TESTIMONY OF CONSUMERS UNION OF U.S., INC.
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BEFORE THE HOUSE COMMITTEE ON FINANCIAL SERVICES

"SUBPRIME LENDING: DEFINING THE MARKET AND ITS CUSTOMERS"
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Consumers Union,[1] appreciates the opportunity to provide testimony to the House Financial Services Committee. The topic of today's hearing is particularly relevant to our efforts to promote and preserve homeownership and to provide consumers with unbiased information about personal finance. Consumers Union has been very active in this endeavor, nationally through our publication, *Consumer Reports*, and our advocacy work in Washington DC, and regionally through our Southwest Office in Austin, Texas, and our West Coast Office in San Francisco, California.

Preserving Home Equity Is Key to Prosperity and Stability

We believe that homeownership is a critical priority for our country, and that protecting the equity that our citizens grow through homeownership is critical to every state's prosperity and stability.

People who own their homes and have built equity in them have a real financial stake in the stability and quality of their communities. It is estimated that for every percentage increase in homeownership, property values for the neighborhood rise $1600 over 10 years.[2] Homeowners are more likely to be concerned that schools are good and government services are efficient, since they are supported by their property tax dollars. They have an incentive to work to keep property values up and crime rates down, since rising property values build their own wealth too. Long-time homeowners add important generational diversity and economic stability to neighborhoods, which is especially critical in areas experiencing economic hardship or decline.

It is no secret that the equity families build in their homes is a substantial portion of the net worth of the homeowner. For the typical homeowner, home equity makes up 45.2 percent of net worth, and it is much higher for Latino and African-American homeowners, making up 60.7 and 61.1 percent of net worth, respectively.[3] For the nation as a whole, home equity accounted for 44 percent of the nation's total net worth – far more than any other investments.[4] Home equity is wealth that can be used to start a business, to get an education, or to pass on to your children.

Subprime Lending Explosion Triggers Concerns in Texas and California

The growth of the conventional mortgage market has expanded the number of people who can purchase a home and build equity. But a more recent and disturbing trend has been the significant growth of subprime lending, particularly in the home refinance and home equity market. Because of the importance of preserving equity, problems associated with foreclosures, and terms and practices associated with high-cost loans, we are concerned with the tremendous growth in the subprime market,[5] particularly for refinance loans.

Our concern, which is shared by other consumer, housing, anti-poverty and civil rights advocates, is that while not all subprime loans are abusive, predatory lending is concentrated in the subprime market. Responsible subprime loans with somewhat higher interest rates that balance the greater risk of lending to borrowers with past credit problems fill an important need in the purchase money market. However, too many subprime loans include abusive terms or conditions, have rates and fees much higher than can reasonably be justified based on the borrower's credit record, serve primarily to strip equity from the home, or are simply unaffordable and destined to fail. Predatory mortgage loans, in particular those which are equity based, undermine homeownership and family wealth by stripping equity out of homes and entire communities.

Nationally, the subprime sector of the mortgage loan originations increased from less than five percent in 1994 to almost 13 percent in 1999. This represents an increase from $35 billion in 1994 to $160 billion in 1999.[6]

Similarly, the growth of the subprime refinance lending markets in Texas and California is notable. In 1997, there were 2512 subprime refinance loans made in Texas, in 2000 there were 23,353.[7] As a measure of the penetration of subprime lending in the Texas market, in 1997, refinance loans made by subprime lenders were six percent of all refinance loans made. Loans from subprime lenders now account for one-third – 33 percent – of all refinance loans across the state. The number of refinance loans is very important, since the refinance data includes home equity loans.

