

Increase in Predatory Lending and Appropriate Remedial Actions

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Testimony on Behalf of

Low-income Clients of Community Legal Services and National Consumer Law Center
Consumer Federation of America
Consumers Union
National Association of Consumer Advocates
U.S. Public Interest Research Group

Chairman Sarbanes and members of the Committee, on behalf of our low-income clients, we thank you for inviting us to testify today regarding the increase in predatory mortgage lending and appropriate remedial actions to address this problem. I testify here today on behalf of my organization, **Community Legal Services of Philadelphia** and the **National Consumer Law Center**¹ with which I work closely, as well as the **Consumer Federation of America**, **Consumers Union**, the **National Association of Consumer Advocates** and the **U.S. Public Interest Research Group**.² The clients and constituencies of these legal services programs and consumer groups collectively encompass a broad range of families and households who have been affected by predatory lending.

We want to commend you, Chairman Sarbanes, for your persistent efforts to address the blight of predatory lending. The bill he introduced in the 106th Congress, S.2415, is a sophisticated and comprehensive proposal which if passed will stop most predatory mortgages.

Abusive home equity lending is a longstanding problem that exploded in the early 1990's. Vulnerable homeowners who cannot access mainstream forms of credit have generally been the target of these abusive practices.³ Many homeowners have been beguiled into obtaining home equity loans with high rates of interest to finance home repairs or for credit consolidation. The refinancing of low rate purchase money mortgages with high rate first mortgage loans has become a serious problem in low and middle income communities leading to the increasing loss of homeownership. The terms of these high cost loans are not necessary to protect the lenders against loss; indeed the terms are generally so onerous that they precipitate default and foreclosure. With these equity based loans, even foreclosure does not pose actual risk of loss to the lender. The Home Ownership Equity Protection Act passed by Congress in 1994 to address these abuses, while helpful, has not significantly reduced the abuses faced by many low-income, minority and elderly homeowners.

There has been considerable discussion over the supposed difficulty in defining a predatory mortgage loan. But, most predatory mortgage loans include one or more of the following basic ingredients:

- The loan is equity based, rather than income based B such that the lender's assurance of repayment is based on the equity in the home, not the homeowner's income.
- High points and fees are financed in the loan.
- The loan is refinanced and new points and fees are imposed.
- Brokers, home improvement contractors and other third parties are used as expensive bird dogs to originate loans.

The balance of this testimony addresses the following issues:

I. Proof of the Problem B Escalating Foreclosures

II. Causes of the Mortgage Crisis for American Households

III. Signs of a Predatory Loan

IV. Lower Credit Scores Do Not Justify Higher Costs of Predatory Mortgages

V. The Shape of Reform B Address Predatory Mortgage Lending By Expanding HOEPA

VI. Increased Regulation Will Not Reduce Access to Legitimate Credit

VII. Other Federal Laws Should Be Changed to Address the Predatory Mortgage Problem

I. Proof of the Problem B Escalating Foreclosures

There should be no doubt that there is a mortgage lending crisis in America.

- Between 1980 and 1999 both the number and the rate of home foreclosures in the United States have skyrocketed. The absolute number of foreclosures rose 277%. This means that although this was a period of economic prosperity, almost four times the number of homes were foreclosed upon in 1999 as in 1980.[4](#)
- This increase in foreclosures cannot be traced either to a rise in homeownership, or to the increase in mortgage loans being made. During the same time period, homeownership increased by only 2%, while the rate of foreclosures per mortgage increased by 120%.[5](#)



The two conditions which unite to cause this alarming increase in foreclosures are the increase in the number of mortgage loans outstanding and the quality of those loans:

- The increase in home secured lending during this period was almost twofold, from 30 million loans outstanding in 1980 to 52.5 million loans in 1998.⁶
- The problem is that too many home loans are being made for purposes that have nothing to do with the home, and too often these loans are being made with terms that are inherently unconscionable B that increase the costs of homeownership and the risk of loss of homeownership to the borrower.

II. Causes of the Mortgage Crisis for American Households

Predatory mortgage lending has been facilitated by several important developments:

- the deregulation of home lending laws;
- the limitation of tax deductibility of consumer debt to home secured loans;
- the increases in real estate values which has expanded availability of home equity for many households; and
- the proliferation of mortgage brokers.

Each is examined separately below.

Deregulation of home lending. The single most expensive, complicated, and important investment most Americans make in their lifetime is thinly regulated in this nation. There are minimal federal or state laws that govern the rates, fees, or terms that lenders can charge for loans used to purchase or refinance a home. In the past two decades, Congress has done little to ensure that the needs of homeowners are balanced against the interests of the lending industry. Indeed, in furtherance of increasing homeownership, Congress has even restricted the states' abilities to set limits on the rates and terms lenders can impose on home loans.⁷ While there have been slight increases in homeownership, the lending industry has had its liquidity greatly increased by the development of a significant secondary market. Other than prohibitions against discrimination in the granting of credit, the Truth in Lending Act and the Real Estate Settlement Procedures Act basically provide the only state or federal regulation of home loans. With slight exceptions, these two laws are mostly limited to disclosure requirements.

Many homeowners go through the home purchase, financing and refinancing process without any problem. Many others, however, find themselves confused, feel deceived, or worse: they lose their home as a result of abusive or unjustified loan terms. This latter group is much larger than it should be. These abusive loans are an indication of a failure in the marketplace; competition and self regulation do not stop bad loans from being made.

Wrong Message Sent by Tax Code. In 1986, Congress changed the tax code to allow taxpayers to deduct the interest for consumer loans only if the loan is secured by the home. This sent a pervasive message to homeowners that borrowing against home equity was sensible economic planning. Unfortunately, this is quite often incorrect, even for middle income families. For low-income households, this tax deduction is generally of no benefit because the working poor has little or no tax liability, due to the earned income tax credit. Others are paying at the tax system's lowest tax rates.

One consequence of limiting deduction of consumer debts to home equity loans is that many Americans are now paying much more interest on consumer debt, albeit generally at a lower rate per year. This is largely due to a lack of understanding and appreciation for the costs of financing debt over an extended period of time.

Generally, families are persuaded to pay off car loans, credit cards, and other non-housing related expenses with loans secured by their homes because of the perceived tax savings generated by the deductibility of interest related to home secured debt. This perception of savings is generally misplaced: although the actual rate of interest is lower, the money is lent for a much greater length of time. Even after tax benefits are considered the result is a costlier loan. For example, consider this .car loan refinanced into a home loan:

- Car loan paid in installments. A five-year loan with an interest rate of 15% for \$20,000, will have a total interest expense on the loan of \$8,548.

- Car loan refinanced into home equity loan. A 30-year home loan for the same amount at an 11% interest rate effectively costs the homeowner more than four times as much in extra interest expense B even after counting the tax benefits. Just the interest charges on \$20,000 over 30 years will be \$48,567. Even if 30% of the interest expenses results in a tax savings for the consumer, the net cost of financing the car over the life of a home mortgage is still 70% of \$48,567 or \$33,997 B almost one and one-half times the cost of the car loan. (Note B even if this home loan is refinanced early, the amount of this debt for the car is always included in the amount owed, or when the home is sold, the net cash to the borrower is reduced by this amount.)⁸

A more serious consequence is the increase in the loss of equity for American households. Even as the ratio of debt to savings for American families has risen over the past twenty years, the ratio of home equity debt to other debts has increased at a much greater pace.⁹ This has several consequences:

- U.S. families are switching much of their debt from installment or credit card loans, to home secured loans.
- This has the effect of significantly reducing the home equity savings for these households B and home equity savings has long been the traditional method of building assets for American families.

