

Increase in Predatory Lending and Appropriate Remedial Actions

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Chairman Leach and Members of the Committee, on behalf of our low-income clients, the National Consumer Law Center^[1] thanks the committee for inviting us to testify today regarding the increase in predatory lending directed at low income and elderly borrowers and appropriate remedial actions to address this problem. I am also testifying here today on behalf of the **Consumer Federation of America**^[2] and the **U.S. Public Interest Research Group**^[3], whose constituencies collectively encompass a broad range of families and households.

We are pleased that the Chairman recognizes the gravity of the predatory lending problem. This is a problem that existed for many years prior to the passage of the Home Ownership and Equity Protection Act, which has since grown exponentially. We attach as an appendix brief stories showing *legal but predatory loans*. We saw these problems in the 1980s, Congress recognized these problems in the early 1990s, and it is obvious from the substantial testimony presented at the HUD hearings presently ongoing around the nation, these problem loans continue to grow unabated.

While there are few records kept of subprime loans, but there is ample evidence that there are real problems in the mortgage market:

- Between 1980 and 1998 the rate of home foreclosures in the United States has increased by 384%. That means that even though interest mortgage rates were almost twice as high in 1980, as they were in 1998, almost four times the number of homes were being foreclosed upon in 1998 as in 1980. ^[4]
- This increase in foreclosure rates *cannot* be traced to the increase in homeownership rates, which was only about 3% during the same period. The increase in home secured lending during the same period was almost twofold, from 30 million loans outstanding in 1980 to 52.5 million loans in 1998. ^[5]
- The problem is that too many home loans are being made for purposes that have nothing to do with the home, and too often these loans are being made with terms that are inherently unconscionable -- that increase the costs of homeownership and the risk of loss of homeownership to the borrower.

The balance of this testimony has several parts:

Part I. The Failure of the Marketplace to Protect Consumers. This section describes how the mortgage marketplace has failed to protect consumers in the deregulated environment of mortgage lending. The alarming increase in the rate of home foreclosures in the United States is also addressed, as is a brief description of abusive loan terms.

Part II. The Home Ownership and Equity Protection Act Should Be Expanded to Cover More Loans and Provide More Protections.

Part III. Three Other Federal Laws Should Be Changed to Address the Predatory Mortgage Problem.

I. The Failure of the Marketplace to Protect Consumers

The single most expensive, complicated, and important investment most Americans make in their lifetime is thinly regulated in this nation. There are no federal or state laws that govern the maximum rates or fees that lenders can charge for loans used to purchase or refinance a home. Also, states cannot set limits on the terms lenders can impose on these loans. Other than prohibitions against discrimination in the granting of credit, the Truth in Lending Act and the Real Estate Settlement Procedures Act are the only federal or state laws that apply to these loans.^[6] These two laws are thus the only significant way in which Congress has ensured that the needs of homeowners are protected and balanced against the interests of the lending industry.

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 improper loan terms. This latter group is much larger than it should be. Indeed, according to the mortgage industry's own analysis, 39-40%^[7] of all mortgage borrowers were confused by the process. Moreover, the Federal Reserve Board and HUD have recognized that the number of homeowners who are exploited in refinancing transactions is far too high. These abusive loans are an indication of a failure in the marketplace; competition and self regulation do not stop bad loans from being made. The message is, therefore, efforts by industry to rely on enforcement of current laws will only hurt consumers.

The marketplace does work to keep interest rates down and loan terms fairly even handed for many middle class borrowers who qualify for "A" credit. (But even this process can work against homeowners in the current market where the terms of the loan may change after the application fee has been paid.) It is clearly not working, however, for too many American homeowners who do not qualify for the best credit rating; all too often these homeowners are elderly, or minority. Nationally, 39% of households with incomes below the federal poverty level^[8] own their own homes.^[9] More dramatically, 58% of older Americans who are below the federal poverty guidelines own homes. Too many of these low-income, elderly homeowners have lost equity in their homes, or their homes altogether as a result of abusive lending.

