Testimony of

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

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Thank you for inviting me to share some of the lessons I have taken from our experience with enforcement in the subprime mortgage lending arena. This is a subject of vital economic and emotional importance to millions of families, and, in the long run, to the American economy. I hope this hearing will help us shed more light than heat on the problem and the full range of solutions which should be considered, for there has been a great deal of the latter in the debates about reform of this industry. These good citizens deserve to have the policies determined based on what the real world looks like, not what theoretical constructs would hope the world looks like.

"ACCESS TO WHAT?" IS THE REAL QUESTION

The title of this hearing suggests two threshold questions. The first question is whether there really must be a trade-off between reform and access. The past 35 years have encompassed much of the consumer protection reform movement – from Truth in Lending in 1969, through the Equal Credit Opportunity Act, the FTC Credit Practices and anti-holder rules,

to HOEPA in 1994. Many, if not all of these reforms, when proposed were met with predictions that the sky would fall, and that the unintended consequence would be to "dry up credit" for those the proponents of reform were trying to protect. A look at the sheer explosion of consumer credit in those decades demonstrates that such fears were ill-founded.

The more fundamental threshold question is whether there really is a possibility that efforts to curb home equity depletion for a great many Americans would restrict access to <u>appropriate</u> credit? That is a different question than whether it would restrict access to credit. The distinction is critical, and responsible policy makers must keep it constantly in mind. Reducing access to the kind of credit that steals equity – the primary (or only) source of wealth for many Americans – is the goal of effective anti-predatory lending laws. It is an easy sound bite to reduce the debate to "regulation will limit access," but behind that slogan is an assumption that "more is better." When the product is debt, and the cost is equity depletion, record foreclosures and bankruptcies from inappropriate credit, and declining neighborhoods, we must be leery of making such a facile assumption.

There are many things in life where more is not necessarily better. Antibiotics have given us great strides in improving longevity. But with antibiotics, more is not better: too much use and indiscriminate use has negative effects both on the individual, (building up immunity), and on the community as a whole (with the growth of resistant strains). Like most public policy questions, it is not as simple a question as it is made to sound, and it is imperative that the policy makers not act (or fail to act) on oversimplifications. The potential consequences are far too great. Household debt today is at record levels, and homes stand behind most of that debt. The indicators are not of too little access to useful and manageable credit. Instead we see signs of too

much access to problem credit. By one estimate, subprime lenders, the arena in which most of problem lending occurs, account for 10% of the mortgage lending market, but 60% of the foreclosures.[1] Reducing access to devastating debt should be a goal: it cannot be assumed that all reduction in access to subprime lending is an undesirable outcome. Quite the contrary. Successful regulation will reduce access to predatory lending. That is why thoughtful, careful analysis of the North Carolina experience such as the UNC study is so important.[2] It shows a reduction in access to predatory lending – but no reduction in access to appropriate lending, nor rise in the price of credit. In short, the North Carolina legislation is doing what it was intended to do.

I would also like to make a brief comment about securitization and holder liability, which the next panel will focus on in more detail. Enforcement to curb unfair and deceptive practices by lenders who rely on securitization to fund and transfer their loans faces serious practical and legal obstacles. Lenders who securitize their loans, then file bankruptcy, make very difficult enforcement targets. The assignees of the loans in the secondary market are trusts and investors who protest that they can't change a retail lender's practices, and it would be unfair to force them to make restitution to consumer victims. This is not uncharted territory, and the lessons from experience are that this is manageable.

Ten years ago, when Congress first examined the predatory mortgage problem, it well understood that the secondary market was part of the problem – that's why HOEPA restricted the ability of assignees to raise the holder in due course defense to borrowers' claims and defenses about the loan.[3] Though some feared then that it would restrict access, the huge growth in the volume of subprime lending – including securitizations – demonstrates that the assignee liability

did not reduce access.[4] To the best of my knowledge, "innocent" assignees have not faced large damage awards, though some players in the secondary market have had to accept the consequences of their own conduct. The recent award against Lehman Brothers, for example, was assessed by the jury for Lehman's own conduct in aiding and abetting First Alliance Mortgage Company's (FAMCO) fraud on borrowers, with the jury carefully apportioning responsibility.

The assignee liability provisions of HOEPA were based in part upon a prior successful effort to assure that liability for conduct relating to credit paper followed that paper. The FTC anti-holder rule made assignees or related lenders liable for the claims and defenses which the buyer would have against the seller. That has not dried up home improvement credit, but has been invaluable in both public and private enforcement by making the buyer's claims and defenses travel with the note and mortgage, rather than making them disappear with a shady contractor.

PROBLEM PRACTICES IN THE SUBPRIME MARKET

One of the early myths about "predatory lending" was that only marginal players in the market engage in problem lending. Our multistate investigation of Household and the FTC action against Associates (which was acquired by Citigroup in 2000 and merged into its subsidiary CitiFinancial) indicate otherwise. CitiFinancial and Household were the top two subprime lenders in 2002, with over 18.5% of the subprime market share between them according to industry figures.[5] The nature of the alleged practices in both these cases demonstrate how the subprime market operates in many crucial respects contrary to the theoretical "self-correcting" marketplace.

Before proceeding to discuss some of the practices at issue and the reforms embedded in the settlement's injunction, I want to thank Household for its cooperation during the states' investigation. The company took responsibility. In doing so, sometime next month $484 million will be returned to its borrowers — a record amount. More importantly, we belive the injunctive relief in our consent judgment represents significant reforms. The commitment and the massive effort that Household is putting into implementing these reforms is commendable. I look forward to working with them as the implementation process continues.

There were approximately thirteen challenged practices in the investigation of Household by state financial regulators and attorney generals.[6] Among them were excessive fees and points, typically 7% or more of the loan, high prepayment penalties and misrepresentations concerning them, misleading sales pitches designed to conceal real interest rates and the high points, insurance-packing, "loan-splitting," and making refinance loans with no real net benefit to the consumer. Many of the these problems in marketing and sales practices in Household were similar to the allegations against Associates by the FTC.[7] These cases illustrate some of the fundamental characteristics of the subprime marketplace that we all must keep in clear focus.