Consider the following chart, which shows the dramatic increase in home secured debt in the past decade, as well as the decrease in home equity. This bleeding of home equity causes a general diminution of the wealth and security of millions of American families.



Increases in Available Home Equity. Many finance companies¹⁰ target homeowners who have substantial equity in their homes in order to protect their investments when the borrowers cannot pay. Elders are a common target for this equity based lending, because many have built significant equity in their properties over time. Based on this equity, a lender is in an advantageous situation: either the borrower pays the loan back with high interest or foreclosure on the home permits a recovery from the property directly. In fact, when foreclosure occurs and the borrower's property is sold to the lender for less than fair market value (as it generally is), the lender can resell the property after foreclosure and realize the homeowner's equity. These anticipated windfalls encourage some lenders to make loans designed to result in foreclosure. Given appreciating real estate values throughout much of the country, finance companies are able

to make loans at high costs with very little risk.

Incentives for brokers and "bird dogs." HUD estimates that mortgage brokers handle about half of all home mortgage loans, or about 3 million mortgages per year totaling \$333 billion.¹¹ Lenders often pay brokers to bring them loans. These lender payments are usually paid in one of two ways: by a "yield spread premium" or "volume-based compensation." A yield spread premium is a fee from a mortgage lender to a mortgage broker paid when the broker arranges a consumer mortgage loan where the interest rate on the loan is inflated to an amount higher than the "par" rate to cover the cost of the fee.¹² The par interest rate is the base rate at which the lender will make a loan to a borrower on a given day. Some lenders also compensate brokers based upon the volume of loans which brokers steer their way.

These payments to brokers drive up the cost of mortgage loans and create reverse competition where brokers have incentives to steer borrowers to lenders that pay brokers the most rather than to lenders who give borrowers the most favorable terms. This problem is exacerbated for low-income borrowers because unscrupulous elements of the mortgage industry perceive them as vulnerable targets.

Home improvement contractors often act as mortgage brokers as well, having agreements to funnel customers in need of financing to a lender. Sometimes, the contractor receives a payment from the lender. Other times, the contractor is simply content to have a funding source at the ready when a homeowner mentions that he or she cannot afford the suggested work.

III. Signs of a Predatory Loan

The most meaningful mark of a predatory loan is in the high amount of points and fees¹³ financed by the borrower.¹⁴ The more the borrower is charged up-front, the more the immediate financial gain achieved by the lender. This is why many of these loans are not affordable to the homeowner B the lender has an incentive to make them non-performing loans. If that loan does not perform such that the homeowner is forced to refinance, it just means more profit for the lender at each refinancing. For the homeowner, it means more equity is stripped from the home each time.

Consider the following high cost loan:

Borrower receives:	\$70,000	
Borrower pays: ¹⁵		
5 Points	3,850	(\$3,850 all profit to lender)
Closing Costs	1,400	(\$1,000 profit to lender)
<u>Credit Insurance</u>	<u>2,200</u>	<u>(\$1,000 commission to lender)</u>
Total Loan Amount	\$77,450	\$5,850 - immediate profit to lender upon sale of loan to investor
Interest Rate of 12%	30 year term	Monthly payment - \$796.66

After 36 payments, the loan balance is \$76,495.40
(yet this homeowner has received \$70,000, and paid \$28,680 over 3 years)

So long as there is sufficient equity in the home (and there generally is plenty), this lender benefits every time the borrower defaults. A default provides the lender with reason to make a new loan, and charge more points and fees. This creates another immediate opportunity to turn a quick profit. Even if the borrower does not default, predatory lenders convince borrowers to refinance their loans and receive a small amount of additional cash to the homeowner, thus taking advantage of the large prepayment penalty typically included in these loans.

Assume in three years, this borrower falls behind and refinances. The refinanced loan will effectively cost the borrower another 10% of the loan amount in points, fees and closing costs. Thus, even though the borrower has paid almost \$30,000 in home secured debt in three years, once he refinances again, his home equity plunges by another \$7,650.

The result of these practices for homeowners is a dramatic loss of equity. In the course of ten years, assuming a refinancing each 3 years, the financial consequences will be devastating:

	ORIGINAL LOAN	REFI #1 @ 3 YEARS	REFI #2 @ 6 YEARS
Value to homeowner	\$70,000	\$0	\$0
Pay off of prior loan		\$76,495	\$83,107
Loan with 10% points and fees financed	\$77,450	\$84,145	\$91,300
Home Equity lost at loan closing ¹⁶	(\$7,450)	(\$14,145)	(\$21,300) ¹⁷
Total amount paid by homeowner to "achieve" this lost equity		(\$28,680)	(\$59,839)

The current state of the law encourages, even rewards, the type of loan described above. Yet, these high points and fees financed in these loans are not necessary to compensate the lender in this market. These costs are charged because there is a complete failure of competition in this marketplace, necessitating increased regulation.

IV. Lower Credit Scores Do Not Justify Higher Costs of Predatory Mortgages

Subprime lenders justify the financing of high fees and interest rates as necessary based on the risk of loss from loans to homeowners with blemished credit. However, the typical structure of subprime loans creates minimal risk of loss due to either a default or a foreclosure. When credit is secured by a home, and the loan-to-value ratio is more than sufficient to protect against foreclosure losses (70% or less), there is no basis for significantly increased rates and fees. Actually, the higher pricing itself creates more risk, and the excessive fees charged up front cause the most damage to the homeowner by stripping equity from the home.

An examination of the risks in mortgage lending supports this point. Losses to a mortgage lender can result from four events:

- 1) late payment and default;
- 2) foreclosure;
- 3) prepayment of the loan before the lender has recouped the expenses incurred in making the loan; or
- 4) litigation expenses.

Risk of Loss from Defaults. As defaults do not necessarily result in foreclosure (and, in fact, the industry agrees that most defaults are self-corrected by borrowers, particularly within the first three months from default), lenders recoup default expenses from late fees and additional interest charges. Late fees are structured to compensate creditors for expenses incurred when payments are made late, such as dunning notices. Additional interest is generally charged for the loss of use of the principal while the payment was late. Late fees in the mortgage context are usually 5% of the payment then due. If the monthly payment is \$1,000, the late fee is \$50. Given the collection of late fees and additional interest, the risk of loss due to a mere default is negligible.

Risk of Foreclosure. A more serious loss could arise if a default continues and results in a foreclosure sale. In this instance, the lender stands to lose only if the sale brings less than the combination of the balance due on the mortgage

plus the costs and fees incurred in the foreclosure. As foreclosure sales generally recoup less than fair market value of the property, mortgage lenders traditionally protect against this risk by requiring a loan-to-value ratio no greater than 80%. When the loan-to-value ratio is greater than 80%, private mortgage insurance of some sort is generally required.

Subprime lenders, however, usually insist that the loan-to-value ratio be no greater 60-75%. This ratio insures little or no loss in case of a foreclosure sale. When the loan-to-value ratios are so low, the risk of loss due to foreclosure also does not justify the increased pricing in the subprime market.

