TESTIMONY SUBMITTED BY THE:

CONSUMER MORTGAGE COALITION

COMMITTEE ON FINANCIAL SERVICES

SUBCOMMITTEES ON HOUSING AND FINANCIAL INSTITUTIONS

"Efforts to Prevent Abusive Mortgage Lending"

November 5, 2003

The Consumer Mortgage Coalition ("CMC"), a trade association of national residential mortgage lenders, servicers, and service providers appreciates the opportunity to submit its written testimony concerning predatory mortgage lending to the House Financial Services Subcommittees on Housing and Financial Institutions.

In considering the problem and impact of, and possible responses to, "predatory lending," we emphasize the following key points:

- ***Many abusive practices are the result of outright fraud.*** As we examine the anecdotal descriptions of borrowers being abused, it is clear that many of the abuses resulted from misrepresentation, deception and other practices that violate existing laws. New laws are not needed to address these problems. Rather, there must be a renewed emphasis on devoting the necessary resources to enforce existing law.

- ***"Predatory lending" is hard to define.*** Practices (other than those constituting current illegal conduct) that are often labeled "predatory" can have both adverse and beneficial consequences for consumers. As policy makers consider restricting individual terms and provisions, such as prepayment penalties and yield spread premiums, they must understand that these terms have legitimate uses that can benefit consumers, for example, by reducing interest rates or upfront costs.

- ***It is not in the interests of lenders and servicers to make loans, whether prime or subprime, which result in default or foreclosure.*** Lenders and services do not benefit from defaulted loans. Rather they lose money—often significant amounts. Simply put, a lender whose loans that go into default represent more than a small proportion of its total loans will not long be in the lending business. In fact, because subprime borrowers by definition present a greater risk, subprime lenders must devote additional resources to ensuring that they will not end up with a defaulted loan.

- ***The goal of policymakers in addressing "predatory lending" should be to educate and empower consumers to make appropriate decisions about their financial affairs, not to restrict consumers' option.*** The CMC is convinced that both consumers and lenders are better off if lenders have the freedom to offer and consumers have the freedom to choose from the widest range of financial options. Consumers, however, must be put in a position to make an informed decision that is most appropriate for their needs and situation.

- ***Current regulatory requirements do not allow consumers to understand their choices. They often act as barriers to competition that could reduce costs.*** Studies have shown that the innumerable disclosures required by a variety of federal and state laws often confuse, and sometimes mislead, consumers who are attempting to shop for loans. In addition, while lenders compete on their offerings based on interest rate and points, because of regulatory restrictions, there is little incentive to compete on the basis of ancillary settlement costs.

The CMC developed a five-part program that we believe best addresses "predatory lending" without unduly restricting consumer's options or unduly burdening the efficient operation of the mortgage market. The program consists of the following:

- ***Adequate enforcement of existing law***
- ***A nationwide licensing registry that allows constant monitoring by state regulators and consumers of licensing complaints, suspensions and revocations***
- ***A comprehensive public awareness and education campaign***
- ***Implementation of Federal regulators' existing authority to address predatory practices***
- ***Reform of mortgage origination regulatory requirements to give consumers simpler, more uniform disclosures that allow them to understand and effectively comparison shop for loans, to give lenders the ability to offer ancillary settlement services at lower cost, and to provide certain substantive protections.***

Following a brief note describing our coalition, we examine each component of this comprehensive solution. In addition, in Tab 1 of this testimony, we describe the subprime market. In Tab 2, we describe the products and practices that often are labeled "predatory," and show how they can be used to the benefit of borrowers and how our solutions would mitigate any abuses they could cause. Finally, in Tab 3, we describe the mortgage origination process, its participants and the compensation each receives for their role.

<u>About the CMC</u>

The CMC was formed, in large part, to pursue reform of the mortgage origination process. From our perspective, one of the principal goals of mortgage reform is to streamline the mortgage origination process so that consumers would be better informed when making credit choices. Complementary to our goal of streamlining the mortgage origination process is the goal of reducing abusive lending practices. We believe that better disclosures and substantive protections can enhance consumer protection. The goal should be to allow consumers to make educated choices in the credit market.

We commend the Committee for its continued attention to the issue of predatory lending. The CMC is particularly concerned because of the damage caused by deceptive lenders to consumers and to the image of our industry. We support the goal of protecting consumers from unscrupulous lending practices and recognize that some elderly and other vulnerable consumers have been subjected to abuses by a small number of mortgage lenders, brokers and home contractors. We share the Committee's objective of developing approaches that prevent predatory lending practices without restricting the supply of credit to consumers or unduly burdening the mortgage lending industry.

The CMC's Alternative: A Comprehensive Solution to Predatory Lending

Rather than further restrictions on products, terms and provisions, the CMC favors a multi-tiered, comprehensive solution to predatory lending, including increased enforcement of existing prohibitions against fraud and deception, coordinated, nationwide enforcement of licensing requirements, and better consumer education on the mortgage process.

Most significantly, the CMC believes that comprehensive reform of the regulation of the mortgage origination process is needed so that all consumers, but particularly those most vulnerable to predatory lending practices, can better protect themselves. As noted above, our solution has five parts.

Part 1: Devoting Adequate Resources To Enforcing Existing Laws

We agree with Federal Reserve Board Chairman Alan Greenspan's comments that enforcement of existing laws is the first step that should be taken. Many examples of predatory lending involve fraudulent practices that are clearly illegal under current law. Adequate resources at both the federal and state levels of government need to be devoted to pursuing those committing fraud. Therefore, the appropriate federal and state agencies should advise policymakers of the resources they need to combat mortgage fraud.

Part II: A Nationwide Licensing Registry

We recommend that all mortgage brokers and companies be licensed, and that a federal system be established to ensure that if a broker or company loses its license in one state as a result of predatory practices, all licenses would be revoked, suspended, or put on regulatory alert nationally. A "Consumer Mortgage Protection Board" could be established to maintain a clearinghouse to identify mortgage brokers and companies whose licenses have been revoked or suspended in any state.

The goal of this recommendation is to prevent those engaging in predatory practices from being able to move from one jurisdiction to the next and continuing to prey upon vulnerable consumers while keeping one-step ahead of law enforcement authorities in prior jurisdictions.

