Consumer Federation of America

TESTIMONY OF

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PROTECTING HOMEOWNERS: PREVENTING ABUSIVE LENDING WHILE PRESERVING ACCESS TO CREDIT

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My name is Allen J. Fishbein and I am the Director for Housing and Credit Policy for the Consumer Federation of America (www.consumerfed.org). Chairman Bachus and Ranking Member Sanders, Chairman Ney and Ranking Member Waters, and members of the two subcommittees, we welcome the opportunity to testify today on the important subject of "Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit." CFA is a national association of 300 pro-consumer organizations, organized in 1968 to promote consumer interests through education, research, and advocacy.

Predatory lending – exploitative lending to financially unsophisticated borrowers – occurs in all aspects of consumer credit, such as auto finance, credit cards, and short term installment debt. However, the explosive growth of predatory and abusive practices in mortgage lending has deservedly received much attention in recent years. This is understandable. Homeownership is the single most important instrument used by Americans to build wealth. Home equity is the largest component of household wealth representing nearly one-half of the total net worth of the average household. And home equity comprises over 60 percent of the net worth of minority and low-income families. Once households become homeowners, refinanced mortgages become an important financial means for sustaining and increasing household wealth, as they allow homeowners to tap into the equity in their home or to take advantage of falling interest rates to pay for a host of family financial needs.

The positive contributions of the home mortgage refinance market are undermined, however, when homeowners are lured into loans with terms that are not beneficial to them, often as a result of abusive practices by so called "predatory lenders." Predatory lending has been a disturbing part of the growth in the subprime component of the conventional mortgage market, which has grown substantially over the past decade. It has been estimated, for example, that borrowers lose $9.1 billion annually to predatory lending practices.[1] Further, while homeownership nationwide has reached record levels, research indicates that the subprime loan market, and possibly predatory practices, are combining to contribute to record high home foreclosure rates.

My testimony this morning focuses on several points concerning the dangers posed by the emergence of the subprime lending market and why greater emphasis on homebuyer preservation is needed. To summarize these points:

- From Credit Gatekeeper to Credit Peddler -- Subprime lending specialists are subjected to less scrutiny than banks and other depository institutions, making this market a fertile ground for predatory lending practices;

- Subprime borrowers obtain credit through different channels than prime

[1] Eric Stein, Quantifying the Cost of Predatory Lending, Coalition for Responsible Lending, 2001.

borrowers; often entail aggressive marketing to less financially sophisticated borrowers. The resulting dual market that has emerged makes certain borrowers much more vulnerable to being victimized by predatory practices.

- Subprime loans are made disproportionately to low-income and minority households and communities and the absence of mainstream lending in many of these markets means that many borrowers are not receiving cheaper loans for which they qualify;

- Why subprime foreclosures may be the smoking gun of predatory lending; and,

- Legislative and regulatory action is needed to curb the problems associated with predatory lending.

From Credit Gatekeeper to Credit Peddler

Not so long ago, banks, savings, and other depository institutions were viewed by consumers as the gatekeepers of credit. Borrowers assumed that if they did not qualify for a loan their banker would turn them down and if they were seeking a loan too big for them to repay, their banker would provide them with a smaller loan or no loan at all. These days, however, the growth and profitability of subprime lending has led financial institutions to adopt a difference approach. This new approach means that more and more lenders now are willing to lend to almost anyone, and the only the price of credit is at question. This evolution of the markets has worked to expand credit opportunities for some consumers. However, it also has caused some lenders go even further and become quite aggressive in pushing credit onto borrowers. This shift from the traditional role of the lender as “credit gatekeeper” to credit to a new one of as “credit peddler” comes at considerable risk to many consumers.

Much of the new “risked-based” priced mortgage lending occurs through non-bank financial institutions that are not subject to the same types of systematic regulatory oversight as are banks. Unfortunately, consumer protections have not kept pace with this change and are not fully aware of the new “buyer beware” climate in lending. Thus, they may be susceptible to entering into loans that are not right for them, or worse still, being victimized by exploitative and abusive lending practices. The problems associated abusive home equity practices are not new, but the extent of this activity seems to be thriving in the current “no holds barred” lending environment.