California has witnessed an explosion in subprime lending from an estimated $18 billion in 1998, to over $62 billion in 2002.[8] Also in California, according to a recent study issued by the UCLA Advanced Policy Institute, the number of refinance loan applications received by subprime lenders in California increased at an average annual rate of 27 percent (compared to just 4 percent for prime lenders) from 1993 to 2000. During the same time period, the market share of loans originated by subprime lenders grew five times from 4 percent in 1993 to 20 percent in 2000.[9]

Subprime Borrowers in Texas and California

Data that allows analysis of trends in the marketplace comes from Home Mortgage Disclosure Act data – HMDA – and provides some information about mortgage borrowers. In addition, by combining HMDA data with information from the Census, we are able to observe

trends in the mortgage market and make predictions about what factors predict the likelihood a person will get a subprime loan. Income, for example, is a factor that predicts when someone is likely to get a subprime refinance loan. But, even when controlling for other factors, the number of elderly people living in a neighborhood or a borrower's race appear to be factors that predict the number of subprime loans in a neighborhood.

In Texas, the more older residents in an area, the more likely that a borrower in that area will get a loan from a subprime lender, controlling for other factors like income and race.[10] This is consistent with a finding from AARP research that found older borrowers were three-times as likely to have a subprime loan than borrowers younger than 35 years of age.[11]

HMDA data available for Texas also demonstrates that not only has the growth of subprime borrowing increased overall statewide, but that the percentage of loans to African-Americans and Latinos that are made through subprime lenders has also increased. In 1997, 7.6 percent of refinance loans to Latinos and 19 percent of loans to African-Americans were made by subprime lenders, in 2000 the percentages were 39.7 and 57.7 percent, respectively.[12]

In California, multiple studies confirm that subprime refinance lending is most concentrated in Latino or African-American neighborhoods of low-socio economic status where certain neighborhoods and borrowers appear to be the targets of aggressive marketing efforts by subprime lenders.[13] The UCLA Advanced Policy Institute found that the result is the same, even when controlling for individual and neighborhood risks, and found a relationship between subprime lending and foreclosures.[14]

Subprime Lending Can Reduce or Eliminate Home Equity

The growth of subprime lending is cause for concern for two reasons – first, higher-cost subprime loans can reduce or eliminate equity building in homes; and, second, practices associated with subprime lending can result in equity being stripped from homes and communities and sometimes foreclosure.

The high cost associated with subprime loans means that subprime borrowers often pay more for less. According to Freddie Mac, in 2002, the average interest rate on a 30-year fixed mortgage was 6.54% and average points paid by the consumer were .6%. A November 2003 California Reinvestment Committee report found, "In contrast, in 2002, several subprime lenders originated loans in California with Annual Percentage Rates (APRs) that exceeded 15%, including: Citifinancial Services, Option One Mortgage, Household Finance, Beneficial, Washington Mutual Finance, and Wells Fargo Financial. Citicorp Trust Bank, FSB originated mortgage loans in California with APRs exceeding 20% in 2001, the last year for which data is available."[15]

Over the life of a loan, differences in the interest rate on a home-secured loan between a conventional and a subprime loan can make a dramatic difference in the amount of equity a homeowner builds in a home. It may mean that a homeowner builds no equity at all, or loses equity already accumulated in a home.

By examining the total interest payments a person would make financing an $80,750 loan for 30 years at eight, 11, and 14 percent interest you can see the effect. A person will pay about $132,000 in interest over the life of the loan for an eight percent loan, whereas a person would pay $196,090 and $263,692, respectively, for an 11 and 14 percent loan. The higher interest rate requires more interest to be paid overall, so a great portion of interest is paid, relative to the principle, in early years in the loan. So, not only is the monthly payment higher, but the overall amount of equity accumulated is less.[16]

Worse, loans where the borrower is unable to make payments results in foreclosure. Obviously, the loss of a person's home is devastating, but it is not only homeowners who suffer from such losses, it is estimated that between homeowners, lenders, mortgage insurers, secondary mortgage market makers like Fannie Mae, and communities, cities, and counties, as much as $73,000 per transaction is lost.[17]

Common Abuses Found in Subprime Loans Hurt Borrowers

In the conventional marketplace, borrowers can usually rely on rates to be competitive, terms to be fair, and for there to be no "gotchas" in loan paperwork. This is often not the case in the subprime market. This reality leaves consumers vulnerable to being overcharged and underserved. Consumers often reports bait and switch tactics. Additionally, there is growing awareness that mandatory arbitration agreements, which prevent consumers from obtaining judicial relief, are
ubiquitous in the subprime market, as evidenced by Freddie Mac's recent ban of such agreements from all mortgage loans it purchases.