This new Consumer Mortgage Protection Board could also be responsible for, among other things, reviewing all new and existing Federal regulations and procedures relating to the mortgage origination process and make recommendations that will simplify and streamline the lending process and make the costs of the process more understandable to consumers. The Board could also be used to initiate and oversee public awareness media programs (described below) that will help consumers evaluate the terms of loan products they are considering.

Part III: Increasing Public Awareness and Improving Consumer Education

Consumer advocates have long advised industry and government officials that certain consumers, particularly elderly seniors, were not able to clearly understand the loan terms disclosed in the innumerable disclosures provided to consumers during the mortgage process.

We recommend a three-step program to increase public awareness and improve consumer understanding of their loan obligation:

1. *Public Service Campaign*.

   Federal policymakers should implement an ongoing, nationwide public service campaign to advise consumers, but particularly the more vulnerable such as senior citizens and the poorly educated, that they should seek the advice of an independent third party before signing any loan agreements. Public service announcements could be made on radio and television, and articles and notices could be run in local newspapers and selected publications.

2. *Public Awareness Infrastructure.*

   Once alerted, consumers will need to be able to avail themselves of counseling services from unbiased sources. Those sources can always include family and friends and industry participants. In addition, however, a nationwide network should be put in place to ensure that all consumers can easily access advice and counseling to help them determine the loan product that best fits their financial needs. A public awareness infrastructure could be built out that would include 1-800 numbers with independent counselors, using sophisticated computer software, to help consumers talk through the loan product they are considering. In addition, programs could be developed with community organizations and other organizations serving senior citizens to provide on-site counseling assistance at local senior and community centers and churches. HUD's 800 number for counseling could be listed on required mortgage disclosures as an initial step to increase awareness of available advice.

3. *"Good Housekeeping Seal of Approval" for On-Line Mortgage Calculators*

   The *Joint Report on the Real Estate Settlement Procedures Act and Truth in Lending Act* of the Board of Governors of the Federal Reserve System and the Department of Housing and Urban Development, issued in 1998 ("Joint Fed/HUD Report") recommended that the government develop "smart" computer programs to help consumers determine the loan product that best meets their individual needs. Since this idea was first discussed in the Mortgage Reform Working Group,[1] mortgage calculators or "smart" computer

[1] The Mortgage Reform Working Group ("MRWG") was an ad-hoc group, comprised of over 20 trade associations and consumer advocate organizations, that was organized at the request of former Congressman Rick Lazio (R-NY) with the goal of reaching a compromise on a comprehensive mortgage reform proposal that would streamline and simplify the mortgage process for consumers while simultaneously reducing the liability for the industry. While all parties did not reach an agreement, many of the recommendations that were developed in that process formed the basis for the recommendations made in the Joint Report issued by the Federal Reserve Board and the Department of Housing and Urban Development.

programs have become available online. Since these computer programs were already developed by the private sector and are widely available, a more appropriate role for the government today would be for the federal government to approve a limited and unbiased generic mortgage calculator module that could be incorporated into any online site that helps consumers evaluate various loan products. (Legislation may be needed to advance this initiative. But there may be resources in agencies' current budgets that could be tapped to implement this recommendation.)

Part IV: Use Existing Federal Regulatory Authority to Stop Abusive Practices

Regulators may have existing authority to implement changes to existing regulations to prevent loan flipping and other questionable practices. Where such authority exists, action should be taken to change existing regulations. Regulators may also be able to use their rulemaking powers under existing law to implement some of the mortgage reform proposals discussed in Part V.

Part V: Comprehensive Mortgage Reform

There is widespread agreement that the mortgage loan origination process is overly complex and that the current legal structure is often an obstacle to improving that process.

Comprehensive mortgage reform would reduce confusion and improve competition, lowering prices for all consumers while discouraging predatory lending. The CMC has been at the forefront of industry efforts to reform and improve the laws and regulations governing the home mortgage origination process in this country. The mortgage reform that we, along with others in the industry, have advocated would directly address many of the weaknesses in current law that allow predatory lenders to operate. We note that some of these reforms can be achieved through regulatory changes while others will require legislation.

Some of the features of mortgage reform that bear directly on the predatory lending problem include:

- ***Early Disclosure of Firm Closing Costs***, leading to greater certainty for consumers on closing costs and increased price competition for both loans and ancillary services required to make the loan. A common feature of most allegations of predatory lending is that the borrower was either confused or deliberately misled about the amount of closing costs that he or she would have to pay. The central feature of mortgage reform is a proposal that mortgage originators disclose to consumers the firm, not estimated, costs of the ancillary services needed to make the loan for which the consumer has applied. If the borrower receives a clear disclosure of firm closing costs early in the transaction, it will be more difficult for an abusive lender or broker to misrepresent the terms of the loan and the borrower will have time to seek financing from other sources if the terms are unfavorable.

Offering guaranteed closing cost packages will not work without a corresponding exemption from Section 8 of RESPA for arrangements negotiated between the lender or mortgage broker and the providers of ancillary services whose costs are included in the firm closing costs disclosure. Thus, for example, lenders would be free to negotiate volume discounts or other pricing arrangements with their service providers without the restrictions of Section 8. If a lender or broker charged more than the total listed on the firm closing costs disclosure, other than those few items, such as taxes and per diem interest, which are not included in the disclosure, it would risk losing its Section 8 exemption. Under current law, the constraints imposed by Section 8 give lenders little incentive to reduce third-party closing costs.

- ***Simplified, Understandable Disclosures*** of key information about the loan. Mortgage reform would consolidate and highlight disclosures of the key terms of a mortgage credit product so that applicants could easily comparison-shop for loans. It would eliminate confusing disclosures such as the "Amount Financed," which has actually been used to mislead consumers about the true amount of the obligation. The disclosure of firm closing costs, noted above, would include any mortgage broker fee paid by the borrower.

- ***Proportional Remedies*** so that lenders are the targets of less litigation over harmless or minor errors while consumers can be compensated for actual harms. The remedies in the mortgage reform proposal, in contrast to current law, are structured to ensure that the borrower receives a loan on the terms that were disclosed. Lenders that detect and correct errors quickly will not be penalized, while those that engage in knowing and willful violations will be penalized more severely than under current law.

