CFAL Coalition for Fair and Affordable Lending

Testimony of Steve Nadon
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on

"Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit"

before the

Subcommittees on Housing and Community Opportunity & Financial Institutions and Consumer Credit

of the

Committee on Financial Services
U.S. House of Representatives

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Introduction & Summary Overview

The Coalition for Fair and Affordable Lending[1] ("CFAL") appreciates the opportunity for me to testify on its behalf at today's hearing. I am Steve Nadon, CFAL's Chairman, and Chief Operating Officer of Option One Mortgage, which is a subsidiary of H&R Block and is one of the nation's largest nonprime mortgage lenders.

First, I want to commend Chairman Ney and Chairman Bachus for scheduling today's hearing so that House Financial Services Committee Members can hear suggestions from interested parties on how Congress can best prevent abusive lending practices and at the same time not limit access to affordable mortgage credit.

Without question, some lenders and mortgage brokers engage in inappropriate lending practices that need to be stopped. Many of these abuses are fraudulent, deceptive and illegal. Enhanced enforcement together with more consumer financial education and counseling opportunities are needed to help prevent them. However, significant new

[1] The Coalition for Fair and Affordable Lending (CFAL), launched January of 2003, was formed to advocate national, uniform fair legislative standards for nonprime mortgage lending. CFAL's members make around one-third of all nonprime mortgage loans.

federal statutory requirements also are needed to remove gaps or weaknesses in current law.

CFAL believes that it is imperative that Congress promptly pass such new federal requirements. H.R. 833, the Ney-Lucas bill, effectively addresses many of the current law's shortcomings. We urge Members to work together after the November 5th hearing to further refine H.R. 833 as may be needed to address any additional concerns and gain broader bipartisan support. We want to work constructively with you and other interested parties to help craft a fair and balanced refined legislative proposal that can be the basis for the new federal law and that the full Committee can act on early next year.

The arbitrary and irrational growing patchwork of state and local laws intended to prevent mortgage lending abuses is proving to be unduly burdensome and costly. Moreover, federally chartered depositories, as well as some state chartered entities, are being exempted from these state and local laws' requirements. This creates not only an unlevel regulatory playing field for lenders, but also confusion and inconsistent levels of protection for borrowers. Many consumers are not being adequately or equally protected by these measures, and the national housing finance market is being disrupted.

Accordingly, CFAL thinks that the new federal fair lending rules should apply uniformly so that all mortgage lenders are governed by them and that every American borrower receives the same effective protections. And, we want to see both federal and state regulators actively enforce these nationwide standards.

Congress clearly has the power to pass legislation providing for uniform national standards for nonprime lending. We believe that such uniform rules are badly needed and that it is sound public policy for Congress to establish them.

As Committee members know, housing is critically important to our nation. Not only is home ownership "the American dream," and central to the welfare and stability of families and communities, it is vital for our nation's economy. Housing has been an essential economic engine for us. Millions of Americans rely on their home equity to help meet their credit needs, and this is especially important during tighter economic times. We clearly need to ensure that they are not abused in the mortgage lending process, but we also must make certain that "protective" measures do not harm them by limiting their access to needed credit or unnecessarily increasing its cost.

Today's nonprime mortgage industry has truly become an interstate business that is increasingly dominated by large nationwide lenders. The primary reason that this business has grown dramatically in the last decade and has been able to provide credit at relatively low rates to millions of Americans who could not have qualified for conventional financing is the development of a strong secondary market for nonprime loans. Our industry has become much more automated, standardized and efficient, and now securitizes the majority of the loans we originate. About 65% of the $213 Billion in

nonprime mortgages originated last year were securitized. Securitization has let us bring in vast amounts of capital from the national and global markets. This has both enabled us to make far more credit available and to dramatically decrease the rates we charge borrowers. However, overreaching legislation, regardless of how well-intended, can easily disrupt our capital markets, and have a horrendous adverse impact on both credit availability and borrowers' credit costs. Unbalanced legislation can also hurt not only those who it is primarily intended to protect (e.g., those perceived as being most vulnerable), but it can also injure the many other people who make up the larger part of the overall nonprime market.

Simply put, housing and housing finance is very special and important for both personal and national interests. In order to continue making reasonably priced mortgage credit available to more and more Americans, industry needs clear, consistent and workable lending standards, not a hodgepodge of differing and often inappropriate restrictions. Congress, starting with this Committee, is in the best position to set such standards, and we ask that you do so.

CFAL's members are flexible and open to compromise and reasonable changes to the initial Ney-Lucas proposal as a part of an overall refined bipartisan proposal that provides fair uniform national standards. Among other things, we believe that workable refinements could:

- ✓ Cover many more loans;
- ✓ Further restrict prepayment penalties;
- ✓ Enhance "anti-flipping" requirements;
- ✓ Provide an effective right to cure unintentional violations;
- ✓ Impose very tough penalties for intentional violations;
- ✓ Address assignee liability concerns while ensuring that borrowers have effective recourse when violations occur; and
- ✓ Increase funding for state and federal enforcement efforts and for expanded consumer education and counseling services.

Before outlining how the current federal law should be changed and strengthened, I will explain a few important points about nonprime mortgage lending.