Abuses found in some subprime loans are usually described as predatory lending. Predatory lenders target vulnerable consumers, including those with good credit, particularly the elderly, the poor and the uneducated, and use an array of practices to strip home equity from their homes. The abusive practices include excessive fees, high interest rates, costly and unnecessary insurance policies, large balloon payments, broker fees tied to interest rates, and repeated refinancing that steadily increase a borrower's debt.

In October 2001, the Coalition for Responsible Lending estimated that every year, borrowers lose $9.1 billion to predatory practices, including $497.9 million in Texas, and just under $1.9 billion in California alone. These estimates were based on equity stripping charges, such as financed credit insurance – often called 'single-premium' credit insurance, excessive fees greater than five percent of the loan amount, and prepayment penalties – and risk-rate disparities, where a borrower pays a higher rate than justified based on the person's credit history. While some of these things are prohibited in Texas home equity loans, and in some cases limited in California, many are relevant. The 2001 California Reinvestment Committee study estimated that one-third of subprime loans held by borrowers surveyed in four California cities are predatory in nature based on loan document review and borrower perception.[18]

Excessive fees and "packing" have been cited by the Department of Housing and Urban Development as an "all too frequent" abuse in the subprime market. The types of abuses found

for these loans include "packing" additional fees into loans – costs that are not found in conventional loans but are common for subprime loans.

Add-on fees, sometimes called "packing," do not increase the equity for the borrower. A couple in Austin made a loan at 13.16 APR which included more than $10,000 in unexpected charges, $4,160 for insurance and $6,213 for points. Points, which in the conventional market buy-down interest rates over the life of the loan, do not seem to have the same effect in the subprime market, where they are merely add-on costs financed over the life of the loan.

Conclusion

Legislators, policymakers and regulators should be concerned about the explosive growth of the subprime mortgage refinance market, because of the likely increase in predatory lending within that sector. We believe a more comprehensive fix is needed to address problems with home equity subprime loans in Texas. In California, we advocate for increased enhancements of the state's anti-predatory lending law passed in 2001, and for the establishment of more protective local ordinances, where needed.

I appreciate the opportunity to provide testimony today.

Endnotes

[1] Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the state of New York to provide consumers with information, education, and counsel about goods, services, health, and personal finance; and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. Consumers Union's income is solely derived from the sale of Consumer Reports, its other publications and from noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, Consumer Reports, with approximately 4.6 million paid circulation, regularly carries articles on health, product safety, marketplace economics, and legislative, judicial, and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

[2] Each percentage point increase in the homeownership rate of a tract would yield about $1600 increase in the property value of the average single-family home over a ten-year period. Rohe and Stewart (1996) p. 66.

[3] McCarthy, G. et al, *The Economic Benefits and Costs of Home Ownership*, Working Paper No. 01-02, Research Institute for Housing America, May 2001.

[4] *Buying a New Home: A Solid Investment*, National Association of Home Builders and Builder Magazine, data from 1993.

[5] The Department of Housing and Urban Development (HUD) identifies subprime lenders. According to HUD, a list of HMDA reporters that specialize in subprime lending is compiled primarily from industry trade publications and HMDA data analyses. Then, HUD contacts the lenders or reviews their web pages to determine if they specialized in subprime lending. In cases where lenders offer both prime and subprime, lenders were identified as subprime if they reported that at least 50 percent of their conventional originations were subprime loans.

[6] Stein, K., California Reinvestment Committee, *Stolen Wealth: Inequities in California's Subprime Mortgage Market*, December 2001.

[7] 2512 subprime refinance loans out of 41,572 in 1997, 23,353 subprime refinance loans out of a total of 70,616 in 2000.

[8] Stein, K., California Reinvestment Committee, *Who Really Gets Home Loans? Year 10*, November 2002, p. 3.
[9] Pitkin, B., et al., UCLA Advanced Policy Institute, *Subprime Refinance Mortgage Lending and Neighborhood Conditions: Evidence from California*, , Sept. 30, 2003, p. 1.
[10] Logistic Regression Analysis – Loans Originated by Subprime Lenders in Texas.