Abusive home equity lending, in particular, is a longstanding problem that exploded in the early 1990's. Vulnerable homeowners who could not access mainstream forms of credit were the focus of these abusive practices.^[10] Many were forced to rely on equity loans with high rates of interest in order to finance home repairs, credit consolidation or other crucial credit needs. Refinancing low rate purchase money first mortgages with high rate first mortgage loans has become a serious problem in the low income community leading to the escalating loss of homeownership. The terms of these high rate 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.

Mortgage Crisis for Low-Income Homeowners. A number of factors coalesced in recent years to create an ongoing mortgage crisis for low-income homeowners:

- In 1986, Congress changed the tax code to establish a tax preference for interest on second mortgages over interest on other consumer loans. This sent a pervasive message to homeowners that borrowing against home equity was sensible economic planning. The message was delivered to and received by low-income homeowners even though they benefit less, or not at all,^[11] from the deductibility of mortgage interest.

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 to fill. Indeed, some mainstream banks helped fill the vacuum by setting up high rate finance companies or, alternatively, by funneling cash to unscrupulous lenders. [\[12\]](#)

- Given appreciating real estate values throughout much of the country, finance companies are able to make loans at high rates with very little risk. Many finance companies target homeowners who have substantial equity in their homes in order to protect their investments if the borrowers do not pay. Elders are a common target for this equity based lending, because many have built significant equity in their properties over time. Based on 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.
- Deregulation has allowed a wide range of marginal players into the lending and loan brokering business. Many of the historic protections against unfair lending practices, such as state ceilings on interest rates and licensing requirements, were removed or eviscerated during the 1980's. Even where licensing requirements remain, inadequate funding has led to inadequate policing of abusive lenders. A significant secondary market then developed during the 1980's creating liquidity for finance companies marketing loans with high interest rates. [\[13\]](#)

Rising Foreclosure Rate. It is significant that foreclosures have increased by almost four times since 1980, and that in 1998 there were over half a million families that lost their home to foreclosure in the United States. [\[14\]](#) There are a number of reasons for this. We believe that one of the most significant reasons is the huge number of new loans that are being made by lenders who pay little attention to a borrowers ability to repay, and instead focus on bleeding the homeowner of the equity in the home.

Data shows that most foreclosures are caused not by homeowner mismanagement, but rather by unexpected life events which are beyond the homeowner's control such as loss of job, illness, death or divorce. Census data establishes that more than 1/3 of households in the lowest 40% of income range will experience a loss of income of at least 33% for one month in a given year. Income disruptions obviously increase the likelihood of mortgage defaults especially since the same lower income households also have low savings rates and high debt to income ratios. As family debt increases as a percentage of income, [\[15\]](#) families are increasingly vulnerable to the exigencies of unforeseen income decreases or increases in expenses. Problems which would be manageable for a family whose housing costs constitute 20% of the monthly budget are unmanageable when those costs are 40% of the total household expenses.

Additionally, there has been a major expansion of home equity lending [\[16\]](#), thus creating an additional pressure on the homeowner's budget. The median amount outstanding on mortgage debt for a typical family rose 30% between 1989 and 1995. [\[17\]](#)

For these reasons, the federal government cannot rely on the marketplace -- or self-regulation by the mortgage finance industry -- to police lending secured by the home. While Americans enjoy a strong home lending industry, the appropriate degree of regulation should not hamper legitimate lenders, while it will serve to protect the most vulnerable homeowners from losing their homes.

Predatory Mortgage Lending Abuses. The home mortgage abuses that too many American homeowners, at every income level, are subjected to in has been extensively chronicled in other Congressional hearings [\[18\]](#), and will be only briefly described here:

- **Home improvement scams**, which are home loans stemming from unsolicited sellers of home improvements in which the work is generally overpriced, and rarely performed adequately;
- **Mortgage broker kickbacks** which result in higher priced loans than the borrowers qualify for with their lenders;
- **Steering** to high rate lenders when consumers qualify for lower rate loans;
- Lending to people who **cannot afford to repay**;