Access to the Products Offered Vs. The Products Needed

Alan Greenspan recently spoke of the $700 billion in equity Americans "extracted" from their homes. For you and me and many others in this room, that "extraction" reflected refinances to lower-rate mortgages, which freed up disposable income for us. Refinancing in the subprime market extracts equity, but often does not free up disposable income. Instead, it sometimes turns prime mortgage debt into more costly subprime debt, or simply churns high-cost debt into more high-cost debt.[8] That extracts equity. Churning debt is not a productive use for mortgage

debt, any more than churning is productive for the consumer in the sale of securities or insurance. Yet refinancing is the major component in the phenomenal growth of subprime lending, constituting 65% of subprime loans in 2000.[9] A recent AARP study confirms what we've known about many of these loans being "sold, not bought," – driven by supply, not demand. Sixty-one percent (61%) of older subprime borrowers reported that the contact was initiated by a broker or lender, not by the consumer. (Only 31% of older prime borrowers reported the same experience.)[10] Many of these refinances or debt consolidation loans provide no real benefit to the consumers, and may leave them worse off. Two of my constituents presents a good example of costly refinances with no net benefits. This couple had $71,600 in a first and second mortgage on their property when they sought $8000 additional funds from Associates in November, 2000. Five loans and five months later, the encumbrance on their home was $112,250, far more than the home was worth. Their installment debt was some $300 a month higher than it would have been if they'd just been given the loan they sought.[11]

The loan products needed in low and moderate income communities are affordable loans to buy affordable homes – purchase money loans. But that is not a significant portion of the subprime market. The loan products needed by elder homeowners, and homeowners in low and moderate income communities are affordable, non-price gouging home repair loans for quality repairs from reputable home improvement contractors. There is no evidence whatsoever that protections such as the North Carolina law reduce access to those kinds of productive credit – in fact, there is some suggestion that good laws may "crowd out" the destructive debt, making more room for productive credit.[12] In other words, some decline in levels of subprime originations may simply show that the effect of good anti-predatory lending laws is to repeal

Gresham's Law. There is no evidence they restrict access to credit -- they may be just what is need to let good money start to drive out the bad.

Spending Wealth – Equity Depletion

Refinancing from prime loans to more costly subprime loans, or churning subprime debt not only does not free up disposable income, it depletes the only stored wealth that many people have – their homes. High interest rates, high fees, and prepayment penalties compound the rate of equity depletion with these loans. The more frequently these loans are written – through churning and flipping – the more is extracted. Attached to this testimony (in Appendix A) are charts which show how the self-inflating nature of some of these fees (particularly points and single-premium credit insurance) can make the same $30,000 in proceeds on a 15% mortgage (a small size loan in the mortgage world) cost an extra $12,000 over the life of a loan, and make the monthly payment rise. Table B of that appendix shows how, in a world of frequent refinancing, that cost is magnified for the consumer over a truncated term. When looking at those figures, keep in mind that they do not reflect any prepayment penalties, which depletes the equity by more thousands of dollars just to try to get out of a loan.

The rising level of equity depletion is running head-on into competitive pressures for growth among subprime lenders, leading to one of the more insidious practices of concern to me in this market, the rise of high loan-to-value mortgages.

High Loan-to-value Loans & Prepayment Penalties: Homeowners Trapped under Water

* Loan splitting and high LTV loans

Mortgage lending has been a high growth area. Too much growth, arguably, so that the mortgage market is rapidly becoming saturated. Here, too, the fallacy of automatically applying

prime market theory to subprime practices is amply demonstrated. When you and I refinanced our 7% mortgages to 5%, many of us were able then to switch from 30 year mortgages to 15 year mortgages, and build up equity faster. But with the equity-depleting characteristics of high cost mortgages, the effect of refinancing is the opposite. (See note 11.) Consequently, that market becomes saturated faster, and the amount of equity available to tap falls. Yet there remains a hyper-competitive supply market, with pressures to continue to show "growth."[13] In normal businesses, saturation means the suppliers let inventory levels reduce until natural demand resumes. In this respect, too, a reduction in levels of origination of subprime loan would actually be a positive sign of a natural adjustment. But in the long-term mortgage debt business, that hasn't happened. Instead, now that homes are mortgaged to the roof, the air over those roofs is being mortgaged as well.

In the late 90s, a few subprime lenders offering 125% - 135% high loan-to-value mortgage loans aggressively marketed their wares. Many people even in the subprime lending field thought that "the market had taken care of that product," and the hype disappeared. While the hype may have disappeared, the product hasn't – it simply became more subtle and more insidious. And it hasn't disappeared because the goal of growth in supply side runs head on into the reality of approaching saturation.

Household was not the only lender to offer the so-called "piggy-back" loans, though the sales practices alleged to accompany these loans were among the first to come to our attention through complaints. It was a feature of the Associates case, and Conseco did it, as well. The piggy-back loans differ from the original high-LTV product offered in the 90s by offering what the consumer would think of as a single loan, but split into two separate loans made

contemporaneously or nearly so. A first lien loan – typically at rates of 12% or more – mortgages from 85 - 100% of the value of the home. A piggy-back second lien loan – at rates we've seen from 16% to 24% – takes the combined loans up to as much as 125% CLTV. (If the appraiser has been generous, as is increasingly happening, the real LTV could be much higher.)

The lenders' rationale behind the higher rate on the piggy-back second is that it is effectively unsecured. But for the borrowers, the homes are at still at risk -- greater risk, in fact.[14]

At first blush, it may be easy to think that people wanted this extra money, and it was still cheaper than borrowing it at unsecured rates. (Though at 20% or more, that is not easy to say with a straight face.) But when one couples the product with the "upselling" of loan amounts,[15] with sales practices which leave many borrowers unaware that there even are two loans until well after the fact, that justification crumbles.

With high-fee loans, the loan-splitting sometimes is even more egregious, for it can be the very existence of the high fees which creates the "need" for the piggy-back second. For example, assume a home is worth $100,000, and has a $90,000 first lien. The borrower was seeking credit for a $6000 roof repair. A 2-point prime loan would make that just under a $98,000 loan. But a loan with 7.5 points plus $2000 in credit insurance and other fees, takes the loan "principal" to $105,350. Since money is fungible, in effect, the piggy-back second of $5350 at 20% or more is simply financing the costs on the primary loan.

Under the terms of our settlement, any piggy-back loans will be unsecured, and we believe that lenders, borrowers, their families, communities -- and the economy as a whole -- would be very well served by the reduction in access to these insidious, extradinarily high-cost

piggy-back second mortgages.