"Nonprime" Lending *Products* vs. "Predatory" Lending *Practices*

Literally millions of Americans are unable to qualify for the lowest rate mortgages available in the so-called "prime"[2] (a/k/a "conventional" or "conforming") market because they have less than perfect credit, or they can not meet some of the other tougher underwriting requirements of the prime market. These borrowers, who generally

[2] The term "prime" in the mortgage context does not refer to the "prime" interest rate that banks charge their best customers for loans; instead, it refers to the lower rate that mortgage lenders charge the lowest risk borrowers who qualify for mortgages that are bought by Fannie Mae and Freddie Mac, the two large housing government sponsored enterprises ("GSEs").

are considered as posing higher risks, must rely on the so-called "nonprime"[3] market which offers many more customized mortgage *products* to meet customers' varying credit needs. And, as one would reasonably expect, they will pay a somewhat higher rate to offset their greater risk. Substantially higher servicing costs also increase the costs of these loans. It is in this "subprime" or "nonprime" lending segment where most concerns over improper lending practices have been raised.

"Predatory lending" is how many people refer to a variety of lending *practices* that may involve actual or perceived abuse with regard to the sale of nonprime mortgage *products*. Although "predatory lending" is a generic term without precise definition,[4] it has been used to describe these questionable practices because the perpetrator often is said to "prey upon" people who are more likely to be vulnerable or desperate for credit.

Due in part to earlier misleading, but widely circulated media stories, as well as the actual higher level of abusive practices that have occurred in this nonprime part of the market, many parties have unfortunately confused "nonprime" *products* with "predatory" *practices*. Accordingly, some have thought "nonprime lending" literally was the same as "predatory lending", failing to recognize that abuses are *practices* occurring in only a relatively small portion of the overall nonprime *product* market. Although this misperception today is far less prevalent than several years ago, this confusion still clouds the public policy debate.[5]

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[3] Customers who are viewed as posing higher risks, for a variety of reasons----most often because of some defects in their credit records, are considered to be of lesser credit quality or below "prime" and hence are termed "subprime" or less pejoratively, "nonprime" borrowers. *"Banking regulators generally designate a 'subprime' borrower as having one of the following characteristics: two or more 30-day delinquencies in the last 12 months; one or more 60-day delinquencies in the last 24 months; judgment, foreclosure, repossession, or charge off in the prior 24 months; bankruptcy in the last 5 years; a high default probability as measured by a credit score of 660 or below; or a debt service-to-income ratio of 50% or greater. (See OCC Bulletin 2001-6.) Generally, a credit score of 680 qualifies a borrower for consideration for a prime loan, whereas a score below 620 virtually eliminates the possibility."* OCC working paper "Economic Issues in Predatory Lending" (July 30, 2003) (hereinafter cited as "OCC Analysis"), p. 8.

[4] *"There is no single, generally accepted definition of a 'predatory loan.' Indeed, disagreements over the definition of predatory lending have often served to confuse the debate over this issue.…The term has been employed loosely by community groups, policymakers and regulators to refer to a wide range of practices.…Within the academic literature on predatory lending, economists typically suggest that judgments as to whether a loan's price is high or abusive in the absence of additional concrete economic analysis of underlying risks, costs and other fundamentals, such as the level of demand for credit, are not a valid basis for defining predatory lending. These analysts point out that without a precise definition, many of the published figures on predatory lending abuses become less convincing. There have been a variety of estimates on the societal costs of predatory lending released in the media. However, a closer examination of some of these studies suggests that with even slight definitional or methodological changes, a case could be made for significantly smaller estimates of abusive lending costs."* OCC Analysis, p. 6.

[5] Most consumer advocates now admit that "nonprime lending" should not be equated with "predatory lending", and that legitimate nonprime lending has "democratized" credit and helps millions of Americans who can not qualify for prime mortgage rates meet their credit needs. They claim that they are only trying to stop the abusive practices, not legitimate lending. But, by their actions (i.e., the overly restrictive

In any case, it is important for policy makers to understand that "nonprime" mortgage lending is, for the most part, not only wholly legitimate and non-abusive, but also critically important for meeting the credit needs of the millions of Americans who are unable to qualify for "prime" mortgage credit. This nonprime market last year amounted to at least $213 billion, or about 10% of the overall mortgage market. Over half of these loans were originated through brokers, and about 65% were sold into the secondary market and securitized. Today, one of the major reasons for the availability of nonprime credit and its relatively low rates is this securitization process. Securitization has provided the capital from the national and international markets to fund these higher risk loans. This has made mortgage credit much more available and dramatically decreased costs to borrowers. As Federal Reserve Board Governor Gramlich said in a recent speech:

"One of the important stories of the 1990s was the huge growth in subprime lending. In dollars, subprime mortgage originations grew by a factor of seven over the 1994-2002 period. Since low-income and minority borrowers are much more likely to rely on subprime credits, these groups have benefited disproportionately from the expansion. One visible outcome has been an increase in home ownership rates for low-income and minority borrowers. This represents a welcome extension of home mortgage and other credit to previously underserved groups--a true democratization of credit markets. Millions of low- and moderate-income families now have a chance at owning a home and building wealth. This rapid growth of subprime credit may have created problems…, but there is plenty of good news in this area."[6]

"Nonprime" Customers

Contrary to common misperceptions and some parties' erroneous contentions, "nonprime" borrowers are not primarily extremely poor and desperate minorities and senior citizens. In fact, most are in their 40s and 50s, have incomes in the $50,000 - $75,000 range, and are not minorities. In many cases, they again become "prime" customers after experiencing temporary problems because of some adverse life event (e.g., a divorce; job loss; or serious medical illness). In others, they may remain unable to qualify for lower prime rates due to ongoing poor management of their finances, or a tendency to periodically become overextended economically. And in many situations, the borrower may have good credit, but might not meet certain of the other strict underwriting requirements for prime loans (e.g., inadequate income documentation; limited down payment or cash reserves; or the desire to take more cash out in a refinancing than conventional loans allow).