Number of Loans Analyzed: 353,042

Odds Ratio Estimates

Effect	Point Estimate	95% Confidence	
Percent of Tract 55 or Older	1.002	1.001	1.004
Percent of Tract Minority	1.006	1.005	1.006
Ratio of Tract to MSA Income	0.998	0.998	0.998
Population Density of Tract	>999.999	>999.999	>999.999
Improvement Loan	0.918	0.872	0.967
Refinance Loan	7.201	7.011	7.396
Amount of Loan	0.999	0.998	0.999
Loan As Percent of Income	1.033	1.025	1.041
Applicant Income	0.996	0.996	0.997
No Coapplicant	1.135	1.105	1.166
Applicant Sex is Female	1.116	1.083	1.149
Applicant Race is Black	3.326	3.202	3.455
Applicant Race is Hispanic	1.416	1.368	1.465

Note: The point estimate of the odds ratio can be interpreted as the number of times more likely the loan is subprime given a single unit increase in the effect variable and holding everything else constant. For example, a black applicant is 3.3 times more likely to get a subprime loan, holding the other factors constant. Model Correctly Predicts 77.7% of observations, predicts a tie for 1.0%. Data Sources: 2000 HMDA,2000 Census, U.S. Bureau of the Census.

[11] Calhoun, M., et al., Home Loan Protection Act, A Model Statute, November 2001, p. 5, citing Lax, H., et al., *Subprime Lending: An Investigation of Economic Efficiency*, (unpublished paper), February 2000.

[12] For African-Americans, 383/2031 subprime/prime refinance loans in 1997, 2937/5091 in 2000. For Latinos, 365/4772 in 1997, 4595/11,585 in 2000.

[13] Pitkin, B., p.2; Stein, K., California Reinvestment Committee, *Stolen Wealth: Inequities in California's Subprime Mortgage Market*, December 2001, p. 22.

[14] Pitkin, B., pp 2, 18.

[15] Stein, K., California Reinvestment Committee, *Who Really Gets Home Loans? Year Ten—Mortgage Lending to African-American and Latino Borrowers in 5 California Communities in 2002*, November 2003.

[16] Comparing the differences between the monthly payments and total payments over the life of the loan:

Interest rate	Monthly payment	Annual payment	Diff. from 8%	Life of loan
8%	592.51	7,110.18	N/A	N/A
11%	769.00	9,228.01	2,117.83	$63,535
14%	956.78	11,481.36	4,371.18	$131,135

[17] Source: McCarthy, G. et al, *The Economic Benefits and Costs of Home Ownership*, Working Paper No. 01-02, Research Institute for Housing America, May 2001:

Party	What is lost	Financial Loss
Homeowner	• Accumulated equity and all costs associated with acquisition of the home • access to stable housing of decent quality (and damage to credit score makes it difficult to buy or even rent other dwellings) • tax advantages of home ownership and face a potential tax burden for forgiven indebtedness	$7,200
Lender	• insured loans: non-reimbursable expenses (interest payments advanced to investors), expenses of holding and maintaining properties) • portfolio loans: full amount associated with foreclosure (legal fees, maintenance, brokers fees for resale) • revenue stream from servicing	$1,500 (FHA) - $2,300 (conv), $1,125 (servicers)
Mortgage Insurers	• difference between sale price at foreclosure and sum of outstanding debt and costs	$28,000 (FHA), $10,600 (VA), $17,300 (conv)
GSEs	• foreclosed properties with mortgages sold on secondary market	$6,400- $8,000
Communities, cities, counties	• tax revenue • unrecovered rehabilitation expenses • nearby properties suffer resale value losses, increased vandalism	$27,000 avg city expenses, $10000 neighborhood (FHA)
Total		$26,000 (conv) - $73,000 (FHA)

[18] Stein, K., California Reinvestment Committee, *Stolen Wealth*, p. 4.