* Prepayment penalties.

These high LTV loans, along with perversely prevalent presence of prepayment penalties in the subprime market, keep the customer in these loans. Prepayment penalties formulae are complicated and almost totally opaque. Only the most sophisticated and math-savvy borrower could anticipate the actual dollar amount of a prepayment penalty.[16] Such lack of transparency brings us to a fundamental problem in this marketplace. Martin Eakes has characterized predatory lending as largely a problem of "misplaced trust." With extraordinarily complex transactions or products, with a startling lack of price transparency, even many educated borrowers have to rely upon the good faith and honesty of the "expert" they are dealing with on the phone or across the table. American business does not want to get to the point where every transaction must be an exercise in self-defense for the consumer. And it particularly does not want to get a reputation whereby that is especially the case for elder or unsophisticated consumers. Yet one of the things we heard over and over again was that specific questions about prepayment penalties were met with a breezy answer that that would not be a problem. Well, not if you don't mind adding as much as $9000 in some cases to pay off your loan early or refinance to a lower rate.

One of the rationales offered for prepayment penalties is that they are a "trade-off" for a lower rate upfront. In our experience, that is an after-the-fact rationalization that rarely, if ever, has panned out in the subprime market. We have not seen evidence of any such trade-off. Even if there were a trade-off, the lack of information about the price of the prepayment penalty or the value of the rate reduction it purports to purchase precludes an informed choice. If consumers

don't know what the cost of that prepayment penalty is, how are they to make an intelligent choice as to whether any rate trade-off is worth the price? If it's a choice at all, it's a black-box choice.

There is no law – not RESPA, not TIL – that helps consumers know in advance what it might cost them to prepay.[17] One of the reforms of the Household settlement is to bring transparency to the prepayment penalty clause. A disclosure must be given of the maximum prepayment penalty which could be imposed in a dollar amount. (Consent judgment, Para. 15(4)). Further, if a rate trade-off is available, the rate differential is to be disclosed early in the application process. (Consent judgement, Para. 15(1, 2).) Finally, the term during which a prepayment penalty may be charged is limited to the lesser of 24 months or as allowed by state law.[18]

. * "The Bridge is Out: Detour Ahead."

High LTV loans and prepayment penalties are effective anti-competitive tactics, as well. While those of us in the prime market had lenders competing to get our business as we searched for lower rates in a declining interest rate environment, these underwater (if not drowning) homeowners are trapped in high-cost high LTV loans by the fact that the cycle of equity-stripping loans has been completed for them -- there is no equity left. The prepayment penalty is a further tax that is not imposed on prime market borrowers seeking lower rates. "On the street" level lingo in the industry demonstrates that the trap is not unintentional. "Closing the back door," "building a fence around the customer," or "taking the customer out of the market" are phrases we've heard to describe lending practices designed to keep customers trapped in these high-cost loans.

These tactics are particularly disingenuous given the fact that many subprime loans are made with the representation that, while they cost more than market rate, they serve as a "bridge" to enable customers with no credit history or blemished history get into the prime market. (This is also one of the benefits often touted for the industry as a whole.) But there can be no bridge when the gate is down at the other end.

Shopping for Credit: the Myth of Self-defense

Shopping for mortgage credit in the subprime market differs greatly from the prime market. "Market" rates in the latter are widely publicized and widely quoted by originators. In contrast, there is virtually no price transparency in the subprime market. Rates and prices are rarely a feature of subprime advertising, and all too often in the subprime market, the game is more one of hide-and-seek, even for those who do ask. But many don't. One recent study shed light on why many borrowers may not do extensive shopping in the first place, with 39% believing that lenders were required by law to give them the best rate.[19] Thinking the law protects them from price-gouging or "opportunistic pricing," they mistakenly trust that there is no need for self-defensive shopping. But, as with the prepayment penalties discussed above, for shopping to work, it has to be met with honesty. Trying to double check the veracity of the sales pitch against the actual documents is no answer. First, the papers with the real numbers come too late in the process. The deal has been closed in all but the technical sense by the time the final deal comes out. Second, the pieces of paper with the useful information are buried in a blinding blizzard if legal jargon with no meaning to the lay person. (And it should be noted that the two documents with the most readable and useful information are the two mandated by federal law – the Truth in Lending disclosure and the HUD-1. It is not federal law that is

creating the information overload.) Third, the level of both language and quantitative skills demanded of mortgage borrowers is far beyond the performance level of most people, according to literacy studies.[20]

The FAMCO, Household and Associates cases all involved allegations of tactics or omissions used to systematically deceive consumers about the price of credit. First Alliance turned Truth in Lending on its head by confusing sales techniques used to make up to 20 points disappear from the consumers' eyes. Household was alleged to fail to give meaningful RESPA good faith estimates of closing costs, though typically charging over 7 points, and to make deceptive representations about the interest rates. (Credit insurance premiums often are omitted from good faith estimates, as well.) Associates' packing and flipping made any disclosures virtually meaningless.

We'd like to think that numbers can't lie, but they can. I referred earlier to the wide range of equity that can be extracted from a "$30,000, 15%" loan. (Appendix A, Table A) But there are many tricks numbers can play. When a loan officer says he can give you a loan that pays out like a 7.68% loan, that sounds reasonable. If he says, "your papers will say 12%, but it's really an effective rate of 7.68%," you might be skeptical. But he has a fancy calculator, and he punches in the numbers, and indeed, it comes out 7.68%. So even if your current loan is 10%, should still come out ahead, right? Not quite.

If you're a lender and your 12% - 14% rates don't look competitive in a falling rate environment, you can either lower the rates, or lower the quotes. If you choose the latter, you might have to back it up with smoke and mirrors. For example, the way to get from a 12% loan to a "7.68% effective rate" is to sell a bi-weekly payment plan. Any reduction in savings comes

from making an extra payment over the course of the year (which you could do on your 10% loan and still come out ahead. Also, you can usually make an extra payment plan without it costing extra, which the bi-weekly plan did.)