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legislative provisions that they are advocating) many advocates indicate that they in fact favor significantly curtailing nonprime credit availability.

[6] Remarks of FRB Governor Edward Gramlich, *"An Update on the Predatory Lending Issue"* (October 9, 2003).

Although they pose somewhat higher risks than prime rated customers, and sometimes are slower paying, the vast majority of nonprime borrowers pay in a timely manner and they are good customers. Nonprime lenders utilize risk-based pricing and generally charge rates that vary based on the particular customer's risk level.[7] Overall, these customers now are given loan products that have average rates only about 2% higher than prime rates, and many are only a fraction of a percent more. This is a far cry from the 15% to 20% rates many people mistakenly think are charged by most nonprime lenders.

How HOEPA Works (and Doesn't Work)

In 1994, Congress recognized that higher risk mortgage borrowers may be more likely to be subject to more coercive or inappropriate lending practices. Accordingly, it then passed the federal Home Ownership and Equity Protection Act ("HOEPA")[8] to provide additional disclosures and substantive protections for certain of the highest cost mortgage loans.

HOEPA applies only to certain "closed-end" loans (a/k/a "HOEPA loans") for refinancing prior loans that "trigger" its provisions by having annual percentage rates ("APRs") above a set level or "points and fees" in excess of a specified percentage of the loan amount.[9] HOEPA does not apply to loans made to purchase a home, or to loans that are structured on an "open-end" basis.

In addition to special warning disclosures, loans subject to HOEPA and its implementing regulations have certain limitations or prohibitions on contract terms or sales practices such as prohibiting: negative amortization, which occurs when the payments made do not reduce the principal balance; increasing interest rates upon default; balloon payments on loans less than 5 years; payments made only to a home improvement contractor from loan proceeds; refinancing within 12 months unless it is in the borrower's "interest"; and making loans without regard to ability to repay on a "pattern and practice" basis. HOEPA also applies expanded assignee liability on covered

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[7] *"[T]he gap between prime and subprime rates is largely explained by differences in risk and servicing costs between the two markets and that subprime rates therefore do not appear to be particularly out of line with underlying risk and cost considerations....The risks and costs associated with subprime lending are significantly higher than those in the prime sector. These factors account for the lion's share of the pricing differential between subprime and prime mortgages. In addition, there are indications that demand for subprime credit is currently outstripping available supply....Therefore, the empirical data do not support the contention that subprime providers are earning economic rents [a/k/a "abnormally high profits"].* OCC Analysis, pp. 13, 16-17.

[8] 15 U.S.C. §§ 1602(aa), 1639. Implementing HOEPA regulations issued by the Federal Reserve Board can be found at 12 C.F.R. § 226.32.

[9] HOEPA's APR triggers are 8% for first liens and 10% for junior liens. The law's points and fees trigger covers loans when the total points and fees (counting only certain specified items) exceeds 8% of the total loan amount, and exceeds an indexed base amount, which is $488 for 2003 ($499 for 2004).

loans for essentially ALL claims and defenses that the borrower could have raised against the loan originator, including those arising under other statutes and common law.

Although HOEPA does provide some limited safeguards, it now generally is accepted that this federal law has serious defects.

Advocates' Concerns - Advocacy groups essentially contend that HOEPA is inadequate because it: (1) applies to only a relatively small portion of higher cost loans; and (2) fails to mandate many substantive protections that are needed to prevent certain abusive practices.

Industry's Concerns – Responsible lenders acknowledge that HOEPA does not contain some restrictions that are needed to protect borrowers from certain abusive practices. However, they note that the current statute also is fundamentally flawed because it: (1) includes unclear requirements so lenders may not know what they must do; (2) fails to provide a meaningful "right to cure" unintentional errors; (3) mandates unduly severe penalties; and (4) imposes liability on assignees who could not reasonably know of violations.

HOEPA's Perverse Effects - It is now widely recognized that HOEPA has the practical effect of prohibiting borrowers from being able to obtain legitimate nonprime loans instead of simply restricting inappropriate practices. Few lenders make loans that are subject to this statute and there are virtually no secondary market purchasers of the relatively few that are made.[10] The HOEPA loans that are originated are held by portfolio lenders who are likely to charge an even higher price *due not to the borrower's credit, but to the higher legal and reputational risks and reduced competition caused by the law itself*!

[10] HOEPA poses two types of risk for legitimate lenders. The first is *reputational* (i.e., *c*oncerns whereby companies do not want to have their reputations hurt by being associated with loans that may be perceived as "high cost"). More frequently, however, the concern has to do with the *legal* risk that arises from HOEPA's provisions. In practice, given how the current restrictions are worded, the main compliance problem here has little or nothing to do with the limitations on practices such as loan flipping, repayment ability or negative amortization. The problem is that lenders sometimes inadvertently miscalculate whether or not certain loans cross HOEPA's thresholds. This puts them in a "got you" situation as they will not have given the required special HOEPA disclosure notice which has to be given before the loan is made. There is inadequate provision for correction in this case or for most other unintentional mistakes. This means that the lender has violated the law. Penalties include having the loan rescinded at any time during its first three years and being required to refund all fees and payments made by the borrower. Lenders understandably consider this an extremely severe penalty, and many do not think it is worth the risk of making loans in these circumstances. Moreover, HOEPA's sweeping assignee liability provisions mean that secondary market purchasers would likewise be liable for such a miscalculation or other unintended violation about which they neither knew, nor reasonably could have known. Not surprisingly, therefore, there is virtually no secondary market and no securitization of HOEPA loans. And, as noted above, only certain portfolio lenders make these loans, and when they do it generally is at higher rates due not to the borrowers' credit risk, but to the law's risks.