Risk of Prepayment. When a lender extends considerable expenses in the making of a loan, the lender does risk loss if the loan is prepaid before the regular payments on the loan allow the recoupment of these expenses. In the prime mortgage market, the effect of competition protects lenders: the low interest rate the borrower currently has discourages the borrower from prepaying the loan. Typical prime mortgage loans stay on the books for an average of five years. Thus only 2% of prime loans have a prepayment penalty.

The subprime market is a different story. Fully 70% subprime loans have prepayment penalties because of lack of perceived options on the part of the borrowers.¹⁸ In the subprime mortgage market the brokers are generally the gatekeepers for the loans, and they operate on the reverse competition method of yield spread premiums. The higher the premium paid to a broker, the more likely the broker will match a lender up with an unwitting borrower. The hefty price paid to the broker in the yield spread premium is an expense that the lender must recoup in order to avoid a loss, especially considering that the same broker has an incentive to market aggressively another loan to the same borrower. Thus, the lender must charge prepayment penalties to protect itself from the costs incurred by yield spread premiums.

If prepayment penalties were disallowed, unreasonable yield spread premiums would not be paid by lenders, because they could not afford the risk. This would not mean that loans would not be made B they are made every day in the prime market without hefty premiums and prepayment penalties.

Real Risk of Loss. Although lending to homeowners with blemished credit does not by itself create the potential for losses sufficient to justify the increased prices and many of the practices in the subprime mortgage industry, there is still considerable risk of loss to investors. The risk of loss comes from lawsuits challenging the predatory activities, not from borrowers' failure to comply with the contract terms.¹⁹ However, this risk of litigation resulting from the lender's own bad acts certainly does not justify higher charges, and should not be considered a valid reason to avoid regulation which might effectively stymie this type of credit.

What Risks Justify High Costs? According to studies by Freddie Mac,²⁰ and extensive analyses of the prospectuses of a variety of subprime lenders, annual losses rarely exceed 3% even in the lowest rated subprime mortgage loans.²¹ Therefore, there is little justification for interest rates or fees which are 50% or more higher than those charged on prime mortgages.²² Certainly there is no justification for the huge differential in rates and points, fees and costs currently charged by many subprime lenders. Regulation which has the effect of preventing loans with unjustified costs will not prevent extensions of credit with justifiable rates.

One particularly outrageous practice of many predatory lenders is the charging of high fees and rates even the homeowner's credit status qualifies for a lower cost loan. According to Fannie Mae, approximately half of all subprime borrowers could qualify for lower cost conventional financing.²³ This practice is abetted by the industry habit of not reporting mortgage payment data to credit reporting agencies. The failure to report positive mortgage payment habits by homeowners actually helps these lenders hold homeowners captive in high cost lending relationships.

V. The Shape of Reform B Address Predatory Mortgage Lending By Expanding HOEPA

The government, as well as the housing and lending industries, has done an excellent job in recent years of expanding programs to establish new homeownership opportunities for low-income families. The next challenge is to enhance the long term sustainability of the homeownership experience for these families. The ultimate success of homeownership as an asset building strategy will be measured by the degree to which new homeowners are able to afford proper maintenance, avoid foreclosures, build equity in their homes, and use their equity effectively as wealth. As illustrated in Part I above, the market does not work to protect homeowners from abusive mortgage loans.

In 1994, Congress passed the Home Ownership and Equity Protection Act (HOEPA) to prevent some predatory lending practices after reviewing compelling testimony and evidence presented during a number of hearings that occurred in 1993 and 1994. This law created a special class of regulated closed-end loans made at high rates or with excessive costs and fees. Rather than cap interest rates, points, or other costs for those loans, the protections essentially prohibit or limit certain abusive loan terms and require additional disclosures. HOEPA's provisions are triggered if a loan has an APR of 10 points over the Treasury security for the same term as the loan, or points equal to more 8% of the amount borrowed.[24](#)

It was hoped that HOEPA would reverse the trend of the past decade which had made predatory home equity lending a growth industry and contributed to the loss of equity and homes for so many Americans. However, experience over the last six years has shown that while HOEPA has made a start at addressing the problems, there are still huge numbers of unprotected borrowers subject to the abuses of high cost home equity lenders.

The three most significant problems with HOEPA:

- 1) HOEPA does not in any way limit what the lender can charge as up-front costs to the borrower. It is the combined fees B closing costs, credit insurance premiums, and points B which deplete the equity in abusive loans. These excessive fees are charged over and over, each time the loan is refinanced. And with each refinancing, the homeowner's equity is depleted by these charges because they are all financed in the loan. The effect of this situation is to encourage lenders to refinance high cost loans because they reap so much immediate reward at each closing. If the law limited the amount of points and closing costs that a lender could finance in high cost loans, this incentive to steal equity would be stopped cold.
- 2) The interest rate trigger and the points and fees trigger in HOEPA are both too high, allowing many abusive lenders to avoid HOEPA strictures by making high cost loans just under the trigger.
- 3) HOEPA does not apply to open end loans. When HOEPA was passed in 1993, there were few predatory open end mortgage loans being made. In the past seven years, that picture has changed. It has become apparent that open end credit provides another vehicle for mortgage abuses. There is no longer any reason to exclude open end mortgage loans from HOEPA's coverage. More importantly, unless open end loans are brought within the scope of HOEPA, the failure to regulate them will simply push the bad actors into that market.

But, otherwise, HOEPA has some good ideas. It is based on the economic rationale that the higher the charges for the loan, the more regulation is necessary and appropriate. By passing HOEPA, Congress has already recognized two essential truths: that there are some loans for which the marketplace does not effectively apply restrictions; and government must step in to provide balance to the bargaining position between borrowers who either lack the sophistication to avoid bad loans or do not believe they have a choice if they want the credit.

Senator Sarbanes' bill from the 106th Congress (S.2415) leaves the basic structure of HOEPA in place while expanding its coverage and prohibiting abusive terms not currently addressed in the law.

Covering More High Cost Loans.

S.2415 covers more high cost loans in several ways:

1. By lowering the annual percentage rate trigger to 6 points over the equivalent Treasury securities for first mortgage loans.
2. By establishing an annual percentage rate trigger to 8 points over the equivalent Treasury security for junior mortgage loans; this has the effect of encouraging lenders to make second mortgage loans B they are permitted a higher interest before their loan is regulated. This will address the problem of high rate lenders refinancing low interest rate first mortgages with a higher rate loan just to extend slightly more credit to the homeowner.
3. By extending the application to open end lines of credit secured by the home. This will address the spurious open end credit that is quite prevalent in the predatory mortgage market.

4. By including all points and fees (explicitly including yield spread premiums paid to mortgage brokers) and credit insurance charges in the points and fees trigger, and limiting it to 5% of the total amount of the loan.

Providing More Substantive Protections for Covered Loans.

Limitation on Financing of Points and Fees. A key regulation is the limitation on the financing of points and closing costs. Loans covered would be prohibited from financing all but 3% of the loan in points or closing costs. To the homeowner, the worst abuse in the predatory mortgage market is the financing of high points and fees.²⁵ The essential core of S.2415 is in the expansion of HOEPA protections to prohibit the financing of points, fees and credit insurance premiums, and the charging of prepayment penalties.