Similarly the self-inflating nature of the financed points and charges, as reflected in Appendices A and B is not something that even careful shopping would reveal. But when even the straight upfront dollar amounts of the closing costs are hidden until the last minute, the concept of shopping is illusory. RESPA's good faith estimates (GFE) of closing costs are required to be sent within 3 days of receipt of an application. A GFE showing 7 points ($7000) on a $100,000 loan application could be enough sticker shock early in the process to give a customer pause. But a GFE that discloses a range of, for example $0 -- $7000 is meaningless. That was another issue in the Household case. The rationale in this case spills out onto another myth about pricing in the subprime market. Points can be characterized as "origination points" or "discount points." In theory, a discount point "buys down" the note rate. But again, the lack of price transparency on the interest rates means there's no way to know whether the discount points buy down a rate. And in fact, there is often no evidence that it does. (It's akin to a scam in the auto sale arena, where the price of the purchased car is raised to offset a down payment, or a generous trade-in allowance. It's called "swallowing the down," or "swallowing the trade.") Unless a consumer knows what the rate would be without a discount point – honestly – there is no way to know whether the discount points purchase anything at all, or, if so, how the price paid compares to the value received.

Under the terms of the settlement, the good faith estimate must reflect the likely costs. For three years, Household will limit origination or discount points to 5% of the loan. If

discount points are offered, they must be bona fide, and the consumer must be told the price of the buy-down. (Consent Judgment, Para. 6 - 8.)

In selling loans as refinance loans or debt consolidation loans, comparing the prospective borrowers' present situation to the loan proposal, there can be a lot of apples being compared to a lot of kumquats. Constructing sales pitches which purport to blend existing mortgage debt and credit card debt into a single rate for comparison purposes can be misleading, as can comparisons of payments. Existing mortgage payments might include principal, interest, taxes and insurance (PITI), as most prime market loans do. But, unbeknownst to the customer, a proposed subprime loan may not escrow taxes and insurance (and most subprime loans do not.) Further, payment comparisons may be used based on a new loan amount which leaves out charges which almost certainly will be included in the loan. Assuring that debt burden comparisons are apples to apples is another feature of the Household settlement.

Spurious Open-end Credit and Balloon Payments

A number of our offices have long been concerned with the problem of "spurious open-end credit" – credit which for all practical purposes is closed-end credit, but disguised as open-end credit. Consumers do not get the information they need up front, before consummation, about the cost of credit – or even what the monthly payment burden will be with open-end credit. In a genuinely open-end context, this is understandable, because the debt amounts happen after the fact, and they fluctuate day to day. In spurious open-end, the amount of the loan is, for all practical purposes, fixed up front, with the initial disbursal filling the credit line (or exceeding it), and a payment schedule driven by that initial advance. In these circumstances, a reasonable

estimate of payment information could be calculated and given up front. But particularly with high priced loans, like some of the piggy-back second mortgages were, accurate before-the-fact information could lead to sticker shock and market resistance. With high-cost mortgage loans, there is an added advantage to the use of spurious open-end credit. Congress excluded open-end mortgages from the scope of HOEPA. That is why many of the piggy-back seconds, typically constructed as open-end, could carry rates as high as 20% - 24%, and not appear on the face of the documents to fall under HOEPA.[21]

These loans were all balloon loans. At those rates, to keep payments low, the loans would not amortize, and there would be a balloon. But there is no payment schedule information required for "open-end" loans, so the existence of a balloon payment on these loans would be a surprise. In the Household settlement, rather than argue about the dividing line between open- and closed-end credit (which in the past has stalled reform efforts on this issue), the settlement gives the consumers the specific payment information before they sign, not years later. (See Consent Judgment, Appx. A in Iowa's, Appx. B in many other states')

Perverse Incentives

One of the fundamental tensions in the subprime market is the correlation between increased costs and/or debt load for the borrower and increased compensation for the originator. The "reverse competition factor" creates a tension between the originator's best interests (higher loan amounts and loan costs) and the borrower's best interests (lower loan amounts and loan costs). One of the innovations of the Household settlement is the use of independent loan closers. The loans will be closed by people whose compensation is not dependent upon the terms of the loan or, for Household employees, loan volume. Furthermore, those closers will not

report to sales management. We hope this provides a circuit breaker on any incentive for deception in sales.

"Best Rate Available"

Related to reforms which seek to eliminate the incentive for the sales force to engage in opportunistic pricing is a provision in the settlement by which Household will provide applicants with the lower rate applicable to one of their products for which the borrower qualifies. As you know, there is evidence that the high-cost market has a sizeable number of borrowers whose credit risk would make them eligible for the prime market. As I mentioned above, almost 40% of respondents of one survey (and a higher percentage of minority borrowers) believe that lenders are required to give them the best rate for which they qualify.[22] We are happy that under the settlement agreement, that particular myth will move closer to reality.

CONCLUSION

The Household and Associates actions addressed a wide array of alleged practices – from sales to servicing. A copy of the Household petition is attached for your reference. The consent judgment is available on our website, and that of many other state Attorneys General and financial regulators. (www.IowaAttorneyGeneral.org) Some of these reforms are present in some form in some of the state laws (such as North Carolina's), and some give shape to the concept of fair and non-deceptive practices. We believe that reform, and greater protections, are not only possible, but in the long run, will lessen the likelihood of negative consequences on homeowners, lenders, communities and the economy as a whole of over-indebtedness and overpriced indebtedness. That isn't restricting access to credit – that's just good business, and that's good for business and good for all of us.

ENDNOTES

1. The Mortgage Bankers Association reports in its National Delinquency Survey for the third quarter of 2002 that 8.58% of subprime mortgages are in foreclosure, compared with 1.15% for all mortgages. The National Mortgage News Quarterly Data Report for the fourth quarter of 2002 reveals that there were $574 billion in subprime mortgage loans outstanding, or about 5.5 million mortgages, and 9% of the total outstanding residential mortgage debt reported by the Federal Reserve Board (about $6.3 trillion). There would therefore be about 470,000 subprime mortgages in foreclosure compared with roughly 250,000 prime conventional, FHA and VA mortgages, or 66% of all foreclosures. The MBA notes that its subprime foreclosure rate is based on a small sample of subprime lenders that may not be representative of the market as a whole. Using lower foreclosure rates of 5% to 6% would reduce the subprime share of foreclosures to about 55% of all foreclosures.

2. Roberto G. Quercia, Michael A. Stegman & Walter R. Davis, "The Impact of North Carolina's Anti-Predatory Lending Law: A Descriptive Assessment," Center for Community Capitalism, University of North Carolina at Chapel Hill. http://www.kenan-flagler.unc.edu/assets/documents/CC_NC_Anti_Predatory_Law_Impact.pdf [Hereafter Quercia, et al.]