The bottom line here is that for many of the most needy borrowers, HOEPA's "protections" are providing relatively little real benefit, and it is likely to come at higher costs due to the law's provisions. We seriously question whether this is what Congress intended, and recommend that Congress restructure as well as broaden HOEPA so this perverse effect is not allowed to continue.

State & Local Initiatives

Congress has failed to update HOEPA despite widespread acknowledgment among both consumer advocates and industry groups that statutory changes are needed. Not surprisingly therefore, starting in 1999 with North Carolina[11] many states and localities have enacted, or are seriously considering enacting their own laws to prohibit perceived abusive mortgage lending practices.[12]

Some of the enacted and proposed state and local measures include two significant types of loans that are not covered under HOEPA: (1) loans for the purchase of a home (a/k/a "purchase money loans");[13] and (2) open-end loans (e.g., home equity lines of credit where the amount of the loan can go up and down and the borrower is not initially paying off the loan by amortizing the amount by set payments over a set number of months).[14]

In most cases, the state and local initiatives use the federal HOEPA law's threshold / trigger-based model as the general framework on which they overlay their own requirements. In essence, these non-federal laws include "trigger" provisions that provide that nonprime mortgage loans that have annual percentage rates ("APRs") above a certain level or "points and fees" in excess of a specified percentage of the loan amount are subject to the state or local law's requirements.

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[11] Many advocates have contended that the NC law should serve as the model for other state laws, or even for a revised federal HOEPA. In that regard, it is worth noting that although some states essentially started with proposals close the NC statute, significant changes have been made elsewhere during the legislative process. Thus, for example, by the time the Georgia Legislature finished with it's work on the first version of that state's law, key NC concepts had "mutated" like a SARS virus---e.g., assignee liability and draconian penalties were added; limitations on the anti-flipping "net benefit" test were removed. Subsequent analysis also has shown the NC law and its impact may be quite a bit different and less favorable than its proponents have asserted. *See* OCC Analysis at pages 18-22; 24-25; and "*Trigger Happy: Enactment And Aftereffects Of North Carolina's 'Predatory Lending' Law*," by Donald C. Lampe (July 2003) (copy available on CFAL's website).

[12] See the information on CFAL's website regarding various state/local measures at: http://www.cfal.ws/resources.htm .

[13] For example: California; Georgia; Kentucky; New Jersey; New Mexico; New York; North Carolina; South Carolina.

[14] For example: Arkansas; Connecticut; Georgia; New Jersey; New Mexico; New York; North Carolina.

The more restrictive[15] laws lower the trigger percentages so that they apply to far more loans than the federal law. In particular, the "points and fees" trigger is often significantly lowered by both decreasing the percentage number (e.g., 8% to 5%) and by including more items within the definition of a "fee" so the percentage is exceeded more often (e.g., by counting indirect broker compensation). Thus, in real terms, the percentage reduction is far greater than at first may appear (e.g., 8% to 5% really in effect can be about 3%).

Sometimes, in addition to "high cost" loans, a second category is created (typically called "covered" loans) where certain loans are subject to some, but not all the requirements that apply to the very highest cost loans. The requirements in either case generally include restrictions on additional practices and/or more stringent restrictions than those found in the federal HOEPA law.

What is especially important to understand for present purposes is that NONE of these various state and local laws are the same. Requirements differ widely. Moreover, not only is there a patchwork of different state/local laws, but some quite frankly are too weak, failing to provide adequate protections. Others are excessive, imposing undue requirements and unnecessarily limiting credit availability. And, MOST states do not have laws that effectively plug HOEPA's gaps.

There is no question but that some nonprime borrowers are subjected to inappropriate practices which should be prevented. There also is no question but that vast numbers of borrowers who are not victims of such practices can become victimized by poorly crafted "protective" legislation that restricts nonprime credit availability or unnecessarily increases its cost.[16] This unfortunately is occurring in all too many cases where state and local "anti-predatory lending" laws are being passed.[17] Legislators therefore need to exercise care to ensure that they do not unintentionally curtail well-priced, affordable nonprime credit from legitimate, responsible lenders, or make it more

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[15] One point that should be understood is that the often-made claim that a harsher state law provides "greater consumer protection" than HOEPA or another state's law can be very misleading. Different, "more restrictive," or "tougher" do not necessarily mean "better" or more appropriate protection of borrowers' interests. In fact, the opposite may be true. Sometimes more actual protection is provided. Other times the law is so restrictive that legitimate practices or products are prohibited, and it is against consumers' interests for this to occur. Put another way, "greater protection" labels may be more political advocacy terms used all too often to disguise unbalanced legislation that can hurt, more than help, many borrowers.

