*Testimony of*

William M. Dana

*On Behalf of the*

AMERICAN **BANKERS** ASSOCIATION

Before the

Subcommittee on Housing and Community Opportunity

and the

Subcommittee on Financial Institutions and Consumer Credit

of the

House Financial Services Committee

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March 30, 2004

Chairmen Bachus and Ney, my name is William M. Dana, President and CEO of Central Bank of Kansas City, Missouri. I am pleased to testify before you today on behalf of the American Bankers Association. I serve on both the ABA's Community Bankers Council and on its Communications Council. The ABA brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks—makes ABA the largest banking trade association in the country.

Today's hearing topic, the subprime lending market and the customers it serves, is an important one for both consumers and lenders alike. I commend you for your attention to the complex issues surrounding the subprime market. Subprime lending is a vital source of credit to many individuals who would not have access to loans without it. It should not be confused with predatory lending, which is characterized by practices that deceive, defraud or otherwise take unfair advantage of consumers. The ABA strongly believes that predatory lending has no place in our financial system and that existing laws should be rigorously enforced. Practices that are routinely criticized – such as guaranteeing the borrower one loan rate and putting a second, higher rate in the mortgage contract are reprehensible -- and are already illegal. The vast majority of predatory practices are engaged in by unregulated, often fly-by-night lenders. In contrast, the banking industry is subject to strong oversight and examination by banking regulators to ensure that banks comply with all laws and regulations. Non-banks should be encouraged to lend responsibly and be held accountable for not doing so.

Subprime lending, or more precisely, lending to those with less than perfect credit ratings, is an extremely important part of my small bank's business. In fact, if we could not do subprime lending, our mortgage lending business would have difficulty surviving. My community is not a community filled with wealthy people who are minimal credit risks. However, we do have many individuals and families who need access to credit and look to our bank to provide it. In many cases, the loans for which they qualify are subprime. We provide full disclosure of all the terms of these loans and work very hard to make sure that our borrowers understand the obligations that they are assuming. It does our bank no good – and certainly our borrowers no good – if they do not fully understand this important financial obligation.

Care must be taken to effectively deal with abusive practices but not inadvertently shut off credit to deserving individuals. Laws that add additional requirements only raise the cost of these types of loans. Complying with many different state and local requirements adds a regulatory burden, impedes efficiency, reduces credit and raises costs. In ABA's opinion, a national standard is an appropriate approach to consider.

In my statement today, I would like to make three key points:

- Subprime lending is an important source of credit for many people who have less than stellar credit histories;
- Subprime lending should ***not*** be confused with predatory lending; and
- For consistency and efficiency, a national predatory lending standard is the most effective approach to curb abuse or fraud.

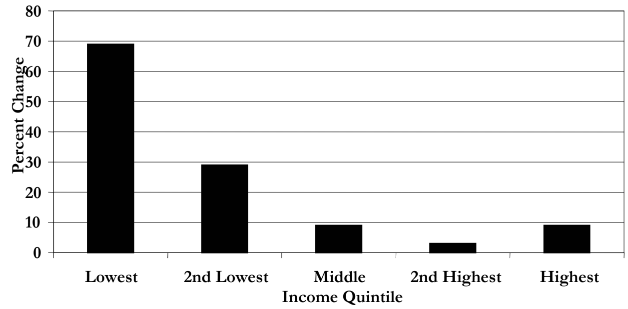
I will address each of these in turn in the remainder of my statement.

## Subprime Lending is an Important Source of Credit for Many People

One of the keys to the strength and resiliency of the U.S. economy is the efficiency of the consumer credit markets. U.S. consumers have access to more credit, from a greater variety of sources, more quickly, and at lower cost than consumers anywhere else in the world. Financial institutions have, over time, gradually expanded credit to borrowers who in earlier times could not have qualified for credit. This broadening of access to credit is a positive development, spurred by market forces and governmental actions, including the elimination of many regulations and limitations on lenders. In the days when deposit and lending rates were regulated or limited – as recently as 1980 – credit was rationed. Good or prime borrowers got credit; others did not.