- **Falsified loan applications** such that the loan originator pads the borrower's income to make the loan qualify, yet which leads to unaffordable payments for the borrower;
- **Incapacitated** homeowners;
- **High interest rates** which are far more than are justified by the alleged additional risks and costs of providing credit to homeowners with lower credit scores;
- **Balloon payments** terms for which the borrower has no way to meet without refinancing the loan at excessive costs or losing the home;
- **Negative or non-amortizing loans**, such that even after making loan payments for years the borrowers end up owing more than was originally borrowed;
- **Padded closing costs**, which can often be fees for settlement services two or three times as high as are charged middle income homeowners;
- **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 frequently require only the borrower to submit to it and not the lender and which can force a homeowner to pay large sums for their concerns to be addressed by arbitrators who have no incentive to follow consumer protection laws, and whose decisions are not reviewable by any court;
- **Repeated refinancings** which have the effect of bleeding the homeowner's equity from the home by increasing the amount borrowed exponentially in each refinancing without providing any benefit to the borrower;
- **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;
- **125% loan to value loans** which effectively prohibit borrowers from selling their homes or filing bankruptcy to escape unaffordable debt, without losing their home.

II. The Home Ownership and Equity Protection Act Should Be Expanded to Cover More Loans and Provide More Protections.

The government, and the housing and lending industries have done an excellent job in recent years in 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 consumers from abusive mortgage loans. Not only is there always significant collateral protection on home loans, there is the very real emotional attachment that homeowners have in their homes, making the home loan the first to be repaid, and the last to be defaulted upon. There is thus generally very little risk in any loan which is secured by a home.

Expansion of HOEPA. 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 bill for the same term as the loan, or points equal to more 8% of the amount borrowed.^[19]

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 four years has shown that while HOEPA has made a start at addressing the problems, there are still yawning chasms 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 excessive, combined fees -- in closing costs, credit insurance premiums, and points -- which deplete the equity in abusive loans. These excessive, combined 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 points and fees triggers for HOEPA are too high, causing many abusive lenders who want to avoid HOEPA strictures to make high cost loans just under the trigger. The effect is that there are no protections whatsoever against these very high cost loans which are just under the HOEPA triggers.
- 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.

HR 4250 leaves the basic structure of HOEPA in place while expanding its coverage and prohibiting abusive terms not currently addressed in the law. As part of this change, mandatory arbitration clauses is prohibited.

The essential core of this proposal is in the expansion of HOEPA protections to prohibit the financing of points, fees and credit insurance premiums, and the charging of prepayment penalties.

HR 4250 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. Presumably, for most borrowers, prohibiting the financing of these charges will be the same as prohibiting the charges altogether, but this will not necessarily mean that these loans cannot be made. It will only mean that these fees will be rolled into the interest rate charged the borrower -- the lender will pay the fees and recoup them through the interest payments on the loan. The rate of interest charged borrowers will increase, but the borrower's equity ownership in the home will be preserved. These loans will be structured exactly the same as the "no cost" mortgage loans provided to prime borrowers all the time.

There are indisputable advantages flowing from the prohibition against the financing of any points, fees or credit insurance premiums:

- *No equity will be stripped from the home.* The amount of money that the borrower directly receives, or is paid on the borrower's behalf will be the full loan amount, and nothing more. Every payment the borrower makes will reduce the loan amount. If there are repeated refinancings, the loan amount will *not* rise. The equity in the home is no longer the source of financing the loan -- the loan can only be financed through the borrower's income.
- *The lender will have the incentive to make these loans affordable.* Currently, a typical predatory mortgage transaction creates thousands of dollars of immediate profit to the lender upon sale of the loan to an investor. When the borrower refinances the loan, the lender sees a substantial profit, providing an incentive to the lender

to encourage refinancings, regardless of whether the borrower can actually afford to repay the refinanced loan. Yet, if the lender only reaps a benefit from the loan through the *payments* the lender has a clear incentive to make sure that the borrower can afford the payments.