[16] As noted in the OCC Analysis, *[t]here is a good deal of empirical evidence to suggest that anti-predatory statutes impede the flow of mortgage credit, especially to low income and higher-risk borrowers, and any reductions in predatory abuses resulting from these measures is probably achieved at the expense of many legitimate loans."* OCC Analysis, p. 20.

[17] In Georgia, for example, we saw the Legislature pass a very onerous bill that resulted in a literal shutdown of nonprime mortgage lending in that state. After this occurred, Georgia legislators had to pass major amendments to correct some of the worst excesses. We now are about to see other major market disruptions due to well-intended but unworkable laws in New Jersey, Los Angeles and Oakland.

expensive. With careful drafting and balanced provisions, however, they can prevent abuses while preserving credit availability.

Finding Workable Solutions and Setting Balanced Lending Standards

Congress should act to bridge the gap that exists between what is in HOEPA and what actually is needed to prevent real abuses. It also should refine certain of HOEPA's provisions to make the law more workable. From a technical perspective, we think that it is relatively easy to draft language that effectively prohibits abusive practices while allowing legitimate nonprime lending to continue. The more difficult question, however, has been whether there is enough political will and discipline to adopt appropriate changes. We believe that there is a growing bipartisan willingness to do so.

Areas of Substantial Agreement - There are a significant number of areas where there appears to be little or no substantial disagreement between advocacy groups and industry. Also, I believe that it is quite important to highlight what many apparently have not realized: *the Ney-Lucas bill as introduced addresses most of these and other questionable practices. And, the bill generally does so effectively, although on some points the bill's provisions may merit further "tweaking" or refinements.* For purposes of today's testimony, I will only briefly highlight the less contentious issues in the chart below and then direct the remainder of my testimony to major issues where Committee members must weigh various options and then make policy choices.

AREAS OF SUBSTANTIAL AGREEMENT	COMMENT
Add New HOEPA Prohibitions on	✓ **= in H.R. 833**
Call / Debt Acceleration Provisions	✓
Modification or Deferral Fees	✓
Short-Term Balloon Payment Provisions	✓ HOEPA & H.R. 833 prohibit less than 5 years; this might be extended to 7 years
Increasing Interest Rate Upon Default	✓
Bad Faith Avoidance of HOEPA's Restrictions	✓
Lending Without Special Warning Disclosures	✓ H.R. 833 adds stronger warnings to current HOEPA disclosure
Recommending or Encouraging Default	✓
Negative Amortization	✓
Charging Fees for Payoff Balance	✓
Home Improvement Lending Without Additional Safeguards	✓
Single Premium Credit Life Insurance	✓ H.R. 833 prohibits single premium "insurance policies" but additional language might be added to clarify that the prohibition also applies to similar or functionally equivalent products like "debt cancellation agreements" that technically might not be "insurance

	policies" under state law
Lending Without Regard to Repayment Ability	✓ H.R. 833 significantly enhances HOEPA's current restriction by removing the "pattern or practice" requirement; the bill applies a 53% debt-to-income test (which is a compromise between 55% urged by industry and 50% urged by advocacy groups)
Profiting from Foreclosures	✓ H.R. 833 would add a significant innovation to HOEPA by prohibiting lenders from profiting from foreclosures; any equity remaining after foreclosure costs would be given to the borrower
Lending Without Reporting to Credit Bureaus	✓
Refinancing Below-Market Low Interest Rate Loans	✓

Issues Requiring Further Consideration - I now will highlight some of the key problems that Congress needs to address, and will suggest some possible solutions and identify certain questions that may merit further consideration. CFAL believes that in most cases, the policy choices are reasonably clear, and thus it should be possible to develop reasonable and workable bipartisan solutions on most issues without great disagreement.

LOAN ORIGINATION-RELATED ISSUES

- **Restricting Prepayment Penalties** – Prepayment penalties are fees that are charged when a borrower pays off a loan earlier than had been agreed when the loan was made. Prepayment penalties are part of a lender's fundamental pricing consideration. Loan pricing is based on having loans on the books long enough to recover various origination costs that are amortized through the planned and agreed upon number of monthly payments. When the loan has a prepayment penalty, either the rate or the points the borrower pays will be lower; if no penalty applies, they will be higher. Thus, by utilizing a prepayment clause a lender can make a loan more affordable for many cash-strapped consumers.

  CFAL believes that there is nothing inappropriate about a prepayment penalty that is properly disclosed and fairly structured, and that borrowers can receive major benefits from such provisions primarily through lower interest rates. However, we also recognize that sometimes prepayment penalty features are not adequately disclosed and explained to customers. In some cases the time duration of the penalty and the penalty amount may be excessive.

  Thus, we support adding further reasonable limitations on prepayment penalties. In crafting such limitations, it is important for Committee members to ensure not only that the penalty is not excessive, but also that it is in fact enough

to allow the lender to give the borrower who accepts it a significant benefit (e.g., a lower interest rate).

H.R. 833 makes a good start at addressing the prepayment penalty issue by limiting penalties so that they can not apply longer than 4 years instead of 5 years as HOEPA allows. CFAL believes that the Committee should further refine these limitations as follows:

1. **Informed Choice** - If a loan is offered with a prepayment penalty, the borrower always should be given the choice of a loan without the penalty, and the penalty should be clearly disclosed and explained to the borrower;
2. **Maximum 3-Year Time Limit** - The time duration of the penalty should be limited to a maximum of 3 years (or 2 years where an adjustable rate product is involved); and
3. **Amount Limit** - The amount of the penalty should be limited to what is allowed by California's law, which is 6 months interest on 80% of the outstanding loan balance.