3. 15 U.S.C. § 1641(d). See, e.g. *Problems in Community Development Banking, Mortgage Lending Discrimination, Reverse Redlining, and Home Equity Lending,* Hearings Before the Senate Comm. On Banking, Housing and Urban Affairs, 103d Cong. 1st Sess. (Feb. 17, 1993) [testimony of National Consumer Law Center.]

4. Securitized subprime loans increased over seven-fold between 1994 and 1999. See Quercia, et al, note 2, supra, at p. 2. (HOEPA became effective October, 1995).

5. *Inside B & C Lending*, p. 2 (February 3, 2003).

6. These are briefly described in the states' complaints. Typical of those complaints is State of Iowa v. Household, International, Petition, Para. 8(A) - (M), a copy of which is attached as Appendix C to this testimony.

7. Federal Trade Commission v. Citigroup Inc., et al, (N.D. Ga., No. 1:01 - CV - 0606 JTC, complaint filed March, 2001)

8. A study of subprime lending in Philadelphia suggests that the rate of refinancing prime to subprime loans and subprime to subprime loans is higher in what it terms "high potential vulnerability neighborhoods." It defines these neighborhoods to be ones with lower housing values, a high percentage of older homeowners and a high percentage of homes owned free and clear. "Predatory Lending: An Approach to Identify and Understand Predatory Lending," a report from the Reinvestment Fund (TRF).(www.http://www.trfund.com/policy/FordForWeb.pdf)

9. Older Subprime Refinance Mortgage Borrowers," AARP Data Digest # 74 (July, 2002)

10. Id.

11. That series of transactions included a "minnow" loan (called "Home Owners Express" by Associates) – a small unsecured loan for $8000 at 24%, payable in 6 months @ $1432 / month. That "Home Owners Express" loan is used as a kind of "bait and switch" for mortgage loan applicants and serves to undermine the Truth in Lending 3-day cooling off right for home equity loans. (See 15 U.S.C. §1635). Two days later, if these customers had balked at signing two loans (a first mortgage refinance @ 17.5% and a second @ 21%), or tried to rescind it, they'd be told they'd still have to pay that $8000 at 24% in unaffordable installments. There were $7000 credit insurance premiums charged in those two mortgages, and the payments were over $300 than they would have been without a forced first lien refinance and insurance packing. Realizing that Associates had pushed too far, Citifinancial rewrote the Associates 1st and 2nd loans just 4 months later, lowering the rates to a still high 15%, but adding $10,600 in credit insurance premiums in the process. That helpful refi took the outstanding encumbrance on the

home from $104,240 (a 140% combined LTV) to $112,251 (a 152% CLTV.)

12. Quercia, et al, supra note 2, at p. 17.

13. *Inside B & C Lending* reported Household loans up from $15.27 billion in 2000 to $20 billion in 2002, while Citifinancial's went from $18.8 billion in 2000 to $19.6 billion in 2002. (*Inside B & C Lending,* March 19, 2001 and February 3, 2003.)

14. For example, these loans are also often unaffordable, or only barely so. In the event of job loss or health expenses, a foreclosure may threaten. In normal circumstances, a consumer could try to sell the home privately at a fair market value, pay the foreclosing lender, and still recoup some equity to move or start over. That is not possible in these circumstances.

15. "Upselling" is urging more debt than the borrower sought. It happens when a borrower who seeks a $6000 home repair loan is upsold to a $47,000 cash-out refinance; it happens when a straight refinance loan is turned into a debt consolidation loan. It happens when the loan broker or retail loan officer calls back and says "Your appraisal came back higher than we thought. We can give you some extra cash. Think you could use that for a little fix-up around the house?" (Unfortunately, that appraisal is often inflated -- a fact which can come back to haunt the borrower -- and perhaps the lender -- later on.) And while the pitch is often that it is cheaper to roll credit card debt into a mortgage, that loses a lot of its persuasiveness when the mortgage turns into a piggy-back pair at 12% and 20% or higher.

16. The language from one home equity line of credit addresses the prepayment penalty below the middle of page 3 of a 5 page agreement. It says that if you prepay within five years, you agree to pay a prepayment penalty equal to six months interest, "determined by applying the monthly periodic rate in effect as of the pay off date on the credit limit as shown on page one." That APR equivalent of that periodic rate was 20.15%.

17. TIL simply requires that a box be checked that says "You may have to pay a prepayment penalty." Reg. Z, § 226.18(k). Whether that would be $50 or $5000, the consumer would have to ask. And if they don't get a straight answer, as note 15 indicates, it is not easy to "trust, but verify."

18. The deletion of prepayment penalty laws from the list of state laws preempted by AMTPA will be of great help in states like mine which limit prepayment penalties.

19. "The Growing Demand for Housing," 2002 Fannie Mae National Housing Survey, p. 9. (The figure was higher for minorities.) (http://www.glensold.com/fnmasurvey2002.pdf)

20. See Alan M. White and Cathy Lesser Mansfield, *Literacy and Contract,* 13 Stanford Law & Policy Review 233 (2002).

21. An amendment to HOEPA regs in 2001 specifically makes it an unfair and deceptive practice to structure a loan as open-end to evade HOEPA requirements. Reg. Z, § 226.34(d).

22. See note 19, above.

SUBPRIME ALCHEMY
APPENDIX A:
SELF-INFLATING CHARGES:
POINTS AND SINGLE PREMIUM CREDIT INSURANCE

Loan purpose: **refinance a $30,000 debt.**
Note Interest rate: **15%**
Term: **15 years (180 months)**

1. **No frills:** (See Table A, column #1)

Principal: $30,000.00 *Itemization: $30,000 pay off old debt*
Interest: $45,578.40
Total of payments: $75,578.40

Mo. Pmt: $ 419.88[1]

2. **Add single premium credit life**: (See Table A, column #2)

a. Single premium credit life charge is typically financed as part of the loan principal.

b. Gross coverage credit insurance pays to insure everything – including unearned interest and the insurance premiums themselves.

c. Where the legally permissible rate is cast as $*x per $100 per year,* the formula for determining the maximum legal premium is:

$$\frac{\text{legal max. rate } x \text{ years insurance is in force } x \text{ total of payments/insured indebtedness}^{2}}{100}$$

d. For purposes of illustration, this sample assumes that the legal maximum rate for single decreasing credit life set by the state insurance department is 47 cents per $100 per year.[3]

---

[1] A complete amortization table would show a precise payment schedule of 179 payments of $419.88 plus 1 final payment of $417.11. To simplify matters, all of these sample runs use 180 equal payments.