- *The market will work to keep the interest rate on these loans competitive.* So long as the borrower has not invested a significant amount of money in each loan -- as is done when thousands of dollars in points and fees are financed -- there is little to stop the borrower from shopping for a lower rate loan when his credit improves, or interest rates fall - just as is done in the prime market. As a result, when the loan is first made the wise subprime lender will make the rate only high enough to cover the costs, the real risk, and a reasonable profit. If more is charged, the borrower will be able to refinance at a lower rate with a competitor.

Consider the following high cost loan:

Borrower receives:	\$70,000	
Borrower pays:		
6 Points	4,200	(\$4,200 all profit to lender)
Closing Costs [20]	2,500	(\$1,500 profit to lender)
<u>Credit Insurance</u>	<u>2,200</u>	<u>(\$1,000 commission to lender)</u>
Total Loan Amount	\$78,900	\$6,700 - immediate profit to lender upon sale of loan to investor
Interest Rate of 12% 30 year term	Monthly payment - \$811.58	
Consumer owes after 36 payments	\$77,927.52	- after 60 payments, the balance is \$77,056

So long as there is sufficient equity in the home (and there generally is plenty), the lender *benefits* if 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. Yet, the refinanced loan would be for an amount at least \$6,000 more to cover the new closing costs, with the same interest rate of 12%, and the consumer will have that much less equity in the house.

However, if the lender could charge as high an interest rate as desired, but could not finance more than 3% in up-front costs and fees, the same loan might look like this:

<u>Borrower receives</u>	<u>\$70,000</u>	(\$1,100 immediate profit to lender)
Closing Costs	\$2,100	
Total Loan Amount	\$72,100	
Interest Rate of 13.25% 30 year term	Monthly payment - \$811.68	

Lender makes up entire difference amount not permitted to be refinanced [$\$8,900 - \$2,100 = \$6,700$] in 6 years in additional interest charges paid by the consumer.

After 36 payments, the consumer owes \$71,415, after 60 payments, the consumer owes \$70,784.

This lender has much less incentive to flip this loan than the lender in the first example. Indeed, the lender's main

concern will be to make sure that borrower can in fact repay the loan. The profit from the loan will only flow from the payments.

Covering More High Cost Loans.

HR 4250 covers more high cost loans in several ways:

1. By lowering the annual percentage rate trigger to 6 points over the equivalent Treasury bill for first mortgage loans.
2. By establishing an annual percentage rate trigger to 8 points over the equivalent Treasury bill for junior mortgage loans; this has the effect of encouraging lenders to make second mortgage loans -- they are permitted a higher interest before their loan is regulated. This will address the problem of high rate lenders refinancing low interest rate first mortgages with a higher rate loan just to extend slightly more credit to the consumer.
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 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 consumer, the worst abuse in the predatory mortgage market is the financing of high points and fees. Not only does the points and fees trigger include all points, fees, and insurance charges, but the prohibition on financing more than 3% also applies to *all* points and fees.

Under current HOEPA law, there are confusing rules to determine which fees and insurance charges are included in the trigger for up-front costs.^[21] For example, under current law, the trigger excludes “reasonable” charges if they are not retained by the creditor and are not paid to a third party affiliated with the creditor. Fees for appraisals performed by unaffiliated third parties would not be counted if only the direct cost is passed on to the borrower. On the other hand, such a fee is counted if the cost is padded. Determining what is a “reasonable” for purposes of triggering coverage, however, is a difficult burden for consumers to meet. The closing costs trigger should include all points and all fees for closing costs.

Financing Credit Insurance Premiums. Credit insurance is a big ticket item in each individual loan.^[22] Nationally, consumers spend as much as \$2.5 billion per year on credit insurance, often with little understanding of what they have bought.^[23] This volume of business conceals overcharges of \$900 million^[24] to \$1.2 billion,^[25] where 40 to 50% of the premiums are paid to lenders as commissions. The marketplace has created reverse competition because credit insurance premiums are paid up front for term insurance policies which cover the whole or a significant portion of the loan term and lenders receive a commission based on the size of the credit insurance premium. Thus, lenders are rewarded for selling the most expensive forms of credit insurance, rather than the least costly to the consumer. As a result, unsophisticated consumers spend thousands of extra dollars for credit insurance which provides negligible value to them.