- **Prohibiting "Loan Flipping"** – When a loan is refinanced frequently with the borrower receiving no real benefit and paying loan closing fees and costs that have the effect of stripping away the borrower's equity, loan "flipping" is said to occur. There is no question that flipping has been a significant problem. Consumer advocates and lenders agree that loan "flipping" is abusive and should be prohibited. There is disagreement, however, on how this should be done.

  Under implementing regulations issued by the Federal Reserve Board, HOEPA essentially prohibits covered loans from being refinanced by the same lender within 12 months "unless the refinancing is in the borrower's interest."[18] The regulations indicate that this determination is to be made on a case by case basis taking into account relevant circumstances.

  Consumer groups usually favor using a differently worded test and applying it to loans for a much longer period of time. In particular, advocates argue that the statutory test should be that the loan should not be made unless there is a *"reasonable tangible net benefit"* to the borrower. This phraseology was first used in the North Carolina "anti-predatory lending" statute.[19]

[18] 12 C.F.R. § 226.34(a)(3).

[19] As noted earlier, there has been much discussion, pro and con, regarding the NC statute. Suffice it to say here that experience has shown that no reputable lenders are known to be making loans that are deemed "high cost" under this law. This NC law has significant qualifications on this test (*e.g., a requirement that the flipping violation be "knowing" or "intentional" and a limitation on the ability of a plaintiff's attorney to collect attorney's fees if a reasonable settlement of a dispute is rejected*) that have made the law such that most lenders can continue to do business, albeit not in the "high cost" area.

CFAL's members and other lenders certainly want to stop loan flipping, but feel strongly that there are better ways of crafting an effective restriction than using an undefined "tangible net benefit" test. [20]

CFAL believes that Congress should recognize that however the flipping test is worded, clear statutory guidance should be given so that lenders can know with reasonable certainty what they are required to do. Providing such guidance is fair to all parties, facilitates compliance and enforcement, and helps avoid unnecessary and costly lawsuits. We suggest that the Committee's basic approach for crafting such a test should involve:

(1) choosing the most suitable wording----"*identifiable benefit,*" which is used in California's law and is proving to be workable is significantly clearer than "tangible net benefit," which seems to require some type of unspecified mathematical netting calculation;

(2) regardless of the term used, including NC's key qualifications (i.e., that the flipping be "*knowing or intentional*" and that the awarding of attorney's fees be limited to encourage settlements and discourage lawsuits);

(3) providing a number of specific "safe harbor" examples to give lenders meaningful guidance on what is intended to be an acceptable "benefit"; and

(4) setting a reasonable limit on the length of time the "flipping" restriction applies (e.g., 2 years).

- **Financing Points and Fees** – Many consumer advocates assert that lenders are engaging in a "predatory" practice when they allow customers to borrow the money needed to pay mortgage closing costs and finance these costs as a part of the total loan amount. These advocates contend this has the effect of stripping away the borrower's equity. They argue that nonprime lenders should instead be required to incorporate all closing costs into the loan interest rate.[21]

CFAL's members and other lenders have a fundamental disagreement with these advocates' position, which we consider extreme and against consumers' best interests.[22] Nonprime borrowers rarely have extra cash available to pay

[20] Some parties favor using the somewhat different approach of simply imposing a very tough but relatively short term (e.g., 1 year) prohibition on refinancing a "high cost" loan with another "high cost" loan (as is done in H.R. 833). CFAL would find such a restriction workable and believes it would be effective during its term. However, we recognize that many parties are insisting on a longer term "borrower benefit" test of some type.

[21] In fact, in a joint letter to House Financial Services Committee Chairman Oxley, many of the most active national advocacy groups termed such financing as "the most egregious predatory lending practice." Thus, it appears they are contending that all nonprime lenders are engaging in predatory practices since all such lenders, as far as we know, allow borrowers to finance such costs. The same might be said of most prime lenders who also allow borrowers to finance costs.

[22] It should be remembered that when effective prohibitions are added to prevent loan flipping, "equity stripping" becomes much less of a problem. Borrowers will not be repeatedly refinancing their loans in a short time period so they will not be repeatedly using equity to pay loan closing costs.

closing costs.[23] They are not required to finance their closing costs, but borrowers choose to do so in most cases because they determine that it is in their interest. (Many prime borrowers also choose to finance their closing costs.) Lenders have found that borrowers prefer paying these costs over the term of the mortgage. They want and need lower monthly payments. Having a higher rate with closing costs included as some have suggested would mean higher monthly payments, making mortgage credit much less affordable.

We support requiring a disclosure that financing points and fees is optional as is done in H.R. 833. However, CFAL believes that most legislators will agree that borrowers, both prime and nonprime, should continue to have the right to finance their loan closing costs. At most, some reasonable limitation on the amount of such costs that could be financed (e.g. at least 5%, depending on what is included in the costs definition) might be considered.

- **Mandatory Arbitration** – Many lenders include a clause in the loan terms that any disputes between the borrower and lender must be settled by a mandatory arbitration procedure instead of by court litigation. Consumer groups generally claim that mandatory arbitration clauses are inherently oppressive and deny borrowers their legal rights. They argue that arbitration is unfair and likely to favor the lender over the borrower. Lenders counter by noting that Congress has clearly indicated that arbitration is an acceptable alternative dispute resolution process. They say that arbitration is fair to both parties, and point out that it usually is much quicker and less expensive for borrowers. In addition, lenders point out that mandatory arbitration is allowed and often required in many other types of consumer financial transactions (e.g., real estate sales; securities; credit cards). Lenders also acknowledge that they favor using arbitration to resolve disputes because this approach helps facilitate settlements and prevents costly class action lawsuits.