S.2415 does not put a cap on the points or fees that can be charged for high rate loans; it only prohibits lenders from financing more than 3% of them. Clearly, for most borrowers, prohibiting the financing of these charges will be the same as prohibiting the charges altogether, but this will not necessarily mean that these loans cannot be made. It will only mean that these fees will be rolled into the interest rate charged the borrower. If the lender will pay the fees and recoup them through the interest payments on the loan. The rate of interest charged borrowers will increase, but the borrower's equity ownership in the home will be preserved. There are indisputable advantages flowing from the limitation on financing of more than 3% in points and fees:

- *Less equity will be stripped from the home.* The amount of money that the borrower owes interest on will be much closer to the amount which benefits the borrower. Every payment the borrower makes will reduce the loan amount. If there are repeated refinancings, the loan amount will not rise. The equity in the home is no longer the source of financing the loan. If the loan can only be financed through the borrower's income.
- *The lender will have the incentive to make these loans affordable.* Currently, a typical predatory mortgage transaction creates thousands of dollars of immediate profit to the lender upon sale of the loan to an investor. When the borrower refinances the loan, the lender sees a substantial profit, providing an incentive to the lender to encourage refinancings, regardless of whether the borrower can actually afford to repay the refinanced loan. Yet, if the lender only reaps a benefit from the loan through the payments the lender has a clear incentive to make sure that the borrower can afford the payments.
- *The market will work to keep the interest rate on these loans competitive.* So long as the borrower has not invested a significant amount of money in each loan. If as is done when thousands of dollars in points and fees are financed. If there is little to stop the borrower from shopping for a lower rate loan when his credit improves, or interest rates fall - just as is done in the prime market. As a result, when the loan is first made the wise subprime lender will make the rate only high enough to cover the costs, the real risk, and a reasonable profit. If more is charged, the borrower will be able to refinance at a lower rate with a competitor.

Financing Credit Insurance Premiums. S.2415 prohibits the financing of single interest credit insurance premiums, as well as the related product of debt cancellation agreements. Mortgage borrowers rarely make a separate, considered decision to purchase these products. Credit insurance sometimes provides lenders with a substantial portion of their profits.²⁶ We have found that the premiums are included in loan documents with little or no prior discussion with the homeowner, who is faced with the daunting prospect of canceling a loan at a closing as the only way to avoid this expensive add-on purchase.

The dual market for credit insurance products has a marked disparate impact on minority homeowners. As recent studies by HUD amply demonstrate, subprime mortgage lending is disproportionately concentrated in minority neighborhoods of major cities.²⁷ The same minority homeowners are paying the high cost of single advance premium credit insurance, while predominantly white homeowners with conventional mortgages are offered the less expensive monthly premium credit insurance products, which are also offered separately from the mortgage transaction. There are significant financial incentives, creating reverse competition in the sale of credit insurance.²⁸ It is the creditor which selects the insurance which will be sold to its customers, which leads the creditor to select the products most profitable for it, the full cost of which is passed on to the homeowner. Some major lenders have their own insurance affiliates.

A recent study calculates that over \$2 billion in excess premiums were paid by borrowers in 1997.²⁹ Some estimates are that half of subprime mortgages have credit insurance, compared to 6% in the prime mortgage market.³⁰ Compensation ratios on credit insurance products range from approximately 33% (for credit life) to over 50% (for credit unemployment).³¹ Additionally, creditors often also benefit from claims experience. This back-end stake gives creditors a financial disincentive to help homeowners through a claims process, which can be especially burdensome for credit disability insurance.

The remedy for this reverse competition is to only allow credit insurance to be sold when the premiums can be paid monthly, along with the loan payments, and the credit insurance can be canceled at any time.³² The Federal Reserve Board and HUD specifically endorsed this proposal in their Report to Congress in July, 1998.³³ Several state and local laws and ordinances designed to stop predatory lending only permit this.³⁴ Further, in just the last few weeks, several of the largest subprime lenders have announced B after significant pressure has been publically applied B that they will forego the sale of single premium credit insurance on the mortgage loan products in the future.³⁵

Prohibiting Prepayment Penalties. The prohibition against financing points, fees and credit insurance premiums only works if it is accompanied by a protection on the backend of the loan: a prohibition against prepayment penalties. Without such a prohibition, predatory mortgage lenders will still be able to strip equity and will not be forced to make their loans actually competitive.

Subprime lenders claim that borrowers voluntarily choose prepayment penalties to reduce their interest rates. Borrower choice cannot explain, however, why some 70% of subprime loans currently charge prepayment penalties and only 2% of conventional loans do (almost all in California). The real reason is that conventional mortgage markets are competitive and sophisticated borrowers have the bargaining power to avoid these fees; borrowers in subprime markets often lack sophistication or are desperate for funds and simply accept the penalty that lenders insist that they take. S.2415 addresses this issue by only allowing prepayment penalties to be charged if the loan is refinanced in the first 24 months and limiting the penalty to that amount of 3% of the loan amount that was not financed in the original loan. The rationale for this is that 3% is sufficient to cover the lender's costs for making the loan; any more than that is unnecessary equity stripping. In this scheme the lender has the option of whether to charge all or part of the 3% up front or if there is an early prepayment of the loan. This aspect of the bill is crucial to clamping down on the frequent loan flipping which is the cause of the loss of equity.

Protections for Homeowners in Home Improvement Loans. Recognizing the high number of abuses which flow from home improvement loans, S.2415 establishes new protections applicable to all home improvement loans secured by the home. This home improvement law would ensure that a) homeowners have an effective method of enforcing their warranty rights, and b) lenders are held responsible for the actions of home improvement contractors.

One of the primary problems which arise from home improvement loans is the application of the Aholder in due course@ rule. This rule generally applies to purchasers of negotiable instruments, such as mortgage loans.³⁶ The holder in due course doctrine protects assignees of negotiable instruments from liability for the wrongdoing performed by the original lender though the borrower might be harmed.

Thus, generally regardless of a home improvement contractor's wrongdoing, the homeowner's obligation to pay the lender/assignee continues as long as the assignee purchased the loan without notice of the fraud or other misconduct. In the mortgage context, the homeowner is left to pay the mortgage despite having perfectly valid claims and defenses arising out of the home improvement transaction. Problems often arise because some home improvement contractors are insolvent, or they disappear (and reincorporate under a new name or file bankruptcy) at the first hint of litigation.

In 1976, the Federal Trade Commission passed a rule limiting the holder in due course doctrine for the purchase of consumer goods or services.³⁷ The purpose of the FTC Holder Rule is to give consumers the right to assert claims and defenses against creditors in situations where a seller provides or arranges financing and then fails to perform its obligations. The FTC Holder Rule rightly shifts the risk of seller misconduct to creditors who could absorb the costs of misconduct.³⁸ While the FTC Rule created some protection for consumers in this context, it is limited in several ways. First, the consumer rights provided by the FTC Rule depend upon seller compliance in placing a required notice in the

loan document. Second, recovery by the consumer for seller wrongdoing is limited to the amount paid under the consumer credit contract. Third, there is no private right of action to enforce the FTC Rule.

If the holder in due course doctrine were eliminated for assignees and purchasers of home equity loans (and these mortgage lenders were potentially liable for all of the claims and defenses which the borrower had against the originator), the industry would be forced to engage in self-policing. If mortgage lenders were to be clearly liable for the claims borrowers have against the originating home improvement contractors, the mortgage lenders would more carefully screen those with whom they do business. That, in turn, should help dry up the financial lifeline that has enabled the predatory home improvement contractors to operate.