- ***Substantive Protections against Loan Flipping*** to protect the most vulnerable consumers from abusive loans. The focus of the mortgage reform effort is on reforming the mortgage process for all consumers, but we include an enhancement to the Home Ownership and Equity Protection Act ("HOEPA") in the form of protections against loan flipping. Under the proposal, when making a HOEPA loan that refinances an existing mortgage loan and that is entered into within twelve months of the closing of that loan, the originator may not finance points or fees payable to the originator or broker that are required to close the loan in an amount that exceeds three percent of the loan amount. This limitation does not apply to voluntary items such as credit insurance, nor to taxes and typical closing costs for settlement services such as appraisal, credit report, title, flood, property insurance, attorney, document preparation, and notary and closing services provided by a third party, whether or not an affiliate.

  Limiting the financing of points will mean that borrowers would have to bring cash to closing to pay high points and fees. This will mean that borrowers of HOEPA loans will be less likely to be "flipped" numerous times. Consistent with regulations adopted by the New York State Banking Department, the limit on refinancing points does not apply to typical third-party closing costs.

Significantly, this restriction is not limited to refinances by the same lender and would thus apply to a much broader number of loans that may not be in the category of "flipped" loans. For this reason, it is appropriate that a reasonable amount of points and fees be eligible to be financed in order to meet real credit needs.

- ***Substantive Protections Affecting Prepayment Penalties.*** On non-HOEPA loans, no prepayment penalty would be permitted after 5 years from the date of the loan. However, prepayment penalties would be authorized during this 5-year period, notwithstanding state law. Any prepayment penalty permitted would be limited to a maximum of 6 months' interest on the original principal balance.

- ***Foreclosure Reforms*** to provide additional protections to borrowers facing the loss of their home without reducing the value of lender's security interest in the property. Lenders and servicers have in recent years significantly changed their procedures for dealing with delinquent borrowers. Workouts, forbearance and other loss mitigation tools are employed and foreclosure is increasingly seen as an expensive (for everyone) last resort. In addition to this business trend, we would support the enactment of a new "Homeowner's Equity Recovery Act" ("HERA"), which would apply at the time lender notifies consumer of consumer's default and rights under HERA.

    - HERA protections would apply if the consumer's indebtedness (origination balance and interest, junior liens, etc.) is not more than 80% of the origination valuation. A consumer would have the right to list the property with a real estate broker or otherwise make a good faith effort to sell the property.

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We believe that the consumer protections made available through HERA strike a reasonable balance between the rights of lenders and investors for repayment of amounts owed and the consumer's right to "breathing room" if the consumer is attempting to resolve the default. However, we do not support the expansion of mandatory judicial foreclosure because it is costly both to the consumer and lender, and is too time consuming, which, among other things, puts the collateral at risk. In addition, we note that the Federal tax code (REMIC provisions), under which loans are sold to the secondary market, places limitations on types of compromise that a lender can offer to a defaulting borrower.

- ***Substantive Protections Affecting Collection Practices.*** Under the proposal, the prohibitions contained in Section 806 of the Fair Debt Collection Practices Act ("FDCPA") concerning harassment and abuse would be extended to the collection of mortgage loan debts by a creditor or its affiliates. The law would be clarified to ensure that loan servicers that collect debts as part of their servicing function would not be treated as debt collectors

- ***Uniform, National Rules*** so that lenders can comply with a uniform set of disclosure requirements that will adequately protect consumers and result in lower costs to lenders and lower rates for borrowers. Imposing uniform laws and regulations ensures that consumers – across the nation – are afforded the same protections. Uniform, national rules would also reduce the number of documents to be signed by consumers at closing. "Information overload" is an almost universal feature of complaints about predatory lending.

  Uniform, national rules are particularly important because the need for uniformity has never been greater. There has recently been a proliferation of state and local legislation to combat predatory lending practices. Although well intentioned, these initiatives can be counterproductive because they can impose very high costs on lenders in comparison to the potential number of loans affected.

  In one example, Georgia enacted anti-predatory-lending legislation that was so broad in its sweep that it threatened to cut off legitimate, mainstream lending as well as the practices at which it was targeted. Corrective legislative action was enacted to prevent the originally passed legislation from shutting down legitimate mortgage lending in the State of Georgia.

  If the Committee decides that clarification of the existing legislation prohibiting abusive practices is needed, we strongly urge that it create a single, nationwide standard that cannot be undermined by myriad local initiatives.

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The CMC appreciates the opportunity to submit its views on the problem of, and appropriate responses to, "predatory lending." We look forward to working with the Subcommittees on constructive, practical solutions to address abuse practices without restricting the availability of credit, reducing consumers' options, or burdening the efficient operation of the mortgage market.

DESCRIPTION OF SUBPRIME MARKET

Although the involvement of CMC's members in subprime lending varies, all CMC members share an interest in the efficient operation of the mortgage lending market. Subprime lending plays a crucial part in that market, allowing individuals who do not qualify for "prime" loans to make use of the equity in their homes to obtain credit at reasonable rates. As Comptroller of the Currency John D. Hawke, Jr., noted in a letter to the Senate Banking Committee—

> "One problem with the fact that 'predatory lending' is not susceptible to precise definition is that many people make the mistake of equating subprime lending to predatory lending. Responsible, risk-based subprime lending, that provides access to credit for individuals with less than perfect credit histories, should not, in and of itself, be considered predatory. The OCC encourages national banks to engage in responsible subprime lending, and has issued guidance to ensure that banks engaging in this type of business do so in a safe and sound manner and consistent with applicable consumer protection law."[2]

Legitimate subprime lending offers many benefits to consumers. A subprime home loan provides financial options to borrowers who cannot obtain prime loans because of problems with their credit history or for other reasons such as a reduction in income or other change in financial circumstances. Subprime credit gives such individuals a chance to buy a home. In other instances, the availability of subprime home-equity credit gives credit-impaired borrowers financial options that would not otherwise be available, including debt consolidation or other purposes.

The Subprime Mortgage Industry

Mortgages are the largest component of the U.S. debt market with over $5 trillion in outstandings. Total first mortgage origination volume in 2000 was over $1 trillion. Subprime mortgage lending accounted for approximately 13% of the entire mortgage industry's production in 2000.

Scale, capital and risk management requirements are driving rapid consolidation in the mortgage banking and servicing sectors of the industry. However, the mortgage origination business remains relatively fragmented.

[2] Letter from John D. Hawke, Jr., Comptroller of the Currency, to the Honorable Phil Gramm, Chairman, Committee on Banking, Housing, and Urban Affairs, United States Senate, May 5, 2000.