  CFAL does not believe that requiring arbitration is inherently unfair, but we do support imposing certain further statutory restrictions on arbitration clauses to ensure greater fairness to borrowers. In this regard, we think that the so-called "New York rule" (based on that state's law) is a reasonable solution. This rule, which is essentially contained in H.R. 833, would only allow arbitration clauses which require that: (1) the arbitration be conducted in accordance with the

[23] There are basically four options facing the consumer: (1) if their credit is adequate, and assuming no prohibition on "indirect" financing is applicable as it is in NJ, they can borrow the cash needed for closing elsewhere---typically at higher cost, unsecured rates *(e.g., a cash advance at a 19.99% APR via an AARP-sponsored credit card)*---and usually have much higher total monthly payments; (2) if they can afford it---and most can not---they can pay a higher rate with higher monthly payments as some consumer groups are advocating; (3) they can not get the loan and not be able to use their home equity to meet their financial needs, and possibly be forced into bankruptcy and/or foreclosure; or (4) they can sell their house and get their needed cash from their home equity.

standards set forth by a recognized national arbitration association; (2) it must be held in the federal judicial district where the loan property is located; and (3) the lender must pay all reasonable costs of the first 2 days of the arbitration.

- **Rulemaking for Additional Prohibitions** – Although this should not be a contentious issue, we want to recommend that the Committee ensure that there is an effective administrative procedure in place so that new prohibitions or further refinements can be added as may be needed based on subsequent experience and circumstances. It is highly likely that unscrupulous actors will find creative new ways to take unfair advantage of borrowers. Therefore, we believe that regulators should be able to move promptly to stop such practices without having to wait for new legislative authority. The Committee should consider whether the existing Federal Reserve Board rulemaking authority is adequate, or whether a different approach is needed.

LIABILITY & PENALTIES-RELATED ISSUES

- **Meaningful Right to Cure** – One of HOEPA's biggest flaws is its failure to provide a meaningful right to cure unintentional mistakes. CFAL believes that it is absolutely essential that such a right be provided for in any amendments. We recommend that lenders be given at least 90 days to correct an error after they learn of it either through their own actions or from the borrower or other persons such as a regulatory audit. Correction should entail whatever is required to make the borrower whole, including full restitution and payment for any loss or actual damages caused by the error. This right to cure should not apply, however, if the violation is considered willful or intentional.

- **Penalties** – Consumer groups have repeatedly sought to have state and local legislators adopt very onerous penalties for violations of "anti-predatory lending" laws. Also, consumer advocates have sought to allow "predatory lending" claims to be raised as defenses in every foreclosure action.

  We believe that many of the penalties advocated by consumer groups are excessive and unfair. In fact, having extremely severe penalties is one of the reasons that many lenders have been reluctant or even unwilling to continue making loans in Georgia earlier and as we are starting to see now in New Jersey and elsewhere. When onerous or unclear requirements are coupled with excessive penalties, the legal risks rise to unacceptable levels. Not only does this tend to limit credit availability, but it also causes higher prices for borrowers to offset the undue legal risks. We also are understandably concerned that legitimate foreclosure proceedings will be stymied by an open-ended provision allowing "predatory lending" claims to be raised in every foreclosure proceeding.

CFAL's members will support strong penalties, but we do ask that all penalties be graduated or proportional to the harm done, as well as to whether the violation was willful or intentional. Very tough monetary penalties should apply to willful violators who are the truly "bad actors". We would welcome the opportunity to work on a bipartisan basis with legislators to develop balanced, proportional penalty provisions.

- **Assignee Liability** – Consumer advocates have contended that traditional "holder in due course" type protection should be ended and that all assignees of nonprime loans should be strictly liable for any violations that occurred before the assignee obtained the loan even if the assignee had no knowledge of, or even could not reasonably have known of, the violation. These advocates contend that the secondary market is providing the funding for predatory loans, and that strict assignee liability is needed to cut off such funding. They maintain that such liability will force secondary market purchasers[24] to better police those from whom they buy loans.

  Nonprime lenders and secondary market purchasers are strongly opposed to extending such strict liability to all nonprime loans.[25] We question whether it is appropriate to impose any liability on assignees, other than perhaps larger lenders who buy loans from smaller correspondent lenders. Today, only larger lenders with substantial resources are able to securitize loans. They clearly have the resources to ensure the borrower receives a full recovery of any damages. Moreover, they are in the best position to police the practices of their brokers, loan officers and correspondents.

  The North Carolina law, which consumer advocates tout, does not include such strict assignee liability provisions. In contrast, imposing broad assignee liability in Georgia resulted in secondary market purchasers refusing to buy loans and loan rating agencies like Standard & Poor's and Moody's being unable to rate loans. This resulted in Georgia's nonprime lending market being shut down, and Georgia's legislature taking emergency action to address this unintended

[24] They typically do not mention that such purchasers include pension funds and other bond buyers who will be very reluctant, and most often unwilling to continue making capital available for mortgage loans if such liability is imposed.