[2] If gross coverage insures the entire total of payments, that is the figure used. If the insured amount is something other than that, the initial insured indebtedness amount is substituted. For example, there may be a $100,000 insurance maximum, though the total of payments might be $110,000.

If the lender wishes to increase the premium when the loan is so large that the total of payments hits the maximum, it can increase the years of coverage. (Or, it can add other types of insurance coverage, such as disability or involuntary unemployment. For simplicity's sake, the illustrations in these appendices include only credit life.)

[3] This was the rate in effect in Illinois recently for single decreasing term credit life.

e. It also assumes truncated coverage for 5 years.

f. A straight-forward application of that formula to the "no frills" contract would come up with a premium of $ 1776.09, if the consumer were to pay it in cash at closing.

$$\frac{.47 \; x \; 5 \; x \; \$75{,}578.40}{100}$$

g. However, since in practice these premiums are financed, either the consumer would get $1776.09 less than sought, or the premium charge has to be added to the basic loan amount, raising the principal above the initial $30,000 sought. Since the purpose of this loan is to refinance a $30,000 loan, the principal must be hiked to cover the insurance premium.

If just the $1776 premium amount were added to the "no-frills" principal of $30,000, the new principal would be $31,776.09. However, that in turn raises the total of payments to $80,051.40, when we hold the 15% note rate and the 180 month term constant. Since the total of payments – part of the formula used to calculate the premium – has now grown, the original premium is too low. So the premium grows yet more. In this sample, it grows 6%, by almost $112 to $1887.98.

h. Adding 5- year truncated credit life, the loan terms now looks like this:

Principal:	$31,890.00	*Itemization:*	*$30,000.00 pay-off old debt*
			$ 1,887.98 credit insurance prem.
			$ 2.02 to borrower[4]
Interest:	$48,449.40		
Total of payments:	$80,339.40		
Mo. Pmt:	$ 446.33		

i. Adding the insurance added nearly $1900 to the loan principal, which added $2871 to the interest. These increased costs added $26.45 to each monthly payment for 15 years.

<u>3.</u> **<u>Add 7.9 financed points to the "no-frills" loan</u>** (See Table A, column #3)

a. If this borrower were asked to bring 7.9% in points to closing in cash, she would pay $2370 on her $30,000 no-frills loan.

b. Points are financed in the subprime market. By financing the points, the principal is

[4] There are minimal cash outs because the additional calculations necessary to bring that to $0 for purposes of this illustration were not worth the time. They are too small to make a meaningful difference in the underlying points being illustrated in these Appendices.

raised, and the points are calculated on higher amount which includes the points themselves, thus raising the dollar value of the points. The compounding in this example raises the dollar value of 7.9 points from $2370 to $2573.43 -- an 8.6% increase.

c. For this borrower to have the $30,000 to cover the debt being refinanced, and pay the lender the 7.9% in points, the loan will look like this:

Principal:	$32,575.00	*Itemization:*	*$30,000.00 pay-off old debt*
			$ 2,573.43 lender points
			$ 1.57 to borrower
Interest:	$49,490.60		
Total of payments:	$82,065.60		
Mo. Pmt:	$455.92		

d. Adding financed points increased the principal from the basic no-frills loan by almost $2600, which added over $3900 to the interest earned at 15% on the loan. The resulting monthly payment is $36 higher.

4. Add both credit insurance and 7.9% points (See Table A, column #4)

a. The self-inflating price of each of these charges individually has a cross-effect, inflating each other, as well, when they are financed.

b. Adding both single premium credit life and 7.9% points to her loan, it would look like this:

Principal:	$34,812.00	*Itemization:*	*$30,000.00 pay-off old debt*
			$ 2,060.94 insurance premium
			$ 2,750.15 points to lender
			$ .91 to borrower
Interest:	$52,887.60		
Total of payments:	$87,699.60		
Mo. Pmt:	$ 487.22		

c. Adding both single premium credit life and 7.9% points raised the principal amount from the no-frills loan by 16%, adding over $4800 to the basic $30,000 loan amount. The inflated principal then increased the scheduled interest by $7309.20. The monthly payment, in turn, increased by $67.34.

SUMMARY -- TABLE A

All at 15% note rate (equal monthly installments) -- 180 months				
	# 1- No-frills	# 2 SPCI charged	# 3 – 7.9 points charged	# 4 -- both SPCI & 7.9 points
To borrower *-Pay-off prior debt* *-cash*[5]	 $30,000.00 0.00	 $30,00.00 2.02	 $30,000.00 1.57	 $30,000.00 0.91
Credit insurance prem		$ 1,887.98		$ 2,060.94
7.9 points			$ 2,573.43	$ 2,750.15
Note principal	$30,000.00	$31,890.00	$32,575.00	$34,812.00
Note interest	$45,578.40	$48,449.40	$49,490.60	$52,887.60
Total of payments	$75,578.40	$80,339.40	$82,065.60	$87,699.60
Monthly payment	$ 419.88	$ 446.33	$ 455.92	$ 487.22

[5] See Appendix note 4, *supra.*

APPENDIX B
PREPAYMENT: FRONT-LOADING THE COST

Most mortgages pay off early. Lenders can increase their revenues from a given loan during its shortened life by front-loading the loan principal with charges which the lender keeps all or a significant portion of when the loan prepays early. Points, for example, are typically not rebated upon early termination. While "unearned" credit insurance premiums are required in most states to be rebated upon early termination, two factors skew the rebate in lenders' favor. First is the method by which credit insurance rebates are calculated in many states. Many states – if not most – permit credit insurance premium rebates to be calculated by an anachronistic pre-computer formula which favors the lender, the Rule of 78. Second, truncated coverage (insurance in force during only part of the loan term) front-loads the earned portion of the premium. For example, if an insurer wrote 2-year truncated coverage on a 15-year loan, there would be no insurance rebate if the loan were refinanced in three years.

These front-loaded credit costs are embedded in the pay-off balance on the loan. That increases the return on the loan being paid off. If the loan is being paid off by refinancing – part of a flipping sequence, for example – those embedded costs in the pay-off balance carry forward into the new loan, and the inflationary cycle begins anew. In the process, more equity is stripped from the home.