A case in point is predatory lending, the subject of today’s hearing. Predatory lending practices threaten to reverse much of the progress made in recent years to expand homeownership and the opportunities for wealth building it creates for underserved households. At a time when a record number of Americans own their own home, for too many families the proliferation of abusive lending practices has turned the dream of homeownership into a nightmare. Abusive practices in the subprime segment of the mortgage lending market have been stripping borrowers of home equity they may spend a lifetime building and threaten thousands with foreclosure. Further, predatory lending disproportionately victimizes vulnerable populations, such as the elderly, women-headed households, and low-income and minority homeowners. The predators selectively and aggressively market their high-cost loans to unsuspecting borrowers, saddling these families with expensive debt, when in many cases they could qualify for less costly loans.

What is predatory mortgage lending?

"Predatory lending" has become a short hand term that is commonly used to cover a range of lending practices that may be disadvantageous to borrowers. A joint Treasury Department/HUD report, Curbing Predatory Home Mortgage Lending (June, 2000), catalogued the key features commonly associated with predatory loans[2]. These include the following:

- Lending without regard to a borrower's ability to repay

Instead of establishing the borrower's ability to pay, predators underwrite the property and charge very high origination and other fees that are not related to the risk posed by the borrower.

- Loan flipping

The predators pressure borrowers into repeated refinancings over short time periods. With each successive refinancing the borrower is asked to pay more high fees, thus stripping further equity.

- Prepayment penalties

Excessive prepayment penalties ensure that the loan cannot be paid off early without paying significant fees, trapping borrowers into high-cost mortgages.

- Balloon payments

Predatory loans may have low monthly payments at first, but the loan is structured so that a large lump sum payment is due within a few years.

- Credit insurance packing

Single premium credit life, disability and unemployment insurance and other fees are "packed" into loans but not disclosed to borrowers in advance. The financing of these products and fees increases the loan balance, stripping equity from the home.

- Mandatory arbitration provisions

Mandatory arbitration clauses to resolve disputes are usually required as a condition for

[2] HUD/Treasury, *Curbing Predatory Home Mortgage Lending: A Joint Report*, 2000.

receiving a loan. Such clauses reduce the legal rights and remedies available to victims of predatory lending.

It has been said that while not all subprime lending is predatory, but that predatory lending is almost always related to the subprime market. Part of the explanation for this appears to be the fact that non-bank subprime lending specialists are not subject to a system of supervision comparable to that which is applied to federally and state chartered banks and other financial depository institutions. This lack of supervisory oversight increases the prospects that abuses may occur that go undetected. For the most part the lending practices of subprime specialists are not routinely reviewed by regulators through on-site examinations to ensure they are adhering to appropriate consumer protection requirements. Thus the burden of enforcement for this segment of the mortgage industry essentially falls on individual consumers, who must first know the law, recognize when a violation has occurred, and elect to take appropriate action. At best, this complaint-driven enforcement system works for only the most egregious of lending practices.

The growth of subprime lending and emergence of a dual mortgage market

Subprime lending has grown rapidly as a segment within the conventional home loan market. From 1993-1999, the number of loans reported by subprime specialists increased tenfold from 104,000 subprime refinance loans in 1993 to 1 million in 1000. In 1994, the $35 billion in subprime mortgages represented less than 5 percent of all mortgage originations. By 2002, subprime lending had increased to $213 billion to 8.6 percent of originations in a high volume refinance year (subprime originations in recent years have represented as much as 13 percent of the mortgage market).

Subprime lending can provide expanded opportunities to borrowers that do not meet credit standards in the prime market to buy new homes, to improve their homes, or to access the equity in their homes for other consumer purposes. However, most subprime borrowers use this form of financing for debt consolidation and other consumer credit purposes rather than for housing purposes. When undertaken responsibly, subprime lending can benefit credit impaired borrowers, including those who may have blemishes on their credit record, an insufficient credit history, or nontraditional credit sources. However, the subprime market is comprised of many lenders who operate outside regulatory oversight, and therefore, it also can be a fertile ground for predatory lending activities.

The growth of subprime lending has also facilitated the emergence of a dual mortgage delivery system, in which new types of lending institutions provide distinctly different mortgage products to lower income markets than those commonly offered in higher-income markets. Conventional prime rate mortgages typically contain payment terms that are relatively straightforward and without contingent terms or hidden pricing. The prime market loans feature fixed-rate mortgages with interest rates that do no fluctuate, thereby assuring borrowers that they will have the same payments for principal and interest every month for the life of the loan. Although the prime market offers alternatives to fixed rate mortgages, such as adjustable interest rates and balloon payments, these are usually left to borrower discretion. Thus, the borrower's ability to repay is solely dependent upon their future income and not on changes economic and credit conditions, which can affect interest rate movements.