The remedy for the reverse competition established by the marketplace: 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.^[26] *The Federal Reserve Board and HUD specifically endorsed this proposal in their Report to Congress in July, 1998.*^[27]

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. HR 4250 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 spect of the bill is crucial to clamping down on the frequent loan flipping which is the cause of the loss of equity.*

Protections for Consumers in Home Improvement Loans. Recognizing the high number of abuses which flow from home improvement loans, HR 4250 establishes new protections applicable to all *home improvement loans* secured by the home. This home improvement law would ensure that a) homeowners have an effective method of enforcing their warranty rights, and b) lenders are held responsible for the actions of home improvement contractors.

One of the primary problems which arise from home improvement loans is the application of the ‘holder in due course’ rule. This rule generally applies to purchasers of negotiable instruments, such as mortgage loans.^[28] The holder in due course doctrine protects assignees of a 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 consumer’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.^[29] 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.^[30] 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 do 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...more often than not. Creditors use arbitration clauses as a shield to prevent consumers 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 consumer, and the arbitration may cost the consumer far more than bringing an action in court. By comparison, indigents in many jurisdictions can file court actions in forma pauperis. And consumers lose their rights to appeal the decisionmaker'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. HR 4250 appropriately includes such a provision.

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

Just as there are a number of causes for predatory mortgages, a panoply of changes to federal law and policies are necessary to terminate the worst abuses. In addition to amending the HOEPA – as proposed by HR4250, other changes in federal law are also necessary. Set out below is an overview of the other changes we believe are necessary:

1. Expansion and Extension of the Community Reinvestment Act and the Home Mortgage Disclosure Act.

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

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

1. Loans with excessive costs. Loans in which more than 3% of the total loan amount (or 4% if the loan is FHA-insured) consists of upfront points and fees.^[31]
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.^[32]
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.

Increased Data Collection is Critical -- HMDA should cover all Mortgage Loans

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

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

2. 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 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.

3. Tax Reform.

The changes in the 1986 Tax Reform Act that only permits personal interest deductions for loans secured by residences should be amended to limit home secured debt to home related debt, and to allow all individuals some measure of deductions for unsecured personal credit.

Appendix 1

Summaries of examples of predatory mortgages:^[33]

- An elderly homeowner in Minnesota whose loan was flipped several times by a major lender. New points were imposed on each occasion and none were rebated upon refinancing.^[34] The lender charged this homeowner 1 cent under 10 points (computed on the amount financed) prior to HOEPA. In the 1996 refinancing, the homeowner paid points which were 1 cent under the 8% HOEPA trigger. Because points were not rebated, the effective interest rates on these loans were much higher than the APR due to prepayment early in the term. The 1996 loan yielded a 26.813% APR based upon the fact that points were not rebated and the loan was prepaid in February, 1997.^[35]