Prohibit Mandatory Arbitration Clauses. Over the last few years, including mandatory arbitration clauses in consumer credit contracts has become standard operating procedure. Creditors use arbitration clauses as a shield to prevent homeowners from litigating their claims in a judicial forum, where a consumer friendly jury might be deciding the case. Arbitrators, who typically handle disputes between two businesses, are unfamiliar with consumer protection laws, and may be unsympathetic to consumers. Creditors also prefer arbitration because their exposure to punitive damage awards is dramatically reduced, and the threat of class actions is generally nullified.

Arbitration also limits discovery in most cases, which benefits the creditor, not the homeowner, and the arbitration may cost the homeowner far more than bringing an action in court.³⁹ By comparison, low-income consumers generally can file actions in court and waive all fees. And homeowners lose their rights to appeal the arbitrator's erroneous interpretation of the law. This allows arbitrators to ignore state or federal consumer protection statutes and judicial precedent.

Consequently, any comprehensive law addressing predatory mortgage lending must include a prohibition against mandatory pre-dispute arbitration clauses. S.2415 appropriately includes such a provision.

Best Practices' Promises by the Industry Will Not Stop Predatory Lending.

Recently, intense public pressure on lenders have yielded some partial, but significant changes in the way some lending companies say they will conduct their business. However, for a number of reasons, these concessions alone will be unable to protect consumers from the threats of predatory lending.

Permanence. Industry concessions can be withdrawn without any public input or recourse. In contrast, sound protections offered by legislation require public action by legislators who are accountable to their constituents.

Enforceability. Statutory prohibitions of predatory lending can provide a variety of enforcement options that are available to consumers, as well as local, state and federal authorities. On the other hand, the enforcement of corporate pledges is left to leadership of these institutions. Should a lender violate a pledge, they would likely face nothing more punitive than fleeting public disdain.

Scope. Of the few lenders who have made statements, none has promised to eliminate all of the abuses that exist in the marketplace. Thorough consumer protection can not be provided piecemeal, with some lenders offering to stop some practices, while other lenders fail to offer consumers even such small guarantees. True consumer protection can only be provided through federal legislation that applies to all actors and addresses all abuses.

VI. Increased Regulation Will Not Reduce Access to Legitimate Credit

The premise of HOEPA is that when rates or fees are charged which are considerably higher than the norm, additional regulation is appropriate. The higher the rates and fees, the more likely the loan is predatory, and the more necessary closer regulation becomes.⁴⁰ When Congress first passed HOEPA, there was little concrete information available about the number of loans that would be affected by the triggers, or the extent to which credit availability would be limited by HOEPA. We now have the data supplied by the staff of the Federal Reserve Board and other federal agencies, and an analysis by Professor Cathy Mansfield.⁴¹ Current information shows that while some subprime lenders charged as much as 13

points above comparable treasury rates, the median subprime mortgage rates are typically 4 to 5 percentage points above comparable treasury securities. Thus, the bulk of subprime lending is well below the proposed B 8 or 6 point B HOEPA triggers in S.2415.

Reducing the trigger to Treasury to 6 points will not substantially affect legitimate subprime mortgage credit. However, loans above the trigger are highly likely to have predatory features, or involve borrowers at very high risk of default and foreclosure, for whom HOEPA protections are especially important. Professor Mansfield's data suggest that even a reduced cutoff of 6 points would affect fewer than 25% of loans made in the 1995 to 1999 period.⁴² Yet, these are the loans most in need of the protective provisions of HOEPA.

To the industry's cry of A reduced credit availability, @ the advocacy community responds: A Only bad credit will be reduced, not good credit. @ Because they fall so far outside the median, no amount of additional credit risk can justify these rates, without the added protections of HOEPA. The Federal Reserve Board commented on this point:

A borrower does not benefit from . . . expanded access to credit if the credit is offered on unfair terms or involves predatory practices. Because consumers who obtain subprime mortgage loans have fewer credit options than other borrowers, or because they perceive that they have fewer options, they may be more vulnerable to unscrupulous lenders or brokers.⁴³

We agree with the Federal Reserve Board that access to predatory lending is not a benefit to homeowners. Destructive credit is worse than no credit at all. This is evident in light of the increase in foreclosures, the disintegration of many low-income and minority neighborhoods,⁴⁴ and the erosion of the tax base of cities due to foreclosures. Further, we maintain that access to credit will not be reduced if predatory mortgage lending is severely curtailed. Predatory mortgage loans have simply replaced other forms of credit that were not as devastating. For example, prior to the explosion in home mortgage lending, homeowners without access to mainstream banks typically obtained credit from finance companies. Small loans B typically with interest rates around 36% B and relatively high second mortgage loans B typically with interest rates of 18% or more B provided needed credit to these households. While there were problems with these types of credit (as equated to what was available from banks, this credit was comparatively expensive) their use did not have the devastating impact on homeownership and communities that predatory mortgage lending has had in the past few years.

If the result of extended regulation is actually to reduce the numbers of mortgage loans available to homeowners with impaired credit, other avenues of credit will simply quickly open up. It does not make sense to encourage the use of home secured credit if that credit creates an increased risk of losing the home.

VII. Other Federal Laws Should Be Changed to Address the Predatory Mortgage Problem.

Just as there are a number of causes for predatory mortgages, a panoply of changes to federal law and policies are necessary to terminate the worst abuses. In addition to amending the HOEPA B as proposed by S.2415 B other changes in federal law are also necessary. Set out below is an overview of the other changes we believe are necessary:

A. Tax Reform to Encourage Preserving Home Equity

The changes in the 1986 Tax Reform Act that only permit personal interest deductions for loans secured by residences should be amended to limit home secured debt to debt which is not only secured by the home, but is also obtained for reasons relating to the home. Also, all individual taxpayers should be permitted some measure of deductions for unsecured personal credit. We propose that changes to the tax code be essentially revenue neutral, to both the U.S. Treasury, and to most individual taxpayers, along the following basic guidelines:

- Loans for home secured debt should be tax deductible only for that portion of the loan which is related to the purchase, repair or improvement of the home or related property.
- In exchange, all individual taxpayers should be provided with a percentage of their income which can be deducted for expenditures spent for consumer debt.

Existing home mortgage loans could be grandfathered, such that the interest expenses for these loans would remain deductible, in recognition of the decisions that millions of taxpayers to date have made.

The effect of this small, but significant, change in the tax laws would be to remove the unhealthy incentives that too many American households are faced with to spend their home equity to pay off consumer debt. This change would encourage the decades-old national policy of encouraging and sustaining home ownership, and reverse many of the terrible consequences of the 1986 tax code.

B. Federal Protections Should Be Established in Foreclosure Proceedings

Given the alarming increase in foreclosures over the past two decades, federal law must provide some additional protections to borrowers losing their homes to foreclosure.

- Increased funding for housing counselors and mandatory notice regarding their availability. Good housing counselors can facilitate loan workouts on purchase money mortgages that preserve home ownership, prevent foreclosure, and reduce costs for lenders. Fannie Mae, Freddie Mac, and the FHA have implemented loss mitigation tools to avoid foreclosure and housing counselors are an essential part of that process. All mortgage lenders should be required to provide some support for housing counselors and notice of the availability of housing counselors should be required before any foreclosure can proceed.
- Lenders should provide homeowners with the opportunity to pay off the arrearage and avoid foreclosure. Although this seems obvious and in the best interest of both parties, this is not always done. Lenders should be required to give notice to defaulting homeowners of the amount past due and the amount needed to avoid foreclosure prior to the addition of fees. The notice should list the various workout options available. These options have been accepted by Fannie Mae, Freddie Mac, and the FHA as appropriate loss management tools in the industry. Lenders should also be required to attempt to avoid foreclosure through various loan workout mechanisms. Further, a lender should not be permitted to unreasonably reject a workout proposal and simply proceed to foreclosure.