In contrast to the prime market, as anyone who has reviewed subprime loan documents can attest, the payments on subprime loans are less easily understood. These loans contain terms and conditions typically require borrowers to make difficult computations about events outside of their control. These loans often feature adjustment- rate features whose interest rate and, therefore, monthly payments fluctuate. They may also contain additional provisions that strip borrowers' equity, such as prepayment penalties and balloon payments, which make it difficult for the borrowers to determine whether future market conditions will permit them to refinance on affordable terms when the balloon payments come due.

The marketing by subprime lenders is also frequently quite different than the way the mainstream mortgages are marketed. It usually starts with a telephone call, a mailing, or a door-to-door solicitation during which time unscrupulous lenders, brokers, or home improvement contractors attempt to persuade a borrower to use home equity for a loan. High-pressure sales techniques, deception, and outright fraud are often used to help "close a deal." According to an AARP survey, over three-quarters of seniors who own homes receive these solicitations, while many take out loans relying solely on these overtures, without taking the necessary time to shop around to find the best possible loan deal for them.

Also, typically products targeted to low-income or credit impaired borrowers have higher interest rates and less favorable terms that the conventional prime loans provided by mainstream lenders. Over the past decade, Government-backed loans and lending by subprime and manufactured housing specialists account for almost two-thirds of recent increases in lower-income neighborhoods. Conventional prime lending accounted for just 37 percent of the growth in lower-income lending, compared with 81 percent of loan to higher-income borrowers in higher-income neighborhoods.[3]

Income and Racial Disparities in the Subprime Market

A growing body of research has shown that subprime loans are made disproportionately to low-income and minority households and are concentrated in low-income and minority neighborhoods. Although these studies recognize that differences in credit behavior explain some of the disparities in subprime lending across the neighborhoods, they argue that the absence of mainstream lenders has also contributed to the concentration of subprime to these patterns. Because of the much higher incidence of predatory practices within the subprime lending market, high concentrations of subprime lending in these markets, as these studies all show, also indicate the likelihood of the greater occurrence of predatory lending practices victimizing borrowers residing in these communities.

For example, as part of the Treasury-HUD Task Force on Predatory Lending, HUD

[3] Joint Center for Housing Studies of Harvard, *The State of the Nation's Housing*, 2002.

documented the concentration of subprime lenders in low-income and minority communities in five cities (Atlanta, Los Angeles, Baltimore, New York, and Chicago). The studies found that subprime loans were three times more likely in low-income neighborhoods than in high-income neighborhoods and five times more likely in African American neighborhoods than in White neighborhoods. In fact, HUD found that homeowners in upper-income African American neighborhoods were twice as likely as homeowners in low-income White neighborhoods to have subprime loans.[4]

Another study prepared by Calvin Bradford on subprime lending patterns in all of the nation's 311 metropolitan areas reached similar conclusions and indicated that the magnitude of these disparities raises serious questions about the extent to which risk alone could account for such patterns.[5] The study found that African American borrowers are nearly three times and Latino borrowers nearly two times more likely to receive a subprime loan than their white counterparts. These racial disparities exist in all regions of the nation and in metropolitan areas of all sizes. Bradford's analysis also suggests that racial disparities actually increase as income increases suggesting that a portion of subprime lending is occurring with borrowers whose credit histories would qualify them for low-cost, conventional prime loans.

There is other evidence that risk factors do not explain racial differences in the use of subprime lending. A study by the Research Institute for Housing America concluded, "after controlling for borrower income, debt, and credit history, racial groups behave differently.[6] Specifically, the study noted that minorities are more likely to use subprime lending than whites.

A lack of competition from prime lenders in low-income and minority neighborhoods has increased the chances that borrowers in these communities are paying a high cost for credit. The finding that upper income African American borrowers rely more heavily on the subprime market than low-income White borrowers suggests that a portion of subprime lending is occurring with borrowers whose credit would qualify them for lower cost conventional prime loans. There is also evidence that the higher interest rates charged by subprime lenders cannot be fully explained solely as a function of the additional risks they bear.