The same loan and variations on it described in Appendix A can be used to illustrate the point. Assume that each of the variations described in A were prepaid at the 36th month.

PREPAYMENT OR REFINANCING AT 3 YEARS ON 15-YEAR LOAN

1. No frills loan: (See Table B column #1)

Pay-off balance: $28,395.07
Interest earned: $13,090.87
Other credit costs earned: $ 0.00
Effective cost on $30,000
real loan amount over 3 years: 15%

2. Single premium credit life insurance: (See Table B, column # 2)

Pay-off balance: $29,874.65
Interest earned: $13,915.64
Other credit costs earned: $ 1,578.54 (84% of original $1888 credit insurance premium)
Effective yield on $30,000
real loan amount over 3 years: 17.37%

3. **7.9 points** (See Table B, column # 3)

Pay-off balance: $30,832.34
Interest earned: $14,214.54
Other credit costs earned: $ 2,573.43 (100% points considered earned at consummation)
Effective yield on $30,000
real loan amount over 3 years: 18.55%[6]

4. **Single premium credit life insurance plus 7.9 points** (See Table B, column 4)

Pay-off balance: $32,612.24
Interest earned: $15,190.73
Other credit costs earned: $ 2,750.15 (100% points considered earned at consummation)
$ 1,723.15 (84% of credit insurance premium)
Effective yield on $30,000
real loan amount over 3 years: 21.2%[7]

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[6] The originally disclosed APR on this loan would have been 16.73%, reflecting the points as a finance charge.

[7] The originally disclosed APR on this loan would also have been 16.73%.

SUMMARY -- TABLE B

15 % note rate; 180- month term; prepayment at month 36				
	# 1 -- No-frills	# 2 -- SPCI charged	# 3 -- 7.9 points charged	# 4 -- both SPCI & 7.9 points charged
To borrower (pay-off prior debt)	$30,000.00 + 0.00	$30,000.00 + 2.02 cash	$30,000.00 + 1.57cash	$30,000.00 + .91cash
Pay-off balance	$28,044.51	$29,874.65	$30,832.34	$32,612.24
Interest earned	$13,090.87	$13,915.64	$14,214.54	$15,190.73
Other credit costs earned (embedded in the pay-off balance above)	$ 0.00	$ 1,578.54 (84% ins. prem.)	$ 2,573.43 (100% points)	$4,473.30 (Sum of *$ 1,723.15 (84% ins. prem.) +$ 2,750.15 (100% points)*)
Total credit cost earned during 3 yrs.	$13,090.87	$15,494.18	$16,787.97	$19,664.03
Effective yield over 3 year term[8]	15%	17.37%	18.55%	21.2%

[8] This effective yield calculation ignores the minimal cash amounts.

APPENDIX C

State v. Household

Standard Petition entered in the Settlement between
50 States and the District of Columbia and Household, International,
December, 2002

The Consent Judgment is available on our web site, and that of many other state attorneys general and financial regulators.

http://www.iowaattorneygeneral.org/latest_news/releases/dec_2002/hhconsent.pdf

The multistate was a joint effort by both state financial regulators and attorneys general, the first such cooperative effort.

IN THE IOWA DISTRICT COURT FOR POLK COUNTY

<table>
<tr><td>STATE OF IOWA ex rel.
THOMAS J. MILLER,
ATTORNEY GENERAL OF IOWA,
99AG25112,

Plaintiff,

v.

HOUSEHOLD INTERNATIONAL, INC.
a Delaware corporation,

Defendant.</td><td>)
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)</td><td>Equity No. CE 45408

PETITION AND REQUEST FOR
INJUNCTION, RESTITUTION AND
OTHER EQUITABLE RELIEF</td></tr>
</table>

Comes Now the State of Iowa ex rel. Thomas J. Miller Attorney General of Iowa, by Assistant Attorney General Kathleen Keest, and brings this action pursuant to the Iowa Consumer Fraud Act, Iowa Code § 714.16. Plaintiff seeks, among other things: a permanent injunction, an order compelling Defendant to pay restitution to consumers and an order reforming contracts between Defendant and Iowa consumers. For its claim, Plaintiff states as follows:

PARTIES, JURISDICTION AND VENUE

1. Thomas J. Miller is the duly elected Attorney General of Iowa. The Attorney General is vested with authority to enforce the Consumer Fraud Act, which prohibits unlawful practices, including "unfair practices" which cause "substantial, unavoidable injury to consumers that is not outweighed by any consumer or competitive benefits which the practice produces," and deceptive practices which have the capacity or tendency to mislead a substantial number of customers as to a material fact or facts. Iowa Code §§ 714.16(1), (2)(a) (2001).

2. In a civil action alleging an unlawful practice the Attorney General has the statutory authority to obtain injunctive relief, monetary reimbursement for consumers and other relief. Iowa Code § 714.16(7) (2001).

3. Defendant Household International, Inc., a Delaware corporation, and/or its direct and indirect subsidiaries, affiliates, officers, directors, employees, agents, related entities, successors, and assigns (collectively, "Household"), at all times mentioned herein, have transacted business within the State of Iowa, through its consumer lending subsidiaries.

4. Venue is proper in Polk County, Iowa.

5. Pursuant to Iowa R. Civ. P. 1.207, no security is required if the State is seeking injunctive relief.

6. No application for injunctive relief in connection with the business practices of Household has previously been presented by the State to, or denied by, any court.

GENERAL ALLEGATIONS

7. In the ordinary course of its business, direct or indirect subsidiaries of Household Finance Corporation ("HFC"), a subsidiary of Defendant Household International, Inc., have negotiated and entered into real-estate secured loans with consumers in the State of Iowa. These real-estate secured loans with the consumers were made from or at Household's retail lending branches during between the period January 1, 1999 through September 30, 2002 (the "Covered Transactions").

8. State attorneys general and state financial regulators in this state and in other states have received and investigated complaints and conducted examinations concerning the Covered Transactions. Those complaints and investigations related to Household's conduct with respect to the following practices, (collectively, "the Lending Practices"):

A. Two real-estate secured loans made at or near the same date to the same consumer ("split loans," or "loan splitting"): Plaintiff alleges that such loans were made through unfair and deceptive means, including, but not limited to, misrepresentations or omissions concerning the number of loans, misrepresentation of the benefits of refinancing and debt consolidation with the high-cost split loans; and as a means to make high loan-to-value mortgage loans which had the effect of preventing borrowers from seeking to refinance with lower rate lenders.