Subprime Credit Borrowers and the Use of Subprime Credit

Subprime borrowers are like any other borrowers in the U.S. economy. In fact, a study of nearly one million subprime and manufactured housing loans originated in 1998 shows a racial and ethnic borrower profile similar to the racial and ethnic composition of the total U.S. population.[3]

As practiced by mainstream lenders, including those CMC members who participate in the subprime market, subprime lending is also not conceptually different from lending to "prime" borrowers. The process begins when the borrower identifies a need for financing, either for a home purchase or for cash for other purposes. Although a significant portion of subprime loans are made to finance the purchase of a home, the proportion is lower than for prime loans.[4]

More frequently, a subprime borrower will seek cash to consolidate existing debt—the most common use of subprime credit. Home equity financing often allows the borrower to reduce monthly payments dramatically, allowing an overextended consumer to gain control of his or her budget. In addition, subprime loans carry significantly lower interest rates than other forms of credit. Although subprime loans average about 250 basis points (2.5 percentage points) above prime loans, at around 9.5%-10% they are still much less expensive than credit cards and other sources of credit (when those alternative sources are even available to credit-impaired borrowers).

Other common uses of subprime home equity loans include—

- Financing a college education;
- Paying medical bills;
- Providing alternatives for homeowners who fall behind on their mortgage payments; and
- Home improvement and repair.

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[3] An April 2000 SMR Research study of 1998 HMDA data.

[4] An April 2000 SMR Research study of 1998 HMDA data showed the following distribution of loans by loan purpose:

Purchase	Refinancing	Home Improvement	Total
Subprime loans			
197,917	661,876	94,116	953,909
20.75%	69.39%	9.87%	100.00%
Prime loans			
3,968,766	5,863,187	819,393	10,651,346
37.26%	55.05%	7.69%	100.00%

Subprime Credit Grades

In the mortgage industry, loans are graded from "A" (a prime loan) to "D" (the riskiest subprime loan). An "A" loan is a "prime" loan, or a loan of the highest credit value. Typical factors that determine a consumers credit grade are:

- Mortgage delinquency history
- Consumer debt delinquency history
- Bankruptcy or foreclosure
- Collection or judgments
- High debt-to-income ratios
- High loan-to-value ratios
- Low credit risk scores

Although the definitions of the subprime grades are neither precise nor completely uniform throughout the industry, the following examples convey the general concept of credit grading:

- A homeowner who filed for bankruptcy two years ago due to mismanagement of credit and was sixty days late on his current mortgage may qualify for a "B-" credit grade;

- A borrower who was laid off and had to accept a lower-paying job, and, as a result, was occasionally thirty days late in making her mortgage payment may qualify for an "A-" credit grade; and

- A widow who has an excellent credit record but has had difficulty in paying outstanding medical and home repair expenses and needs cash for her son's college education may qualify for a "B" credit grade. In this example, the subprime credit grade is based on income compared to total amount of debt, rather than on credit history.

<u>SPECIFIC PRACTICES OFTEN LABELED "PREDATORY"</u>

In this section we discuss a number of practices that have been attacked as "predatory."[5] As the Board of Governors of the Federal Reserve System has noted, there are two types of abusive practices in home equity lending—blatant fraud or deception, and the use of practices that are not inherently abusive but can be misused to injure consumers:

> "[A]busive practices in home-equity lending take many forms but principally fall within two categories. One category includes the use of *blatantly fraudulent or deceptive techniques* that may also involve other unlawful acts, including violations of HOEPA [the Home Ownership and Equity Protection Act]. These practices occur even though they are illegal. For example, loan applicants' incomes and ability to make scheduled loan payments may be falsified, consumers' signatures may be forged or obtained on blank documents, or borrowers may be charged fees that are not tied to any service rendered. The other category of abuses involves various techniques used to manipulate borrowers, *coupled with practices that may ordinarily be acceptable but can be used or combined in abusive ways*. . . . [S]ome loan terms that work well for some borrowers in some circumstances may harm borrowers who are not fully aware of the consequences. For example, a consumer may not understand that a loan with affordable monthly payments will not amortize the principal or that the consumer may have to refinance a balloon payment at additional cost."[6]

Fraud and Deception

Predatory lenders who are disregarding existing legal requirements—including, in many cases, prohibitions against fraud and forgery that predate current consumer protections by many centuries—will not be deterred by additional rules. Instead, public policy should focus on more effective and sophisticated enforcement of those existing requirements. Examples of "predatory" practices that are prohibited under current law include the following:

<u>Misleading Solicitations</u>

Advertising and marketing material may mislead consumers about the true cost or nature of a loan. These marketing practices are already prohibited under the Federal

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[5] This list of alleged predatory lending practices is largely drawn from Patricia Sturdevant and William J. Brennan, Jr., *The Double Dirty Dozen Predatory Mortgage Lending Practices* (National Association of Consumer Advocates, Inc. 2000).

[6] Testimony of Gov. Edward M. Gramlich before the Committee on Banking and Financial Services, U.S. House of Representatives (May 24, 2000) (emphasis added).

Trade Commission Act and analogous state laws. In many instances, deceptive solicitations also violate the Truth in Lending Act.

Home Improvement Scams

A home improvement contractor may originate a mortgage loan to finance the home improvements and sell the loan to a lender, or steer the homeowner to the lender for financing. The contractor may mislead the consumer about the work to be performed, fail to complete the work as agreed, damage the property, or fail to obtain required permits.

Current law prohibits all of these practices. In addition, under the Federal Trade Commission's "Holder in Due Course Rule," similar state law provisions, and HOEPA (for HOEPA loans), the lender will generally subject to the same claims and defenses that the consumer has against the contractor (up to the amounts that the consumer has paid on the contract). Thus, if the work is not completed in a satisfactory manner, the consumer will not be responsible for full payment.

As a result of this exposure, subprime mortgage lenders use devices such as joint proceeds checks and progress payments to ensure that home improvement contractors perform the work properly. We would recommend that all lenders these practices.

Falsified or Fraudulent Applications; Forgery of Loan Documents; and Inflated Appraisals

An unscrupulous broker or lender may convince an unsophisticated borrower who cannot repay a loan to sign a blank application form. The broker or lender then inserts false information on the form, claiming income sufficient to make the payments, and sells the loan to an investor on the basis of the false information. Alternatively, the "predatory" broker or lender may simply forge the borrower's signature. Another fraudulent practice is for the broker or lender to collude with a corrupt appraiser to deliver an appraisal that exceeds the true value of the property. The investor then purchases the loan on the basis of the inflated appraisal.