Both Fannie Mae and Freddie Mac, the publicly chartered secondary mortgages market enterprises, have suggested that a significant portion of subprime lending is occurring with borrowers whose credit would qualify them for cheaper loans sold to the GSEs. Freddie Mac staff has estimated that 10 to 35 percent of subprime borrowers meet Freddie Mac's purchase guidelines for conventional loans.[7] Fannie Mae has stated that half of all mortgage borrowers steered to the high-cost subprime market are in the A-

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[4] HUD report, *Unequal Burden: Income and Racial Disparities in Subprime Lending in America*, 2000.
[5] Calvin Bradford, *Risk or Race? Racial Disparities and the Subprime Refinance Market.* A report prepared for the Center for Community Change, 2002.
[6] Anthony Pennington-Cross, Anthony Yezer, and Joseph Nichols, *Credit Risk and Mortgage Lending: Who Uses Subprime and Why?* Research Institute for Housing America, 2000.
[7] Freddie Mac, *We Open Doors for America's Families, Freddie Mac Annual Housing Activities Report for 1997*, 1998.

minus category, and therefore are prime candidates for Fannie Mae.[8]

High Foreclosure Rates on Subprime Loans

While there is a variety of evidence that indicating that opportunistic pricing practices and predatory lending practices have been on the rise, unfortunately there is no systematic data available on the volume of loans that might be considered predatory. One consequence of predatory lending is that borrowers are stripped of the equity in their homes, which placed them at an increased risk of foreclosure. In fact, high foreclosure rates for subprime loans – currently one out of every eight subprime loans is either seriously delinquent or in foreclosure – provide the most concrete evidence that many subprime borrowers are entering into mortgage loans they simply cannot afford. A study of default and foreclosure experience of 16 large subprime lenders estimated that the default rates for subprime loans were three times as high as the default rate for all mortgages.

The wave of foreclosures now coming out of the subprime market has been documented by at least ten research studies of subprime foreclosure activity in various local markets. The findings from these studies raise important concerns about the impact of subprime loans on low-income and minority neighborhoods. They also provide the most compelling evidence that subprime lending has become a fertile ground for predatory practices is that current disproportionate percentage of subprime loan foreclosures in low-income and minority neighborhoods.[9]

The higher risk of foreclosure associated with subprime lending reinforces concerns that predatory lending can potentially have devastating effects not just on individual families but also on the neighborhoods where they reside. Because subprime loan are so heavily concentrated in communities of color, this also raises the prospect of concentrated foreclosures that may affect entire neighborhoods, including those homeowners whose loans are in good standing.

Further, the extremely high incidence of subprime foreclosures has also been termed the smoking gun of predatory lending.[10] For example, research suggests that foreclosures of subprime loans have increased rapidly with the growth of subprime loan originations and account for a larger share of overall foreclosures than total loan originations. For example, according to a study of Baltimore foreclosure activity conducted by HUD in 2000, subprime loans accounted for 45 percent of all foreclosure petitions in that city, compared with only 21 of all loan originations. In Atlanta, it was found that overall share of foreclosures attributable to subprime lenders was 16 percent, also larger than the subprime share of originations (9 percent).

In addition, the research indicates that foreclosures of subprime loans occur much more

[8] Washington Post, *Fannie Mae Vows More Minority Lending*, March 16, 2000, page EO1.
[9] Allen Fishbein and Harold Bunce, *Subprime Market Growth and Predatory Lending*, HUD, 2000.
[10] Harold Bunce, Debbie Gruenstein, Christopher E. Herbert, and Randall M. Scheessele, *Subprime Foreclosures: The Smoking Gun of Predatory Lending?* HUD, 2000.

quickly than foreclosures on prime loans, and that they are concentrated in low-income and African neighborhoods. The Baltimore study, along with other foreclosure studies conducted for Atlanta and Chicago found subprime lenders foreclosed much more quickly than prime lenders. In Baltimore, for example, the mean lag between the loan origination and the date that the foreclosure petition was filed was only 1.8 years for subprime loans compared with more than 3 years for prime loans. Very similar results were found in Atlanta and Boston. The fact that most of subprime loans reaching foreclosures had a median age of three years, compared to as much as seven years for loans made by prime lenders suggests that the loans were not affordable for the borrowers even at the time of origination and therefore, very possibly were predatory.

Legislative and regulatory action is needed to curb predatory lending

Given the scope and nature of the problems a comprehensive set of solutions is needed to curb predatory lending involving all levels of government, the mortgage and real estate industries, working together with local community, housing, and consumer organizations. This was the approach recommended by the Treasury/HUD National Task Force on Predatory Lending in 2000.

Federal Reserve Board Governor Edward Gramlich in a speech he gave last month cited a number of positive steps that have been taken at the federal, state, and local levels, at least in varying degrees. And indeed Governor Gramlich is right. There has been some movement to address the problem of predatory lending. Unfortunately, it has not been nearly enough.