- For individual borrowers, the costs of a credit insurance policy are huge in relation to the loan amount. For example, a Georgia homeowner paid \$2,200 for a credit life insurance policy sold to her in connection with a home-secured loan with a principal of \$40,606.26. The cost of this insurance added over 5% to cost of the loan. Nevertheless, this loan is not covered by HOEPA because the countable points are 5% which do not alone exceed the 8% trigger. Credit insurance is not currently included in the HOEPA points and fees trigger. If the credit insurance charge is added to the points, the total of over 10% easily triggers HOEPA protections.
- Some high rate lenders require homeowners to sign two loans, one which refinances debt, and the other, a smaller second mortgage, to finance the lender costs from the first loan. The APR on the first lien loan may be under the HOEPA APR trigger. But the APR on the second lien loan is a whopping 24%. This problem is evidenced made to two homeowners in Baltimore, Maryland. The homeowners are paying an APR of 19.2% on the first lien loan and 10 points. ^[36] The second lien loans reveals a 24% APR. When the HUD-1 Settlement Statements for both loans are compared, it is clear that the cash owed by the homeowners to pay for settlement costs (line 303) on the first loan is the same amount which is financed by the second loan.
- Another homeowner is paying an APR of 14.59% on the first lien and 10 points (calculated in the same way as the homeowners described above). The second lien loan reveals a 24% APR. When the HUD-1 Settlement Statements for both loans are compared, it is clear that the cash owed by the homeowner to pay for settlement costs (line 303) on the first loan is paid by the cash to be disbursed by the second loan. ^[37] Significantly, these homeowners report that they did not realize there would be two loans prior to settlement.
- Some lenders solicit borrowers with the promise that the borrowers can consolidate all of their debt into one payment which will cost less and save money over the term of the new mortgage. At settlement, when the borrower realizes that this claim is false, the lender or settlement agent for the lender promises that the loan will be refinanced on better terms in 6 months to a year. Further, borrowers are told, this is standard practice. Borrowers are induced to enter into the loan by these statements. Further, many borrowers are not in a position at that point to refuse the bad deal because they have paid appraisal, application or other fees or are in danger of losing their homes. This is a practice of a lender doing business in the Baltimore, Maryland area. Of course, the bad loan is never refinanced or, if it is, the same lender re-charges points and fees, thus gouging the borrower yet again
- At least one major lender is beginning to refinance its already existing portfolio of closed-end loans with a new "credit line account." The initial APR is just under the APR HOEPA trigger but it could easily exceed the trigger shortly thereafter, depending upon the index that is used. The maximum annual interest rate allowed on the account is 21%. In many loans, the initial advance was very close to the credit line limit suggesting that the loan may be a disguised closed-end transaction. These loans typically have high initial interest rates - such as the 15.5% charged to some borrowers -- in addition to the 3 points the borrowers were charged. Every exception to HOEPA encourages lenders to craft a loan product to meet that loophole. Given the more widespread use of open-ended loans secured by real property, this loophole should be closed.
- Some lenders will get homeowners to sign loan applications which inflate their incomes or add other information to the application unbeknownst to the homeowners in order to satisfy underwriting requirements. Frequently, the homeowners do not see these applications in their final form until settlement when they are asked to sign numerous documents in a rush. Or homeowners are asked to sign loan applications that are not completely filled in. The lender later adds additional information. This causes borrowers problems for two reasons: first, credit is extended when the borrower does not have the true ability to repay which leads to foreclosure; and second, the holder throws the "fraud" on the application back at the borrower later to defeat any complains that the borrower has against the loan.

^[1] The **National Consumer Law Center** is a nonprofit organization specializing in consumer credit issues on behalf of low-income people. We work with thousands of legal services, government and private attorneys around the country, representing low-income and elderly individuals, who request our assistance with the analysis of credit transactions to determine appropriate claims and defenses their clients might have. As a result of our daily contact with these practicing attorneys we have seen examples of predatory lending to low-income people in almost every state in the union. It is from this vantage point--many years of dealing with the abusive transactions thrust upon the less

sophisticated and less powerful in our communities--that we supply this testimony today. *Cost of Credit* (NCLC 1995), *Truth in Lending* (NCLC 1996) and *Unfair and Deceptive Acts and Practices* (NCLC 1991), are three of twelve practice treatises which NCLC publishes and annually supplements. These books as well as our newsletter, *NCLC Reports Consumer Credit & Usury Ed.*, describe the law currently applicable to all types of consumer loan transactions.

[2] The **Consumer Federation of America** is a nonprofit association of some 250 pro-consumer groups, with a combined membership of 50 million people. CFA was founded in 1968 to advance consumers' interests through advocacy and education.

[3] **U.S. PIRG** serves as the national lobbying office for state Public Interest Research Groups. PIRGs are non-profit, non-partisan research and advocacy groups with offices around the country.

[4] At the end of 1980 there were 150,165 homes in foreclosure, at the end of 1998 there were 577,566. 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.

[5] 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.

[6] 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 1983, Congress prohibited states from limiting the types of terms (such as balloon payments and negative amortization) that could be allowed on first mortgage loans. The Alternative Mortgage Transaction Parity Act of 1982 (AMTPA). 12 U.S.C. § 3800, *et seq.*

[7] Given the proclivity of many of us to want to minimize our weaknesses, we can safely assume that some additional number of mortgage borrowers were also confused, but were too embarrassed to admit it.