All of these practices have two things in common—

- They are illegal under current law; and
- The investor is a victim along with the borrower, since the loan will eventually default and the investor will lose most or all of its investment.

Although legitimate, mainstream lenders maintain extensive procedures to avoid being caught in scams of this type, they are sometimes victimized by fraud by "predatory lenders." We recognize that more can be done—CMC's plan for addressing predatory lending includes the creation of a nationwide registry that would report on licensing status and disciplinary actions, so that brokers and companies who are caught engaging in fraud in one jurisdiction could not simply relocate to another area.

Incapacitated Homeowners

There have been allegations that predatory lenders make loans to homeowners who are mentally incapacitated. Since the homeowner does not understand the nature of the transaction, the end result is default and foreclosure.

Under long-standing contract law principles, a mortgage loan in which the borrower was incapacitated at the time of signing is unenforceable. Entering into such a transaction may also represent civil or criminal fraud.

As noted, subprime lenders are not in the business of making loans that are likely to default, and major lenders maintain procedures to avoid originating or purchasing loans in which the borrower lacks the legal capacity to enter into a contract.

Acceptable Practices That Are Subject to Abuse

The second type of alleged predatory lending consists of practices that are not illegal or unacceptable but may harm consumers when used in abusive ways.

Mortgage Broker's Fees and Kickbacks (Including Yield Spread Premiums)

A prominent target of critics of "predatory lending" has been the yield-spread premium —compensation paid to the broker through an increase in the interest rate. Yield spread premiums have been the subject of extensive class-action litigation in which plaintiffs have argued that this form of compensation is illegal under the prohibitions in RESPA against kickbacks and fee-splits.

Yield spread premiums can be helpful to consumers. Paying a yield spread premium allows a lender to reduce the cash required to close the loan by financing closing costs through a higher interest rate. A borrower who understands the cost of the loan can choose between paying more of these costs upfront or over the course of a loan.

The appropriate remedy for any abuses of yield spread premiums is not to prohibit a practice that often benefits consumers. It is to provide more effective disclosures and improve the competitive environment so that consumers can make informed choices that serve their interests. If consumers understand their closing costs, including the broker's fees they are to pay, before they commit themselves to a transaction and lenders are allowed to compete in providing ancillary settlement services, the broker's receipt of a yield spread premium is irrelevant to the consumer's shopping decision. Importantly, we note that the Mortgage Bankers Association of America and the National Association of Mortgage Brokers have encouraged the use of a form, developed jointly by those organizations, that explains the broker's role.

Prepayment Penalties

Another practice that is often criticized as "predatory" is the imposition of a prepayment penalty—a fee for paying off the loan before some specified time. In most instances, the penalty is reduced over time until it is finally phased out completely.

Legitimate lenders use prepayment penalties to protect themselves against the risk that the borrower will prepay the loan before the lender has recovered its origination costs. A prepayment penalty is one way for a lender to hedge against that risk as well as other financial risks that can occur from early prepayment of the loan. The benefit of reduced prepayment risk can be passed on to the borrower in the form of lower points or a lower interest rate. If a lender is not allowed to impose a prepayment penalty, then it may not be able to offer a zero- or low-closing-cost loan or it may have to increase its rates to be profitable.

On the other hand, an unscrupulous lender can use a prepayment penalty to lock a consumer into an undesirable loan. The CMC believes that the appropriate remedy for the "predatory" abuse of prepayment penalties is to ensure that borrowers understand that a loan with a prepayment penalty is an option that allows them to reduce their interest rate or upfront costs, not a requirement to obtain the loan. In addition, under the CMC's mortgage reform proposal, no prepayment penalty would be permitted after five years from the date of the loan. However, prepayment penalties would be authorized during this five-year period, notwithstanding state law. Any prepayment penalty permitted would be limited to a maximum of six months' interest on the original principal balance.

Making Unaffordable Loans (Asset-Based Lending)

Another common allegation is that predatory lenders make loans on the basis of the value of the property, disregarding the borrower's ability to pay and in fact anticipating that the borrower will default and the lender will foreclose.

CMC members and other responsible subprime lenders are not in the business of making loans that borrowers cannot repay. Foreclosing on a house is costly, time-consuming, and almost always results in significant losses to the lender. As discussed in greater detail under Tab 3, many subprime loans are now sold into the secondary market, and the rating agencies insist that such loans meet underwriting standards.

For those reasons, the CMC supports, in principle, the existing HOEPA rule against engaging in a pattern or practice of lending without regard to repayment ability. In practice, however, it is difficult to craft specific rules to prevent such "asset-based" lending that reliably apply to all situations. Attempts to specify static rules regarding each borrower's repayment ability are likely to be counterproductive and injure the very borrowers they are intended to protect. For example, one common proposal is to establish a presumption that a borrower with a debt-to-income ratio ("DTI") above a certain cutoff, such as 50%, lacks repayment ability. This rule seems to make sense until a lender encounters a borrower who currently is meeting her obligations with a DTI of 65% and wants a loan that would reduce her DTI to 55%. Moreover, a DTI that indicates an excessive debt load in a rural area may reflect the average in areas such as New York City or San Francisco with very high housing costs.

In addition, setting a cutoff for DTI at any particular level ignores differences in borrowers' circumstances that affect the debt load they can carry. At one extreme, an individual with a very high income, $1 million/year for example, and few family obligations can easily afford to make high monthly payments and still have enough to

meet other living expenses. At the other extreme, a borrower with a low level of income and many dependents may not be able to make mortgage payments that represent a high fraction of his or her income.

Another proposed remedy for asset-based lending is to institute "suitability" rules that create lender liability for making an individual loan if, in hindsight, the lender should have anticipated that the borrower would default. For a mainstream subprime lender that already makes every effort to avoid making loans that go into default, the effect of such a rule will be to increase the costs of foreclosure by requiring the lender to absorb both the losses on the loan itself and the cost of settling the claim that it made an unsuitable loan. These costs will ultimately be passed onto borrowers in the form of higher loan costs or reduced credit availability.