C. Expansion and Extension of the Community Reinvestment Act

The CRA should be expanded so that all mortgages made by a bank, as well as its subsidiaries and affiliates, are considered when a CRA rating is determined. All mortgages which are considered predatory should be counted against a bank's CRA rating. Similarly, HMDA should provide better information about all mortgage loans made by financial institutions, including information about rates, points and fees charged, refinancings and foreclosures.

We propose that for each loan that a bank or its subsidiaries or affiliates makes which fits any one of the following criteria, there should be explicit negative consequences B the loan should be counted against the bank's CRA rating:

1. Loans with excessive costs. Loans in which more than 3% of the total loan amount (or 4% if the loan is FHA-insured) consists of up-front points and fees.[45](#)
2. Loans with higher annual percentage rates. Loans in which the annual percentage rate equals or exceeds four percentage points (4%) over the yield on United States Treasury securities having comparable maturities at the time the loan is made.[46](#)
3. Loans with prepayments penalties and other abusive terms. Loans which (a) have a prepayment penalty provision; (b) have a clause allowing for the interest rate to increase upon default; or (c) negatively amortize at any point during the term.
4. Loans in which credit insurance is financed. Loans in which the lender financed, directly or indirectly, any credit life, credit disability, credit unemployment or credit property insurance, or any other life or health insurance, or any payments financed by the lender directly or indirectly for any debt cancellation or suspension agreement or contract, except insurance premiums or debt cancellation or suspension fees calculated and paid on a monthly basis shall not be considered financed by the lender.
5. Loans which contain mandatory arbitration clauses. Loans which contain a mandatory arbitration clause that limits in any way the right of the borrower to seek relief through the judicial process for any and all claims and

defenses the borrower may have against the lender, broker, or other party involved in the loan transaction.

D. Increased Data Collection is Critical B the Home Mortgage Disclosure Act should cover all Mortgage Loans

Effective enforcement of these rules requires sunshine B HMDA should be changed to require the full disclosure of all information for all subprime lending by all mortgage lenders, regardless of whether the loans are made by the lender, its subsidiary or an affiliate. Specifically, HMDA should require the following information about each loan:

- the annual percentage rate and interest rate of the loan;
- the principal amount of the loan and the amount financed (as defined by TILA);
- the total closing costs, points and fees, and financed credit insurance premiums (and related products);
- the delinquency and foreclosure rates on an annual basis (for all subprime loans, as compared to other types of loans in the total portfolio);
- the length of time between purchase and refinance, if any, on an aggregate basis.

1 Community Legal Services, Inc. is a non-profit legal aid organization that represents low-income consumers in Philadelphia at no charge. CLS represents thousands of individuals who receive Truth in Lending disclosures in the course of consumer credit transactions. CLS also represents the Association of Community Organizations for Reform Now ("ACORN"), a membership advocacy group of low-income citizens concerned, among other things, about the predatory lending epidemic.

The National Consumer Law Center is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of eleven practice treatises and annual supplements on consumer credit laws, including Truth In Lending, (4th ed. 1999) and Cost of Credit: Regulation and Legal Challenges (2nd ed.(2000), and Repossessions and Foreclosures (4th ed. 1999) as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC has advised legal services and private attorneys on litigation strategies to deal with such loans, and provided extensive testimony to Congress regarding necessary protections to be included in federal law, including the Home Ownership and Equity Protection Act. Since the passage of HOEPA, NCLC has continued to work with a broad coalition of consumer and community groups and with various federal agencies to create a comprehensive solution to abusive lending practices.

NCLC launched a Sustainable Homeownership Initiative several years ago. As a part of that initiative, NCLC works closely with Freddie Mac, Fannie Mae, the Neighborhood Reinvestment Corporation, banks, and housing counselors to sustain homeownership through training, coalition building, as well as specific intervention projects in some cities, such as Boston and Chicago.

2 Consumers Union is the publisher of Consumer Reports.

The Consumer Federation of America is a non-profit association of over 280 pro-consumer groups, with a combined membership of 50 million people. CFA was founded in 1968 to advance consumers' interests through advocacy and education.

The National Association of Consumer Advocates (NACA) is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers.

The U.S. Public Interest Research Group is the national lobbying office for state PIRGs, which are non-profit, non-partisan consumer advocacy groups with half a million citizen members around the country.

3 Dozens of examples were raised in the variety of Congressional hearings held on these issues. Problems in

Community Development Banking, Mortgage Lending Discrimination, Reverse Redlining, and Home Equity Lending: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 103d Cong., 1st Sess. 258, 260 (Feb. 17, 1993); Hearing on S.924 Home Ownership and Equity Protection Act, Before the Senate Banking Committee, 103d Cong., 1st Sess. (May 19, 1993); The Home Equity Protection Act of 1993, Hearings on H.R. 3153 Before the Subcommittee on Consumer Credit and Insurance of the House Committee on Banking, Finance and Urban Affairs, 103d Cong., 2d Sess. (March 22, 1994); Hearing on Community Development Institutions, 103-2, before the House Subcommittee on Financial Institutions Supervision, Regulation and Deposit Insurance, 103d Cong., 1st Sess. (Feb 2-4, 1993).

4 Mortgage Bankers Association of America. National Delinquency Survey, 2000. Data of mortgages in foreclosure at the end of each period studied comes from 130 different lenders and is representative of approximately 2 of the mortgages in existence. These numbers are actually grossly undercounted because the foreclosures of mortgages made by finance companies are not included in the statistics compiled by the Mortgage Bankers Association of America (which provides the raw data for the Census statistics). Also, foreclosure statistics do not include homeowners who simply turn their home over to the lender to avoid foreclosure.

5 Id.

6 See Table No. 823, Mortgage Delinquency and Foreclosure Rates: 1980 to 1998, U.S. Census Bureau, Statistical Abstract of the United States, Banking, Finance and Insurance, 1999.

7 In 1980, Congress preempted the ability of states to set interest rate caps on most first mortgage loans. Depository Institutions Deregulation and Monetary Control Act of 1980, ' 501 (DIDA), codified at 12 U.S.C. ' 1735f-7a. In 1982, Congress prohibited states from limiting the types of terms (such as balloon payments and negative amortization) that could be allowed on many first mortgage loans. The Alternative Mortgage Transaction Parity Act of 1982 (AMTPA). 12 U.S.C. ' 3800, et seq.

8 Even if the interest rates are lowered in this example, to those generally available to the prime borrower, the end result is still the same. The cost of financing a car loan in a 30 year home loan is far more expensive, even with the tax benefits.

9 Federal Reserve Board of the United States. Federal Reserve Bulletins, January, 2000. A Survey of Consumer Finances@ tables, 1989-1998.