These findings are confirmed by a recent study by professors Michael E. Staten and Fred H. Cate, entitled: *The Impact of National Credit Reporting Under the Fair Credit Reporting Act: The Risk of New Restrictions and State Regulation.* [1] The authors document the positive impact of credit reporting on traditionally underserved Americans. They state: "One of the more remarkable achievements attributable to the development of comprehensive credit reporting is the increased access to credit down the household income spectrum in the U.S. over the past three decades." (See Chart.) The reasoning behind this finding is straightforward: detailed and reliable information on past payment behavior gives lenders confidence in assessing the creditworthiness of new borrowers and allows them to design products to meet the needs of previously underserved populations. Because the credit-reporting infrastructure helps to support broader access to credit, it can enhance asset and wealth accumulation – an effect particularly pronounced for younger households.

**Change in the Proportion of U.S. Households Using Non-Mortgage Credit (1970 vs. 2001)**




Source: Federal Reserve Board, Surveys of Consumer Finances.

Borrowers with a history of always paying their utility, credit card, and other bills on time often qualify as prime borrowers, and are thus eligible for credit on the most competitive terms available. Many other borrowers, however, do not have perfect payment histories; others may not have significant assets to fall back on; and others may be self-employed and have wide fluctuations in their annual incomes. Borrowers in these categories may not qualify for prime status, but they are often eligible for credit in the subprime market, where, because of greater risks, the interest rates and fees can be higher, and the loan amounts lower, than those available in the prime market.

Thus, combined with the national credit histories, the other major innovation that facilitated the expansion of credit to subprime borrowers was the development of credit rating tools to

[1] Michael E. Staten is the Distinguished Professor and Director of the Credit Research Center at the McDonough School of Business, Georgetown University and Fred H. Cate is the Distinguished Professor and Ira C. Batman Faculty Fellow at the Indiana University School of Law-Bloomington.

measure the relative risks of potential default of different borrowers. These credit scores are now used by a wide range of lenders, depository and non-depository institutions alike, to help determine interest rates and other terms to offer to borrowers based on analysis of the risks of non-payment. This practice is known as risk-based pricing, and it is a tool that has made credit available to many consumers who had previously been left out of the marketplace. The development of the subprime market has assisted these borrowers tremendously. I would also like to note that for many institutions, like mine, a credit rating is a starting point, not a cut off point for many loans. We look at a potential borrowers' credit rating, but frequently we make loans based on broader criteria than those covered in the credit ratings.

Preserving the national credit system, as Congress did just last year was extremely important. In the same vein, preserving access to credit to those with less than perfect credit histories is equally important.

I am particularly proud of my institution's record of extending credit to subprime borrowers. I would like to share some examples of the kinds of lending we do and the impact it would have on our community if we ***did not*** extend these loans.

- We have helped people who have been victims of predatory loans, like a retired couple with a $19,000 annual income. They had taken a second mortgage against their home with a siding contractor paying 19 percent annual interest. Central Bank refinanced their home. We paid off the first and second mortgage. Our loan, on much improved terms, resulted in a lower monthly payment amount, allowing them to have a much better quality of life, and to not worry about losing their home.

- We have helped new businesses get started that enhance our local community. A borrower came to us seeking a loan to purchase (from a deceased owner) a tax services business targeted to Spanish-speaking immigrants. The applicant had a low credit score and multiple collections and her business partner had an even lower score. Nevertheless, Central Bank financed the acquisition at 8.5 percent fixed for 15 years, using the business and a personal residence as collateral. But for our loan, these women would not have been able to provide a needed service in this community with a large Hispanic population. They were both inviting targets for predatory lending by unscrupulous lenders, but instead they have a good loan, at a fair price, benefiting them and the customers they serve.

- We have helped those in trouble in our community. A local church came to us when they had a church van repossessed and another lender had begun foreclosure proceedings against the church. The pastor came to us, and even though he had bad credit, he agreed to guarantee a loan made by Central Bank. Working together we were able to help him to save both the church and the van.

Without Central Bank's participation in the subprime market, these borrowers and many more like them would not have these opportunities to help themselves and their community and would likely have been targets for predators.