High Points and Fees: Padding Closing Costs; Inflated Appraisal Costs; Padded Recording Fees; Bogus Broker Fees; and Unbundling (Double-Charging for the Same Service)

One of the major sources of criticism of and litigation against the subprime lending industry has been fees paid to mortgage brokers and to other participants in the mortgage process such as appraisers. For example, critics allege that lenders overpay mortgage brokers in comparison to the services the brokers provide or require an expensive appraisal when a "drive-by" evaluation would suffice. Critics also note that the actual amount of these costs (as opposed to an estimate) is not disclosed in advance of settlement, when the borrower still has the opportunity to shop for a better deal or negotiate an improvement in the current one.

Although the CMC agrees that borrowers should not have to pay for services that are not needed or not provided, we believe that a focus on the specific components of the cost of the mortgage is misplaced. Ultimately, the borrower is concerned with total costs (closing costs and interest rate) and not with the relationship among the different providers of settlement servicers or the cost of each individual component of the loan.

The CMC also agrees that present disclosure requirements do not give borrowers accurate and understandable information about the costs of obtaining a loan when they are in a position to use it. In some instances, current requirements may actually have facilitated abuses—as when an unscrupulous lender allegedly misrepresented the TILA-required "amount financed" (which does not reflect loan fees deducted from the proceeds) as if it were the total amount of the loan.

But the CMC believes that it is ineffective to combat excessive loan fees through ever-increasing scrutiny of the practices of settlement service providers and the relationships among them. A more sensible approach—the one taken in the CMC's mortgage reform proposal—would be to eliminate the disincentives in current law that prevent mortgage originators from offering a single, guaranteed price for all settlement services, and then impose a requirement mortgage originators to honor that commitment. Borrowers have no way of knowing what a service such as an appraisal or flood certification "should" cost, yet current law has created an elaborate system of disclosure and monitoring of such costs that is of very little value to most consumers.

Credit Insurance

Consumer advocates often assert that credit insurance products are of little or no benefit to consumers. In fact, while credit insurance is clearly not a good choice for all consumers, lender-provided credit insurance meets a consumer demand that is not met elsewhere in the marketplace. Independent insurance agents are often not interested in providing insurance to subprime borrowers in the relatively small amounts characteristic of a second mortgage loan. In addition, the liberal eligibility standards and convenience of purchasing the insurance are attractive to some subprime customers.

An unscrupulous lender can abuse the credit insurance product by selling it to a consumer who does not want or need it, based on the misrepresentation that insurance is required to obtain a loan. But a report on subprime lending shows penetration rates for single-premium credit insurance ranging from 28.3% for first-mortgage loans to 47.9% to second mortgages.[7] These statistics do not support the common assertion that credit insurance is being foisted on unwilling consumers.

Moreover, abusive credit insurance practices are illegal under current law. TILA currently permits a creditor to exclude credit insurance from the finance charge and annual percentage rate only when the lender discloses in writing that it is voluntary and the consumer consents to the purchase by signing or initialing the disclosure form.[8] Misleading consumers about credit insurance would also violate the Federal Trade Commission Act and similar state laws.

Voluntary credit insurance helps to address an unmet demand for life and disability insurance. About 25% of all U.S. households have no life insurance coverage, and about 40% of single parent households and households with annual incomes below $35,000 are completely uninsured. About 50% of all households are uninsured. The Department of Housing and Urban Development estimates that 46% of all foreclosures on conventional mortgages are caused by borrower disability and that 33% of Americans will suffer a serious disability between ages 35 and 65.

Single-premium credit insurance—in which the cost of the insurance is financed as part of the total cost of the loan—has been particularly controversial. The CMC members and other large lenders have modified their sales policies in response to concerns about the marketing of this product. Our members are offering a monthly-premium product and instituting a liberal cancellation policy.

The CMC's mortgage reform proposal, discussed above, includes a number of other protections related to credit insurance. There would be a clear and conspicuous disclosure given to the consumer that the insurance is voluntary and that it may be cancelled at any time with a refund of unearned premiums. Monthly-pay insurance could also be sold at or before closing. In both situations, there would be a notice after closing

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[7] *See* Michael E. Staten and Gregory Elliehausen, *The Impact of The Federal Reserve Board's Proposed Revisions to HOEPA on the Number and Characteristics of HOEPA Loans* at 12 (July 24, 2001).

[8] 12 C.F.R. § 226.4(d).

that the borrower may cancel the insurance at any time. Refunds of unearned premiums would be based on the actuarial method, not the less favorable Rule of 78's.

Loan Flipping

Loan flipping is the practice of an unscrupulous broker or lender repeatedly convincing the borrower to refinance in order to get a small amount of cash back. The broker or lender then receives additional points and fees. Consumer advocates often argue that it would be better for the consumer to take out a second, junior loan than to refinance the entire obligation. While that may be true in many instances, there are other situations in which the rate and terms on a new first mortgage are more desirable than the combination of retaining the existing first mortgage and obtaining a new second mortgage.

Loan flipping is another example of a practice that is easy to condemn in theory but difficult to prevent through a single rule that can be applied to all situations. One approach, taken in several state anti-predatory laws, is to require a demonstrated "net benefit" to the borrower before the same lender can refinance a loan. The difficulty in this approach is its subjectivity, which could leave lenders exposed to litigation if they could not demonstrate an adequate net benefit.

The CMC's mortgage reform proposal would limit the financing of closing costs and points on HOEPA loans to 3% of the loan amount for refinancings or equity loans entered into within twelve months of a prior financing. The rationale for this approach is to reduce the lender's incentive to flip HOEPA loans. Borrowers who must bring cash to closing to pay costs over the 3% are less likely to be "flipped" numerous times. At the same time, the CMC believes that 3% should be sufficient to allow for refinances to take advantage of declining interest rates.

Arbitration Clauses

Many consumer credit contracts—including many subprime mortgages—include a provision requiring that disputes be resolved through arbitration rather than through the lengthy process of litigation in the courts. Consumer advocates have asserted that binding arbitration clauses are inherently unfair, and there is no question that such a clause could be abused by erecting insuperable obstacles to a consumer's obtaining relief. But the U.S. Supreme Court has upheld the use of such clauses even when the case involves "claims arising under a statute designed to further important social policies," so long as the consumer can vindicate the rights granted under the law before the arbitrator.[9]

The Supreme Court noted in another case that arbitration benefits consumers in many ways:

> "[A]rbitration's advantages often would seem helpful to individuals, say, complaining about a product, who need a less expensive alternative to litigation. See, *e.g.,* H.R. Rep.