[25] As I observed earlier, HOEPA currently applies such liability to "high cost" loans and that this is a major reason that most lenders do not make such loans. (HOEPA's assignee liability is so broad that it essentially makes the assignee liable for any violation of any law committed by the originator, even if the violation is not a violation of HOEPA.) Currently, virtually no private secondary market purchasers, including Fannie Mae and Freddie Mac, will buy such "high cost" loans. The relatively few such loans that exist appear to be ones made by retail lenders who keep them in their own portfolios. The cost of such loans, when available, also is generally significantly higher for the borrower not because of their credit risk, but because of the higher legal risk and reduced competition caused by the law. This is one of the perverse effects of the current statute.

consequence of its earlier legislative actions. New Jersey, Los Angeles and Oakland are now poised to have similar experiences for the same reasons.

Legislators must be extremely cautious in making changes that upset secondary market dynamics because unfettered access to the capital markets is largely responsible for having dramatically increased nonprime credit availability and for lowering costs for millions of Americans. Lenders and secondary market purchasers believe that it is very unfair to impose liability when there is no reasonable way that the loan or securities holder could have known of the violation. In any case, we feel that liability generally should apply only if the assignee by reasonable due diligence knew or should have known of a violation of the law based on what is evident on the face of the loan documents.

CFAL's members include many of the largest securitizers in the nonprime mortgage business. We again want to work closely with Committee members, as well as Wall Street investment bankers, the rating agencies, the GSEs and other key players in the securitization process to develop workable provisions on this liability issue so that mortgage capital.

SCOPE OF HOEPA'S COVERAGE

- **Expanding to Cover Other Types of Nonprime Loans** – At the present time HOEPA only applies to certain "closed-end" loans involving a refinancing of an existing mortgage. It does not cover either "open-end" loans, such as home equity lines of credit, or loans for the purchase of a home. A number of state measures have applied restrictions to such open-end and/or purchase money loans.[26] CFAL believes that it would be appropriate to expand the federal law so that its protections cover both of these types of loans. We feel that this is both proper policy and consistent with our support for uniform national lending standards for nonprime lending, which I will discuss further momentarily.

- **Expanding Coverage by Changing HOEPA's APR and "Points and Fees" Triggers** – As noted earlier, HOEPA currently only applies to a relatively small part of the nonprime market---i.e., certain of the highest cost loans where the APR or points and fees exceed specified threshold levels. Advocacy groups have consistently sought to extend coverage at both the federal and state levels by significantly lowering the trigger levels. We are unwilling to support such reductions unless HOEPA's current flaws are corrected and any new restrictions are truly balanced and workable. Our opposition is based on the very real concern that doing so would expose lenders and secondary market participants to unacceptable risk levels on far more loans. This would destroy large portions of the nonprime market, greatly limiting borrowers' credit access and increasing

[26] Please refer back to footnotes 13 and 14.

their costs. However, if HOEPA is restructured in a reasonable and fair manner, we are quite open to discussing expanding it to cover more nonprime loans.

UNIFORMITY & ENFORCEMENT-RELATED ISSUES

- **National Uniformity and Enforcement** – The irrational patchwork of state and local "anti-predatory lending" laws that is developing is not workable. None of these laws is the same, and requirements vary greatly. Provisions are often arbitrary, unclear and totally impractical for lenders to implement. Well intended, but poorly crafted state and local requirements are having unintended negative consequences for borrowers. Most states also still have no effective borrower safeguards in place.

  Today, nonprime lending is clearly a nationwide, interstate business that is highly dependent on the national capital markets in order to make affordable mortgages available to the millions of Americans who can not qualify for conventional financing. We need consistent, nationwide requirements to be able to do so effectively and efficiently. Borrowers need protections not only from abusive lending practices, but also from differing, poorly crafted state and local laws that limit their access to affordable credit and force them to pay more.

  CFAL therefore strongly supports prompt Congressional action to provide clear, effective and workable uniform national fair lending standards[27] for nonprime mortgage loans. These standards should provide equal protections for all Americans and apply to all mortgage originators, regardless of how they may be structured or chartered.

  We also believe that state officials should have an active role along with federal authorities in enforcing these national standards.

OTHER RELATED ISSUES

In closing, I want to mention that we also want to work with Committee members and other interested parties on various other related issues that are likely to come up in this debate---such as expanding consumer financial education and counseling opportunities; mortgage broker licensing requirements; loan servicing; and preventing "property flipping". In particular, CFAL is especially interested in pursuing proposals, such as Rep. Scott and others have offered, relating to borrower education which can empower people to make more informed financial choices and to avoid abusive practices. The long term answer to many of these problems is education, not restrictive legislation. Among other things, we think

[27] Both Fannie Mae and Freddie Mac also have now expressed their support for uniform national standards, as have many other lenders and trade groups.

that the Committee might want to consider having nonprime lenders pay a reasonable fee into a central fund when they originate a mortgage. This fee could be used as a funding mechanism for state and community based education programs and quite possibly for state enforcement efforts.

* * *

CFAL is confident that Congress can fairly resolve these issues and pass effective national standards for fair lending that protect nonprime borrowers without unduly limiting their access to affordable mortgage credit. We look forward to working constructively with Committee members and all other interested parties to help enact such legislation.[28]

[28] *Please feel free to contact me, or CFAL's Executive Director, Wright H. Andrews (202-742-4245, wandrews@butera-andrews.com), if you have questions or would like further information about CFAL's positions*.