10 Mainstream banks nearly abandoned low-income neighborhoods across the country, especially minority low-income neighborhoods. This created a vacuum for finance companies charging high rates of interest. Indeed, some mainstream banks helped fill the vacuum by setting up high rate finance companies or, alternatively, by funneling cash to unscrupulous lenders. The term "reverse redlining" has been coined to describe a practice wherein banks make loans at one rate in white communities through their banking arm and at another higher rate in communities of color through separate finance company subsidiaries. Evidence in a case brought in Atlanta, for example, established that black borrowers were charged 11.06% in up front fees by Fleet Finance Co. (a subsidiary of Fleet Bank). In comparison, white borrowers were charged fees of 8.26% of the loan amount (still too high a figure).

11 See News Release of Sept. 17, 1997 last located at www.hud.gov/fha/res/respa/html, accompanying HUD's announcement of proposed changes to regulations under the Real Estate Settlement Procedures Act.

12 For an example, see the National Consumer Law Center, Cost of Credit: Regulation and Legal Challenges ' 11.2.1.4.3 (2d ed. & Supp.).

13 We include in our definition of fees the high costs of single premium credit insurance.

14 There are numerous other predatory mortgage loan indicators, as set out below. Each must be addressed. But the single most important aspect of predatory lending is the financing of points and fees. Until this part of the problem is directly addressed, predatory lending will continue, without significant reduction of the problem:

- Credit insurance packing with high priced pre-paid term credit insurance which add thousand of dollars in unnecessary costs to loans for borrowers who could obtain more reasonably priced credit insurance if paid on monthly basis;
- High and unfair prepayment penalties;
- Mandatory arbitration clauses, which require the homeowner to arbitrate at considerable expense before arbitrators who have no incentive to follow consumer protection laws, and whose decisions are not reviewable by any court;
- Spurious open end loans whereby the lender is allowed to avoid making the more comprehensive disclosures required by closed end credit, and thereby avoid any chance of the homeowner asserting the right of rescission, as well as completely avoiding the restrictions under the Home Ownership and Equity Protection Act, regardless of the cost of the loan;
- Paying off low interest mortgages such as purchase money loans with FHA with much higher interest rate loans;
- Refinancing unsecured debt for which the borrower could not lose the home, with high interest rate debt which must be paid to avoid foreclosure;
- Yield spread premiums paid to the broker even when the homeowner has already paid all closing costs, increases the cost of the loan.
- 125% loan to value loans are predatory for a different reason than the typical predatory loan we most often see in the low-income community. These loans effectively prohibit homeowners from selling their homes or filing bankruptcy to escape unaffordable debt, without losing their home.

15 See, Testimony of the New York State Attorney General's Office before the Banking Committee of the U.S. House of Representatives, May 24, 2000. Mortgage brokers routinely charge up to 10% of the total loan value in fees. Conversely, the Federal Housing Finance Board's "Monthly Interest Rate Survey" shows initial fees and charges averaging less than one point from 1993 through 2000 on conventional residential mortgages.

16 This amount assumes the market value of the home remains the same.

17 It should be noted that if the same \$70,000 loan had only 3 points in fees financed instead of 10, and there were no subsequent refinancings, this homeowner would not have lost any equity by year six.

18 See Gail McDermott, Leslie Albergo, Natalie Abrams, Esq., NIMS Analysis: Valuing Prepayment Penalty Fee Income Standard & Poor's, News Release, Jan. 4, 2001. Also see, North Carolina Coalition for Responsible Lending, Prevalence of Prepayment Penalties, available at <http://www.responsiblelending.org/PL%20-%20Coalition%20Studies.htm> citing data obtained in an interview with the Mortgage Information Corporation and the industry newsletter, Inside Mortgage Finance, and the following articles on conforming mortgages: "Freddie offers a new A-, prepay-penalty program," Mortgage Marketplace, May 24, 1999; Joshua Brockman, "Fannie revamps prepayment-penalty bonds," American Banker, July 20, 1999.

19 For example, United Companies and First Alliance Mortgage Company filed bankruptcy in recent years largely to protect themselves from litigation precipitated by predatory practices.

20 See Howard Lax, Michael Manti, Paul Raca, and Peter Zorn, Subprime Lending: An Investigation of Economic Efficiency, (Feb. 25, 2000) (Freddie Mac study which compared the interest rates on subprime loans rated A-minus by the lenders originating these loans with the rates on prime loans purchased by Freddie Mac which Freddie Mac then rated A-minus using its underwriting model; Freddie Mac found that, on average, the subprime loans bore interest rates that were 2.15% [215 basis points] higher; the study could find no justification for such a large discrepancy).

21 Typical subprime lenders experience annual loss rates below 1% of their loan portfolios. For example, Banc One reported in a March, 1999 prospectus supplement that its net losses as a percentage of the average amount outstanding on all serviced mortgage loans was .78% on 3/31/99. See Banc One Financial Services Home Equity Loan Trust 1999-2, Prospectus Supplement at S-20. All prospectuses and supplements hereafter cited may be obtained through the SEC's EDGAR database, at www.sec.gov/edgarhp.htm. Subprime mortgage lenders concentrating on the most risky borrowers still report modest losses. For example, Aames Financial Corp. reported in February 1999 that its actual annual losses as of 12/31/98 were 1.08% of the serviced portfolio, and it estimated cumulative (i.e. not annual,

but over the life of the loan pool) losses of 2.7% of the balance of loans securitized. A more conservative lender, New Century Financial, reported in March 2000 that its current loan production was a mix of about 25% AC@ category loans, 20% AB@ category, and 55% AA-@ or AA@ categories. See New Century Home Equity Loan Trust Series 2000-NC1, Prospectus Supplement, form 424(b)(5) dated March 22, 2000 and filed with the S.E.C. March 24, 2000, at page S-25.

22 An interest rate of 12% is 50% higher than an interest rate of 8%.

23 See, Fannie Mae, March, 2000 Press Release at p4, www.FannieMae.com/news/pressreleases/0667.html.

24 15 U.S.C. ' 1602(AA)(1)(B).

25 In S. 2415, the points and fees trigger includes all points, fees, and insurance charges. Under current HOEPA law, there are confusing rules to determine which fees and insurance charges are included in the trigger for up-front costs. For example, under current law, the HOEPA trigger excludes Areasonable@ charges if they are not retained by the creditor and are not paid to a third party affiliated with the creditor. 15 U.S.C. ' 1602(aa)(4)(C). Fees for appraisals performed by unaffiliated third parties would not be counted if only the direct cost is passed on to the borrower. On the other hand, such a fee is counted if the cost is padded. Determining what is a Areasonable@ for purposes of triggering coverage, however, is a difficult burden for homeowners to meet. The closing costs trigger should include all points and all fees for closing costs.

26 Equity Predators: Stripping, Flipping and Packing Their Way to Profits: Hearing before the Special Committee on Aging United States Senate, 105th Cong. 2d Sess. 33-34, Serial No. 105-18 (Mar. 16, 1998)(statement of Jim Dough, former employee of predatory lender).

27 See e.g. HUD, Unequal Burden: Income and Racial Disparities in Subprime Lending in America (April 2000) in which HUD discusses the results of studies conducted in Atlanta, New York, Baltimore, Los Angeles, and Chicago. Key findings of the Department of Housing and Urban Development analysis show that: 1) From 1993 to 1998, the number of subprime refinancing loans increased ten-fold. 2) Subprime loans are three times more likely in low-income neighborhoods than in high-income neighborhoods. 3) Subprime loans are five times more likely in black neighborhoods than in white neighborhoods. 4) Homeowners in high-income black areas are twice as likely as homeowners in low-income white areas to have subprime loans.