[8] In 2000, the U.S. Department of Health and Human Services poverty level for a family of four is \$17,050. *Federal Register*, Vol. 65, No. 31, February 15, 2000, pp. 7555-7557.

[9] NCLC generated data.

[10] 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).

[11] Many low-income homeowners are working poor, with no tax liability, because of the earned income tax credit. Others are paying at the tax system's lowest tax rates.

[12] 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). White borrowers were charged 8.26%.

[13] See examples referred to in Footnote 10.

[14] At the end of 1980 there were 150,165 homes in foreclosure, at the end of 1998 there were 577,566. 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.

[15] The Federal Reserve Board concludes that one in nine families face debt payments that are higher than 40% of annual income. The rate rises to one in six families among those earning less than \$25,000 per year. "Family Finances in the U.S.: Recent Evidence from the Survey of Consumer Finances" at 21, Table 14, *Federal Reserve Bulletin*, January 1997. See Pearlstein, "Trendlines: The Fed's Knowledge of Wealth", *Washington Post*, p. E1 (1/23/97).

[16] Canner, Durkin, & Lockett, "Recent Developments in Home Equity Lending," *Federal Reserve Bulletin*, April, 1998.

[17] *Id.*

[18] Most recently, these were illustrated in the hearings before the Senate Special Committee on Aging, Mar. 16, 1998. They continue to be documented at the hearings currently being held before the Department of Housing and Urban Development in cities around the nation. To date there have been hearings in Atlanta, Los Angeles, New York and Baltimore. A hearing is scheduled for Chicago later this week.

[19] 15 U.S.C. § 1602(AA)(1)(B).

[20] In over 50% of mortgages loans, closing costs includes a broker's fee. HR 4250 would include fees paid to brokers both directly by the borrower -- as part of the closing costs -- and those paid by the lender, which is covered in the interest rate. In the interests of simplicity of this example, we have not identified and included either broker's fee.

[21] *Id.*

[22] For individual borrowers, the costs of a credit insurance policy are huge in relation to the loan amount. For example, a Georgia homeowner paid \$2,200 for a credit life insurance policy sold to her in connection with a home-secured loan with a principal of \$40,606.26. The cost of this insurance added over 5% to cost of the loan. Nevertheless, this loan is not covered by HOEPA because the credit insurance premiums are allowed to be excluded from the closing cost trigger in HOEPA under current law.

[23] *Credit Life Insurance Hearing Before the Subcommittee on Antitrust, Monopoly and Business Rights of the Senate Committee on the Judiciary*, 96th Cong., 1st Sess. 48 (1979) (statement of Robert Sable).

[24] *Id.* at 3.

[25] *Id.* at 7 (testimony of James Hunt). *Credit Life Insurance: The Nation's Worst Insurance Rip Off*, Statement of Consumer Federation of America and National Insurance Consumer Organization (June 4, 1990), updated (May 20, 1992 and July 25, 1995).

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

[27] 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.

[28] 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).

[29] 16 C.F.R. § 433.

[30] Forrester, *supra* Footnote 12, at 1108.

[31] 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.

[32] The equivalent yield for the Treasury Bills 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.

[33] Exhibits providing the evidence for the loans detailed below were presented to the Federal Reserve Board at hearings regarding the Home Ownership and Equity Protection Act, Docket No. R-0969, June 17, 1997, by Elizabeth Renuart, Staff Attorney, National Consumer Law Center.

[34] The loans prior to 1996 contained a provision purporting to rebate unearned points. Application of the formula, however, never results in a rebate unless the prepayment occurs within the first year of the loan.

[35] The homeowner could no longer afford to make the monthly payments that increased with each refinance and was forced to sell his home. He paid off the lender in February 1997.

[36] The 10 points were calculated on the principal amount of the loan. If, instead, the amount financed is used, the number of points charged is 11.

[37] One homeowner reports that she did not receive all of the cash allegedly disbursed by the second loan even after the closing costs from the first loan were paid.