[9] *Green Tree Fin. Corp. v. Randolph,* 531 U.S. 79, 90, 121 S.Ct. 513, 521 (2000).

> No. 97-542, p. 13 (1982) ('The advantages of arbitration are many: it is usually cheaper and faster than litigation; it can have simpler procedural and evidentiary rules; it normally minimizes hostility and is less disruptive of ongoing and future business dealings among the parties; it is often more flexible in regard to scheduling of times and places of hearings and discovery devices . . .')."[10]

In place of long, drawn-out proceedings in which the attorneys' fees often dwarf any nominal amount received by consumers, an arbitration clause offers consumers speedy access to a neutral forum that can resolve their dispute with the damages being paid to the consumer, rather than attorneys. The one group that clearly does not benefit from reasonable arbitration clauses in consumer contracts is the class-action trial bar.

Balloon payments and Negative Amortization

Consumer advocates often characterize two loan structures—*balloon payments* and *negative amortization*—as types of predatory lending. In a balloon payment loan, the monthly payments do not fully amortize the amount of the loan, resulting in a large final payment. In negative amortization, the monthly payments are insufficient to pay the interest that accrues on the loan, and the difference is added to the principal. Balloon payments are restricted and negative amortization is prohibited under HOEPA.

We recognize that both of these structures can be used in an abusive manner. If the broker or lender misleads the borrower about the nature of a balloon loan or the final payment is due in an unreasonably short time, the homeowner may not be able to afford the balloon payment and may either lose the home or be forced to refinance on unfavorable terms. A borrower who does not understand the nature of negative amortization may face similar negative consequences.

At the same time, both of these loan structures can be helpful to some consumers. Balloon payments can benefit borrowers by allowing them to obtain lower-cost credit than they would otherwise qualify for. A balloon note can be particularly helpful to a borrower who expects to move to a new location within the period of the balloon mortgage. Such a mortgage would be less expensive than a fixed-rate, long-term mortgage loan for the consumer.

Negative amortization, by definition, reduces the monthly payment and may make a loan more affordable to a borrower with significant equity but insufficient income to qualify for a standard loan. Congress has recognized the benefits of one form of negative-amortization loan—the reverse annuity mortgage—by exempting such loans from the general prohibition against negative amortization in HOEPA.

Thus, further blanket restrictions on these loan structures, while protecting some consumers, could prevent others from obtaining loans that fit their financial circumstances.

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[10] *Allied-Bruce Terminix Cos. v. Dobson,* 513 U.S. 265, 280, 115 S.Ct. 834, 843 (1995).

MORTGAGE LENDING AND SERVICING PROCESS

In this section of our testimony, we describe the mortgage origination, funding and servicing process, its participants and the compensation each receives.

Mortgage Origination

Application Processing

In some instances, the borrower seeks out the source of financing, or responds to direct mail or other direct marketing. In others, the borrower is referred by a real estate broker or home improvement contractor. In both prime and subprime lending, there are two major distribution channels for distributing mortgage credit:

- In the *retail* channel, the lender offers mortgage loans directly to borrowers, through a sales force of loan officers. Loan officers are employees of the lender/servicer who counsel the applicant, take and process the application, obtain verification documents, order the appraisal of the property, and prepare the loan for *underwriting* (evaluation).

- In the *wholesale* channel, the lender does not deal directly with the consumer. Instead, the lender and consumer work though an intermediary.

  The types of intermediaries in the wholesale channel include the following:

- A *mortgage broker* is usually an independent contractor that offers loan products from a number of wholesale lenders. The mortgage broker generally does what the loan officer does (described above), i.e., discusses loan options with the borrower, takes an application, and usually processes the loan—obtains a credit report and appraisal, verifies employment and assets, and otherwise prepares the loan for underwriting.

- A *correspondent lender* not only takes the application and processes the loan, but also funds the loan. The correspondent then sells the loan to a wholesale lender, usually under a previous commitment of the wholesaler to purchase a certain amount of loans at an agreed-upon interest rate.

- A *home improvement contractor* may act as, in effect, the originating lender, taking an installment sales contract in payment for the goods and services provided and then discounting (selling) the contract to a lender. In that situation, the application is usually processed and underwritten by a mortgage broker or mortgage banker.

Underwriting

Historically, the next step after taking and processing the application was for the lender to *underwrite* (evaluate and approve or reject) the application. With the advent of credit scoring and automatic underwriting systems, much of the evaluation of an applicant is now accomplished during the application stage, but loans are still subject to final underwriting approval by the lender, including the underwriting of the property to be used as collateral for the loan.

There are a number of factors used to assess risk. Typically, they include:

- Credit-Related Factors
- Mortgage or Consumer Debt Payment History
- Bankruptcies, Foreclosures or Judgments
- Borrowing Capacity Factors
- Debt-to-income ("DTI") requirements (the borrower's debt load, including the proposed loan, compared to his or her income)
- Loan-to-Value ratio (the amount of the proposed loan compared to the appraised value of the property)
- Non-standard Collateral
- Mixed-use commercial/residential properties

Closing

Once the loan has been underwritten and approved, the closing is scheduled. The lender generally has certain conditions to closing which must be met, including assurance that (i) the borrower has clear title to the property (through title insurance), (ii) the borrower has other required insurance on the property, such as flood insurance or property and casualty insurance, and (iii) the borrower has sufficient funds to close the loan. At the closing, the borrower executes the mortgage note evidencing the debt and the mortgage on the property in exchange for the closing proceeds. Funds for points and closing costs, payable by the borrower to the lender, the mortgage broker or correspondent, or third party settlement service providers, are collected either directly from the borrower or from the loan proceeds.

Funding: Holding the Loan In Portfolio or Selling into the Secondary Market

After the loan has been underwritten and closed, the lender will either hold the loan in its portfolio or to sell it in the *secondary market* either in a *securitization* or a whole loan sale. If the loan is held in portfolio, the lender is effectively the investor in the loan. In a securitization, a pool of loans is used to back an issuance of securities to be traded in the securities market, or an undivided interest in the loans themselves is sold to

investors. There are costs to the lender in the execution of both a whole loan sale and an issuance of mortgage-backed securities.