B. Loan points and origination fees: Plaintiff alleges that Defendant failed to provide timely and adequate information to borrowers concerning the amount and purpose of the putative "discount" or "buy-down" points and fees imposed on their loans, including, but not limited to, failing to provide meaningful early disclosures as required by law, 24 C.F.R. § 3500.7.

C. Misrepresentation of interest rates: Plaintiff alleges that Defendant misrepresented the interest rates to be charged on loans through such means as using a "low-ball" rate purporting to be an "effective" rate, or equally deceptive term. Such misrepresentations and omissions occurred in the context of Defendant's attempting to disguise a high-rate mortgage as a low-rate mortgage through use of (for payment of an additional fee) a bi-weekly payment plan. Plaintiff failed to inform consumers that accelerated principal reduction occurred through making extra payments, instead misleading consumers into thinking the savings were attributable to lower interest charges than the loans provided for. Additionally, misleading comparisons were made between rates on existing debts which applicants were considering refinancing or consolidating, and the rate(s) to be charged on Defendant's proposed loan or loans.

D. Monthly payment amounts: Plaintiff alleges that Defendant failed to inform consumers that higher payments, rather than lower rates, were the feature of the bi-weekly payment program which would result in overall savings in finance charges. Further, in making sales presentations with respect to refinancing and debt consolidation applications, Defendant

made misleading comparisons of monthly payment obligations between existing debts and the proposed new loan or loans to be made by Defendant.

E. Single premium credit and other insurance product: Plaintiff alleges that Defendant engaged in a pattern of "insurance packing," including, but not limited to, misleading consumers as to the voluntary nature of the insurance, to the price of the insurance, and the benefits and/or term of the insurance.

F. Prepayment penalties: Plaintiff alleges that Defendant engaged in a practice of misleading consumers about the presence of prepayment penalties on their loans.

G. Unsolicited loans offered through an unsolicited negotiable check that the consumer can accept by endorsing and depositing or transferring the check ("live checks"): Plaintiff alleges that Defendant used "live checks" as a "bait" to make high-cost mortgage loans; used misleading representations, such as that the receipt of a live check constituted a "guaranteed loan approval," and failed to adequately inform consumers that the unsolicited check was a loan.

H. Practices with regard to home equity lines of credit: Plaintiff alleges that Defendant extended what was in substance closed-end credit disguised as open-end credit with the intent to avoid making meaningful disclosures concerning the payment terms, such as the existence of large balloon payments. Plaintiff further alleges that Defendant extended what was in substance closed-end credit with APRs in excess of 10% over the US treasury rate for comparable maturities, disguised as open-end credit to evade the requirements of the Home Ownership and Equity Protection Act, 15 U.S.C. § 1639.

I. Loan billing practices relating to simple interest calculations: Plaintiff alleges that Defendant's practices by which payments were credited to accounts on the basis of the number of days between payments frequently resulted in situations in which scheduled payments were insufficient to pay accrued interest, creating a shortfall in interest ("interest short"), which

resulted in excess finance charge costs for borrowers. Such shortfalls could occur even when payments were not late. Defendants further made representations concerning the opportunity to "skip a payment," without informing consumers that such would result in "interest short" situations. Defendants failed to provide borrowers with material information necessary to avoid such extra charges.

J. Balloon payments: Plaintiff alleges that Defendants extended credit to borrowers which would eventually require balloon payments, without disclosing to borrowers the existence or amount of the balloon payments.,

K. Pay-off information: Plaintiff alleges that Defendants failed to provide timely pay-off information, which impeded borrowers' efforts to seek refinancing elsewhere.

L. Non-English language documentation: Plaintiff alleges that Defendants engaged in unfair and deceptive practices by failing to provide meaningful descriptions of loan terms to non-English-speaking borrowers.

M. Net tangible benefit in loan refinancing. Plaintiff alleges that Defendants engaged in the practice of refinancing its own or other loans, thereby imposing additional fees and costs, where the new loan provided no net tangible benefit to the consumer.

UNFAIR AND DECEPTIVE PRACTICES
IOWA CODE § 714.16

9. Plaintiff realleges and incorporates by reference the allegations of Paragraphs 1 to 8 of this Petition.

10. Defendant, through its direct or indirect subsidiaries, engages in trade or commerce in connection with the sale of intangible "merchandise" within the meaning of Iowa Code § 714.16, by making loans to consumers in "sub-prime" mortgage loan market. Defendant advertises, offers, solicits sales of, and sells real estate secured loans and related goods and

services to Iowa consumers.

11. Defendant, through its direct and indirect subsidiaries, engaged in the business of making loans to Iowa consumers that were secured by those consumers' homes. Defendant used misleading unfair or deceptive promotions, marketing and sales techniques to induce primarily low and moderate-income homeowners to refinance their mortgages and consolidate their debts using Household's real-estate secured loan products.

12. In the course of its dealings with consumers and in furtherance of its own direct pecuniary and business gains, Defendant committed deceptive or unfair acts, or made material misrepresentations or omissions in violation of Iowa Code § 714.16(2)(a).

WHEREFORE, the Attorney General prays that the court:

A. Permanently enjoin Defendant, its direct and indirect subsidiaries, affiliates, officers, directors, employees, agents, related entities, successors, and assigns, and any and all other persons who act under, by, through, or on behalf of Defendant, pursuant to Iowa Code § 714.16(7), from:

(1) Making or disseminating any misleading unfair or and deceptive representations in violation of Iowa Code § 714.16(2), relating to the marketing or sale of loans to consumers.

(2) Engaging in unfair and deceptive practices referenced in the Petition, in violation of Iowa Code § 714.16(2).

B. Order the Defendant make restitution pursuant to Iowa Code § 714.16(7) to consumers who paid or are obligated to pay money to Defendant under circumstances alleged herein to be in violation of Iowa law.

C. Order the Plaintiff be awarded such recompense as is authorized under Iowa Code § § 714.16(7), (11).

D. That the Plaintiff be awarded such other and further relief as the Court deems just and proper and is equitable under the circumstances.

Dated:

[December 12, 2003]____________________

THOMAS J. MILLER
Attorney General of Iowa

By:

S/________________________________

[****]
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Consumer Protection Division
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