Some predatory practices are already clearly illegal and can be dealt with through effective enforcement of both federal and state law. However, while perhaps it once was, it should no longer be a “dirty, rotten secret” that predatory lending operates in the grey area of the law. Many of the worst abuses are more subtle and therefore, difficult to address without the enactment of additional consumer protections.

Consequently, new legislative action is needed to provide consumers in the high cost loans market with the protections they need to borrow in the subprime loan market. Some steps the Congress should consider.

1. *Strengthening the Home Ownership and Equity Protection Act (HOEPA)*

HOEPA continues to remain a useful, but far too limited tool. It still covers too few high cost loans. It does not cover home purchase or home equity and home improvement loans that are structured as open-end credit lines. Moreover, the statute does not cover some important abuses associated with high cost lending, nor does it provide for adequate civil remedies to address violations of the statute. Important features that should made to HOEPA include --

- Revising the definition of “High Cost” Mortgage to expand the scope of coverage for subprime borrowers by lowering the triggers for when certain consumer protections are triggered –

a) First mortgages with APRs that exceed Treasury securities by 6 percentage points (current law is 8%)
b) second mortgages with APRs that exceed Treasury securities by 8 percentage points (current law is 10%); or
c) mortgages where total points and fees payable by the borrower exceed the greater of 5% of the total loan amount, or $1,000 (including making the definition of points and fees to be more inclusive).

- Providing additional protections for high cost mortgages under the new trigger definitions.

  a) Restrictions on the financing of points and fees
  b) Limitations on the payment of prepayment penalties
  c) Further prohibitions on balloon payments
  d) Prohibitions on upfront payment or financing of credit life, or comparable products on a single premium basis
  e) Extension of liability for home improvement contract loans
  f) Limitations on mandatory arbitration clauses
  g) Increase statutory damages in individual civil actions and class action

- Assignee liability requirements are critical to ensuring that the secondary market does not support predatory lending practices. Any new provisions adopted by Congress to address predatory lending should include some reasonable degree of liability for assignees.

Legislation along these lines was introduced in the last Congress by Senator Sarbanes and then Rep. John LaFalce.

In an effort to fill the gap in consumer protection for subprime borrowers a number of states have enacted their own predatory lending laws. As a rule, these state laws are patterned after HOEPA. The better ones, such as in North Carolina, New Jersey, New Mexico, New York and several other states have sought to cover a larger segment of the subprime market, prohibit or place limits on additional abusive practices, such as the financing of fees, and establish suitable standards for determining “assignee liability” for subsequent purchases and/or investors in loans with predatory features.

State anti-predatory laws can serve a useful function to curbing predatory practices, particularly those not address by federal legislation. They also provide opportunities for experimentation to find the most effective approaches for curbing abusive mortgage lending practices. Moreover, states protections traditionally have formed an important component in a federal system of protections for consumers. Accordingly, the enactment of Federal legislation to strengthen HOEPA should not preclude states from continuing to regulate in this area.

2. Congress should establish lender liability for illegal broker/contractor acts.

Most subprime lending is conducted through mortgage broker channels. There is evidence that a very large number of third parties brokers that participate in the origination of predatory loans employed aggressive marketing and solicitation practices. Better regulation of mortgage brokers, therefore, would be helpful in deterring some aspects of predatory lending. Most regulation of mortgage brokers, home improvement contractors, and appraisers occurs at the state level. However, this oversight is uneven, and in some cases non-existent. Making lenders liable for broker or home improvement contractor malfeasance if such party act as the lender's agent would help to improve the accountability and policing of third parties engaged in predatory practices. Encouraging better regulation of these entities at the state and local levels would also help to weed out those third parties engaged in unscrupulous practices.

3. Encouraging the Expansion of Prime Lending in Underserved Communities

The lack of competition from prime lenders in low-income and minority neighborhoods increases the chances that borrowers in these geographic areas are paying more for credit than they should. Part of the reason for prime eligible borrowers receiving high cost or predatory loans is that they have been misclassified by large financial conglomerates that do not have adequate systems in place to "refer-up" would be borrowers who walk into a subprime affiliate but whose credit record may qualify them for a prime loan.

Accordingly, Congress should encourage federal banking regulators to use their authority under the Community Reinvestment Act and other laws to "promote" borrowers from the subprime to the prime market, while penalizing the lenders they supervise that engage in predatory lending practices.

This concludes my testimony. Thank you again for the opportunity to testify. I will be happy to answer any questions members of the committee may have