28 See generally NCLC, Cost of Credit: Regulation and Legal Challenges (2nd ed. 2000) ' 8.2.3.2

29 See also, NCLC, Cost of Credit: Regulation and Legal Challenges (2nd ed. 2000) ' 8.1.

30 The Coalition for Responsible Lending reports that estimate from a person knowledgeable about the industry in its comments to the Board on the proposed HOEPA revisions. See Comments of Self-Help and the Coalition for Responsible Lending on Docket #R-1090 (Feb. 20, 2001).

31 See Mary Griffin and Birny Birnbaum, Credit Insurance: The \$2 Billion A Year Rip-Off,@ p. 3 (1997 figures) (March, 1999 Consumers Union and the Center for Economic Justice)[hereafter Griffin and Birnbaum]. The report notes that in Texas, commissions for auto dealers averaged around 50%, compared to an overall average of 35% for credit life and disability. Id. p 15. A 1999 SEC 10-K filed by American Bankers Insurance Group (now part of Fortis, Inc.) listed the following data for 1998: Operating expenses: 13.9%; Commissions 43.7%; benefits, claims, losses & settlement expenses, 35.5%. For the 5 year period between 1994 and 1998, commissions ranged from 40% to 43.7%.

32 Allegations of coercion in the sale of what is suppose to be a Avoluntary@ product have been the subject of federal enforcement cases and private litigation. In re US LIFE Credit Corp. & US LIFE Corp., 91 FTC 984 (1978), modified on other grounds 92 FTC 353 (1978), rev'd 599 F.2d 1387 (5th Cir. 1979); Lemelledo v. Beneficial Management, 674 A.2d 582 (N.J. Super. Ct. App. Div. 1996).

33 Board of Governors of the Federal Reserve System, Department of Housing and Urban Development, Joint Report to the Congress Concerning Reform to the Truth in Lending Act and the Real Estate Settlement Procedures Act, July,

1998, at 74.

34 North Carolina's anti-predatory lending statute (N.C. Gen. Stat. " 24-1.1) prohibits prepayment fees on most home loans under \$150,000. Regulations for the states of New York (NYCRR " 41.1 BB 41.9) and Massachusetts (209 CMR 32.32; 209 CMR 40.00; 209 CMR 42.00) prohibit prepayment fees for borrowers with debt payments exceeding 50% of income or if fees, including insurance, exceed 5% of the loan. Illinois regulations (38 Ill. Adm. Code 160, 190, 345, 1000, 1050, and 1075) prohibit these fees for Ahigh cost loans.@

35 See e.g., Patrick McGeehan, Third Insurer to Stop Selling Single-Premium Credit Life Policies, New York Times, Business Section.

36 Morton J. Horwitz, The Transformation of American Law, 1780-1860, at 213-215. A promissory note is an unconditional promise to pay a fixed amount of money, with or without interest, that is payable to order or to bearer, is payable upon demand or at a definite time, and does not state any other undertaking. U.C.C. ' 3-104(a), (e) (1990). The actual note or loan document signed by a borrower secured by a mortgage is ordinarily considered a negotiable instrument and bought and sold on the secondary mortgage market. For a more in depth discussion of this doctrine, see Julia Patterson Forrester, Constructing a New Theoretical Framework for Home Improvement Financing, 75 Or. L. Rev. 1095, 1103-09 (1996).

37 16 C.F.R. ' 433.

38 Forrester, supra, at 1108.

39 While arbitration proceedings can theoretically be inexpensive, lenders intentionally make their arbitration proceedings costly as an added deterrent to consumers pursuing their rights. This financial cost is exemplified by one of the few cases in which a predatory lending victim actually pursued Ajustice@ in a lender required arbitration proceeding. Candace Truckenbrodt, a victim of the notorious lender, First Alliance Mortgage Co. (Famco), filed her claims in arbitration. Ms. Truckenbrodt was required to pay \$1,350 merely to initiate the arbitration, a cost ten times greater than filing a case in federal court (unlike court proceedings, arbitration does not provide for the waiver of fees for consumers who are poor). Her total expenses were \$2,377.14 to obtain, one year later, an arbitration ruling that denied her claims against FAMCO without any explanation and without any right to appeal. This is the same FAMCO that has been pursued by several Attorneys General (including Massachusetts, Illinois and Minnesota) for its predatory lending practices and has been found by the Federal Trade Commission to have engaged in deceptive lending practices.

40 See generally, Problems in Community Development Banking, Mortgage Lending Discrimination, Reverse Redlining, and Home Equity Lending, Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs, 103d Cong., 1st Sess. (Feb. 3, 17, 24, 1993); Hearing on S. 924 Home Ownership and Equity Protection Act, before the Senate Banking Committee, 103d Cong., 1st Sess. (May 19, 1993), The Home Equity Protection Act of 1993, Hearings on H.R. 3153 Before the Subcommittee on Consumer Credit and Insurance of the House Committee on Banking, Finance and Urban Affairs, 103d Cong., 2d Sess. (March 22, 1994); Hearing on Community Development Institutions, 103-2, before the House Subcommittee on Financial Institutions Supervision, Regulation and Deposit Insurance, 103d Cong. 1st Sess. (Feb. 2-4, 1993).

41 Cathy Lesser Mansfield, The Road to Subprime AHEL@ Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market, 51 S.C.L. Rev. 473, 536-37 (Spring 2000).

42 Id. at Table 1. It should be noted that the HOEPA trigger is based on APR, which is generally higher than the interest rate. On the other hand, a significant difference between the APR and the interest rate on a long-term mortgage loan results from very high prepaid finance charges (points), which is another strong indicator of potential predatory practices.

43 65 Fed. Reg. 81438, 81441 (Dec. 26, 2000).

44 See Debbie Gruenstein and Christopher E. Herbert, Analyzing Trends in Subprime Originations and Foreclosures: A Case Study of the Boston Metro Area, Abt Associates Inc. (Sept. 2000); Daniel Immergluck and Marti Wiles, Two

Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development, Woodstock Institute (November 1999), available at www.woodstockinst.org.

45 Points and fees must be defined as: (a) all items listed in 15 U.S.C. ' 1605(a)(1) through (4), except interest or the time-price differential; (b) all charges listed in 15 U.S.C. ' 1605(e); (c) all compensation paid directly or indirectly to a mortgage broker, including a broker that originates a loan in its own name in a table-funded transaction; (d) the cost of all premiums financed by the lender, directly or indirectly for any credit life, credit disability, credit unemployment or credit property insurance, or any other life or health insurance, or any payments financed by the lender directly or indirectly for any debt cancellation or suspension agreement or contract, except insurance premiums calculated and paid on a monthly basis shall not be considered financed by the lender. Total loan amount means the principal of the loan minus the points and fees.

46 The equivalent yield for the Treasury securities should be determined by the following rules: (a) adjusted to a constant maturity of a comparable term (as made available by the Federal Reserve Board) as of the week immediately preceding the week in which the interest rate for the loan is established. Further, b) if the terms of the home loan offers any initial or introductory period, and the annual percentage rate of interest is less than that which will apply after the end of such initial or introductory period then the annual percentage rate of interest that shall be taken into account for purposes this subsection shall be the rate which applies after the initial or introductory period; (c) in the case of an annual percentage rate which varies in accordance with an index, the rate shall be the maximum rate permitted at any time by the loan documents.

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