**Subprime Lending Should *Not* Be Confused With Predatory Lending**

Subprime lending is an important category of lending. As with all lending, it must be done in a straightforward manner with all appropriate disclosures so borrowers understand the obligations they are undertaking. Abusive practices that use deceptive or fraudulent sales tactics, or that intimidate or mislead consumers into borrowing, should not be tolerated and there should be aggressive enforcement of laws and regulations designed to prevent such practices.

Depositories, like mine, are significantly regulated, and must meet strict reporting and other disclosure standards that ensure that credit is extended on a fair and equitable basis. Not all institutions serving the subprime market are regulated as intensely. Depository institutions are also examined on their history of extending credit to subprime borrowers under the Community Reinvestment Act – an obligation not shared by many other financial companies.

Abusive practices by some of these less well regulated lenders has caused Congress, as well as state and local lawmakers, to pay increasing attention to what has come to be known as "predatory lending." Although the term itself has not been precisely defined, it has come to refer to loans extended under terms that are more onerous to borrowers than if they were to be fully informed about the loans themselves and the alternative sources of finance that might be available to them. In response, the Congress has enacted laws like the Home Ownership Equity Protection Act

(HOEPA), and state and local lawmakers have enacted or considered various anti-predatory lending laws. These state and local laws, while well intentioned, often have the effect of driving legitimate lenders from a marketplace, or of balkanizing the subprime market by preventing the efficiencies and cost-savings of national markets from developing.

In effect, many of the state and local laws constitute a new type of "usury" statutes. Usury laws were once prevalent throughout the country, but have since been abandoned so that the market can work efficiently – except in this new guise as an attack on predatory lending. Moreover, the implicit connection drawn in many of these laws between "high cost" lending, which appropriately reflects the risks of lending to customers outside the prime market, and "predatory" lending, which is inherently abusive, is simply incorrect.

While the motivation behind legislation aimed at predatory lending is understandable and commendable, virtually all of the practices complained of are already against federal law. What is often lacking at the federal level is the proper enforcement. Furthermore, federal law already contains numerous disclosure requirements relating to mortgage loans generally, and especially high-cost loans. Additional statutory measures at the state and local level at this point run a significant risk of unintentionally cutting off the flow of funds to creditworthy borrowers. This potential outcome is a very real concern and should be seriously considered by policy makers at all levels of government. There have been successful efforts, at the federal level in particular, to increase lending to minorities and low-income borrowers in recent years. Such lending should not be jeopardized by counterproductive measures at the state and local level.

**For Consistency and Efficiency, a National Predatory Lending Law is the Most Effective Approach to Curb Abuse or Fraud**

The best approach to address concerns over predatory lending without disrupting credit to the subprime lending market is the passage of targeted federal legislation setting a national standard against predatory lending practices.

There are a number of areas where Congress has determined that a federal approach to a given consumer protection issue is warranted, and the Congress has been able to enact appropriate legislation without undermining the dual banking system. We believe that such an approach would have the added advantage of leveling the playing field for all participants by bringing all participants under the same standard.

We do understand that real estate lending is in many ways a local issue, as real estate markets are, by and large, local. However, the huge impact of the secondary market on real estate lending is evidence that a national approach to predatory lending may be the best solution. In fact, several state and local initiatives have immediately run afoul of the national secondary market, with the result that those initiatives had to be changed.

Concerns about predatory lending should be addressed through a unified national standard, and we recommend that the Congress actively consider proposals for such an approach to predatory lending. Bills introduced by Representatives Robert Ney (R- OH), Mel Watt (D- NC) and Brad Miller (D-NC), may serve as good starting points for consideration of a national standard.

**Conclusion**

In conclusion, the ABA believes that the development of the subprime market has been a positive development for American consumers. To ensure that consumers receive credit on fair and equitable terms, it is vital that they be served by legitimate lenders with appropriate levels of regulation. A national standard to prevent predatory lending may be desirable to ensure that all lenders, whether depository or non-depository, operate under the same requirements. The ABA looks forward to working with the Members of the Financial Services Committee to explore these options.

Chairmen Ney and Bachus, I again thank you for the opportunity to testify here today.