Mortgage-backed securities are first analyzed and rated by an independent bond-rating agency such as S&P or Moody's. The rating agency's evaluation includes computation of the average credit scores of the loans in the pool to be securitized as well as a due diligence review of the lender's procedures. The lender will generally have to promise that proper underwriting procedures were followed. If it fails to keep that promise, the investors will often have the right to force the lender to repurchase the loan in the event of default.

Even when a lender expects to retain a loan in portfolio rather than sell it into the secondary market, prudent risk management dictates that the lender complies with appropriate underwriting criteria to ensure that the borrower can afford to repay the loan.

Investors, whether they be secondary market investors or portfolio lenders will only make a return on their investment if the loans that they fund perform.

Servicing

Whether the loan is held in the lender's portfolio or sold in the secondary market, the loan must be serviced, that is, the monthly payments must be collected, payments must be passed through to the investor, and delinquencies, defaults, bankruptcies and foreclosures must be dealt with, as they arise. On first mortgage loans, the servicer must collect funds for tax and insurance escrow accounts and disburse those funds to the taxing authorities and insurance companies, in accordance with state and federal law and the mortgage contracts. Second lien loans generally do not involve escrow accounts.

Except for correspondent lenders, lenders often retain the servicing responsibilities on loans they make and fund. Sometimes they conduct the servicing functions through a contractor in a "subservicing" arrangement. In other cases, they will sell the servicing rights (including the rights to servicing fees) and responsibilities to another servicer.

Compensation

Compensation to Brokers and Correspondent Lenders

The mortgage broker or correspondent may receive its compensation for the borrower, the lender, or both. Compensation by the borrower, if any, is in the form of points or an application fee, an origination fee, or a broker fee.[11] All or part of the application fee may be used to pay for the credit report and appraisal. Compensation paid by the lender reflects the difference between the retail rate charged to the borrower and the lender's wholesale rates. When a correspondent lender sells a loan to a wholesaler, the price reflects this compensation and may exceed the amount that the correspondent lender advanced to the borrower. When a mortgage broker brings a loan to a lender, the

[11] Some originators also charge a lock-in fee for locking-in an interest rate for the borrower.

lender may pay a "yield spread premium" that is equivalent to the difference in value between a loan at the retail rate and one at the wholesale rate.

The points and fees paid to a mortgage broker or loan correspondent cover the costs of processing the application and underwriting a subprime loan. These costs are generally higher than for prime lending, for several reasons:

- First, by definition, a subprime borrower is likely to have issues that must be resolved through manual verification. For example, the borrower's explanations for late payments or for a reduction in income must generally be independently verified—an expensive, hands-on process.

- Second, subprime loans tend to be for somewhat lower amounts than prime loans, thus the cost per loan tends to be proportionally higher.[12] Many processing and underwriting costs are fixed regardless of the size of the loan.

- Third, as "lenders of last resort," subprime lenders receive a much higher proportion of applications from applicants who do not qualify even for subprime loans. Accordingly, subprime lenders have much higher rejection rates than do prime lenders.[13] Brokers and lenders generally do not recover the cost of processing rejected applications through fees charged to rejected applicants and must make up some of those costs through revenues from approved loans. Thus, the cost of processing loan applications that are eventually denied raises per-loan processing and underwriting costs on approved subprime loans.

As noted, in the wholesale loan market, the mortgage broker or correspondent lender bears many of these processing and underwriting costs. The broker or correspondent also has advertising and marketing costs that would otherwise be borne by a retail lender. Either the borrower or the lender, or both, must compensate the broker or lender for these expenses.

Compensation to Lenders/Servicers

Lenders who originate loans through a retail channel receive compensation from borrowers in the form of am application fee, a lock-in fee if applicable, and points and fees paid at closing. In addition, if a lender sells the loan in the secondary market, it will receive some compensation on the execution of that sale, whether in a whole loan sale or a securitization.

[12] According to the same study, 1998 HMDA data show that subprime lenders had an 11.25% share of the total mortgage market in terms of number of loans, but only 8% of the dollar volume.

[13] The study of 1998 HMDA data showed denial rates for subprime lenders of 50.0% in purchase loans, 59.5% in refinances, and 69.1% in home improvement lending. Comparable figures for prime lenders were 11.8% in purchase-mortgage lending, 13.6% in refinances, and 33.2% in home improvement lending.

The compensation a lender receives from the borrower through fees and through a secondary market sale often do not fully cover, or cover only by a small margin, the costs of originating and, if applicable, transferring the loan. Thus, the lenders' profits come principally from its servicing earnings, and there is a great incentive for the servicer to do everything it can to keep the borrower paying the loan on time. Defaults interrupt the servicer's income until the borrower resumes making payments. A foreclosure not only stops the income, but it results in the added costs of prosecuting the foreclosure. Not all of these costs are entirely reimbursed by the investor. In fact, foreclosures are costly, time-consuming, and almost always result in large losses to the lender/servicer.

Servicing income is also the principal component of earners for subprime lenders/servicers. The upfront fees are higher because originating a subprime loan is more costly. Upfront fees are also higher because lender/servicers need to defray the higher origination costs to compensate for the shorter period over which these loans will be serviced. Subprime loans refinance more quickly because borrowers, as they become qualified for prime loans, refinance into a prime loan product. Moreover, subprime loans have higher default rate and are more expensive to service. Those additional costs need to be built into the price charged to consumers. Nonetheless, subprime servicers have the same very high incentive to do everything they can to keep the borrower paying the loan. Conversely, they have no incentive whatsoever to get the borrower into a loan that he or she cannot afford to repay. Nor do they have an incentive to get the borrower into a loan with a very high interest rate that is more likely to refinance more quickly. In either case, the servicing income on that loan comes to an end.

<u>Compensation to Investors (Portfolio Lenders or Secondary Market Investors)</u>

Investors earn the interest paid on the loan by the borrower over the life of the loan, minus the fraction of a percent that is paid to lender/servicers that service the loan. Like lender/servicers, mortgage market participants that fund loans, whether they are portfolio lenders or secondary market investors, do not have an economic incentive to fund loans at above market interest rates because those loans will refinance more quickly. (Of course, consumers have the choice of agreeing to a lower market interest rate if they agree to a prepayment penalty.)

Like lender/servicers, investors earn money when consumers are provided loans they can afford to repay over time.

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