civil Money Penalties | $6.17m | $6.5m |
| Lenders Assessed Civil Money Penalties | 103 | 116 |
| Indemnifications | 2,906 | 8,980 |
| Potential Savings from Indemnifications | $87.2m* | $209m** |
| Suspensions/Proposed Debarments/Final Determinations | 742 | 1,384 |
| Referrals to OIG | 204 | 1,101 |

* The dollar amount is based on the historical average loss of $30,000
** The dollar amount is based on the more recent average loss of $23,300

HUD also addresses predatory lending through its Loss Mitigation Program, which is often able to help a victim of predatory lending who has defaulted on the mortgage and faces possible foreclosure. Under this program, lenders have options that may help homeowners stay in their homes or may mitigate the financial consequences of the default if the homeowner does not have the resources to make that possible. FHA regulations require that mortgagees explore all available loss mitigation options prior to proceeding to foreclosure. The success of this program is clear. In 2002 the number of loss mitigation cases resolved by the borrower retaining homeownership exceeded the number of cases resolved through foreclosure.

HUD also supports efforts to provide pre-purchase counseling, at little or no cost to potential homeowners, and consumer education specifically targeting predatory

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lending. Housing awards grants to HUD-Approved Counseling Agencies. During FY 2002, HUD-approved counseling agencies provided assistance to 423,000 homeowners or potential homeowners; HUD provided grant funds to directly support 226,000 of those clients. In addition, HUD has developed a Homeownership Education and Learning Program (HELP) that is offered through sponsoring groups such as nonprofits, community-based organizations, and community colleges. HUD also plans to launch a national advertising campaign specifically warning the public of the dangers of predatory lending, and HUD distributes literature concerning the subject at Homeownership Fairs and other public exhibitions throughout the country.

With respect to RESPA, the final rule has been submitted to OMB and is now being reviewed. During that review, the Department cannot comment on the rule. However, the Department recognizes and has stated that RESPA was not intended to eliminate predatory lending, and regulatory reform under RESPA cannot achieve that objective. The Department's rules concerning FHA lenders and appraisers are based on that recognition.

As evidenced by the aforementioned, the Department is strongly committed to curbing the abusive practices associated with predatory lending and would appreciate the final report acknowledging those efforts.

The Department also has several comments specific to the report that we have included as an enclosure to this letter.

Again, we wish to thank the GAO for the opportunity to add our comments to the report prior to finalization.

Sincerely,

John C. Weicher
Assistant Secretary for Housing-
Federal Housing Commissioner

Enclosure

# Comments from the National Credit Union Administration

**National Credit Union Administration**

Office of the Executive Director

January 14, 2004

Harry Medina, Assistant Director
Financial Markets and Community Investments
U.S. General Accounting Office
301 Howard Street, Suite 1200
San Francisco, CA 94105-2252

Re: Predatory Lending Draft Report

Dear Mr. Medina:

You have asked for our review and comment on the draft report prepared by the General Accounting Office (GAO) discussing challenges faced by federal and state agencies in combating predatory lending (Report). We appreciate the opportunity to comment and offer the following observations.

The Report is a comprehensive treatment of this difficult topic and provides a useful discussion of the issues. While we have no specific experience with non-bank subsidiaries of financial holding companies, we accept the characterization in the Report that these entities frequently escape meaningful regulatory oversight. Thus, we concur in GAO's recommendation that Congress consider providing the Federal Reserve with clearer statutory authority to supervise them.

As the Report notes, NCUA has supervisory responsibility for federally insured credit unions. Consistent with the experience of the other federal banking regulators, we have not observed predatory lending practices among the depository institutions that we regulate. Credit unions are nonprofit cooperatives, owned by their members and democratically controlled, that may only lend and pay dividends to their members and, as such, are disinclined by their nature and structure to engage in the kinds of practices regarded as predatory or abusive.

In Chapter 2 of the Report about guidance issued by the federal regulatory agencies on subprime lending, we request that the following language be added. On page 27, after the first sentence in the second paragraph, insert the following new sentence: "The NCUA issued similar guidance to insured credit unions in 1999." A footnote should be inserted at the end of this sentence, to read as follows: "NCUA Letter to Credit Unions No. 99-CU-05, Risk Based Lending, June, 1999." Inclusion of this language and footnote will help document that NCUA, consistent with the other federal financial institution regulators, has also issued guidance addressing this issue.

1775 Duke Street - Alexandria, VA 22314-3428 - 703-518-6300

Harry Medina
January 14, 2004
Page 2

The Report accurately describes NCUA's experience and position on the issue of federal preemption. Given the lack of evidence that federal credit unions are engaging in predatory lending practices, we remain comfortable that enforcement of the Federal Credit Union Act and the other federal laws pertaining to real estate lending provides sufficient safeguards for consumers. We note that state efforts to strengthen licensing and qualification requirements for mortgage broker activity by persons not associated with federally regulated depository institutions may be an effective way to limit predatory and abusive behavior.

While we acknowledge, as described in Chapter 5 of the Report, that there may be limits to the effectiveness of consumer education efforts and enhanced disclosure requirements, NCUA remains committed to promoting and supporting financial awareness and education for consumers. NCUA has been very active in encouraging credit unions to educate and provide service to those with limited access to financial services. Our "Access Across America" is one such example. This program has focused on creating economic empowerment through expanded credit union service into underserved neighborhoods and communities and facilitating the sharing of resource information for credit unions expanding into these areas. As part of "Access Across America" NCUA supported many programs including the "Money Smart" training materials developed by the FDIC, as well as numerous other workshops and training programs developed in collaboration with organizations such as the Neighborhood Reinvestment Corporation and the Department of Housing and Urban Development. We believe that credit unions themselves are part of the solution to predatory lending, and we are committed to helping them present alternatives for their members.

We hope these comments are useful and will be happy to respond to any questions.

Sincerely,

J. Leonard Skiles
Executive Director

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