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Subcommittee on Financial Institutions and Consumer Credit

Hearing: Rising Regulatory Compliance Costs and Their Impact on the Health of Small Financial Institutions

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Chairman Capito, Ranking Member Maloney, and Members of the Subcommittee, thank you for inviting me to testify at today's hearing. I look forward to answering your questions.

I currently serve as President of the Center for Responsible Lending (CRL), a nonprofit, nonpartisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is an affiliate of Self-Help, a nonprofit community development financial institution with a 30 year track record of serving low-income, rural, women-headed, and minority families. Self-Help's two credit unions, the state chartered Self-Help Credit Union and the federally chartered Self-Help Federal Credit Union, manage a total of $950 million in assets for approximately 90,000 members in North Carolina and California. Prior to my current position at CRL, I have also served at various points as General Counsel, Director of Real Estate Development and Director of the Secondary Market Program at Self-Help.

In my testimony today, I would like to touch on three main points:

- **Abusive Lending Practices Led to the Ongoing Foreclosure Crisis, Which is Not Yet Halfway Over:** As we all know, the 2008 financial crisis and the related housing market collapse have been disastrous for households and communities across the country. CRL's research shows that we are not yet halfway through the foreclosure crisis, which was fueled by abusive lending practices that have disproportionately affected African-American and Latino borrowers.

- **Financial Reform – Including the Creation of the Consumer Financial Protection Bureau – is Good for Consumers as well as for Safety and Soundness:** In the years leading up to the 2008 financial crisis, federal banking regulators failed to protect consumers from abusive and predatory practices. This not only harmed individual consumers, but it also jeopardized the safety and soundness of financial institutions and the broader financial sector. The Dodd-Frank Wall Street Reform and Consumer

Protection Act – as well as the CARD Act – are important financial reforms that will produce benefits for both consumers and financial institutions.

- **Upcoming Regulations on Mortgage Lending Will Level the Playing Field for Consumers:** The Consumer Financial Protection Bureau's upcoming rulemaking on the Ability to Repay and Qualified Mortgage provisions in Dodd-Frank will be a critical reform, especially for communities that were targeted for mortgages with abusive and predatory terms. CRL supports an Ability to Repay and Qualified Mortgage rulemaking that 1) specifies a broad qualified mortgage definition to encompass the vast bulk of the market; 2) establishes bright lines providing lenders with certainty about whether a mortgage can be designated as a qualified mortgage; and 3) determines that qualified mortgage status is a rebuttable presumption and not a safe harbor from any future liability concerning lender requirements to determine a borrower's ability to repay a mortgage.

1. Abusive Lending Practices Led to the Ongoing Foreclosure Crisis, Which is Not Yet Halfway Over.

In looking at the current regulatory environment for financial institutions, I believe it is essential to begin my remarks today talking about the recent financial crisis and housing market collapse. It is an understatement, as we all know, to say that the last five years have been difficult ones for homeowners and communities. In recent years, homeowners have lost over $7 trillion in home equity, leaving over 11 million homeowners owing more on their mortgage than the current value of the house. Additionally, millions of homeowners have lost their home through foreclosure.

Further, the far-reaching impact of the 2008 financial crisis on financial institutions of all sizes has revealed the dramatic cost of lax regulation. Since 2008, over 400 financial institutions have failed, which is a substantial increase from 27 failures between 2000 and 2007. As of 2010, bank write downs and credit losses in the U.S. have exceeded $1 trillion.[1]

Over the last ten years, CRL has produced research highlighting the increased foreclosure risk posed by abusive lending practices. In 2006, which pre-dated the worst of the foreclosure crisis, CRL released a report estimating that abusive and predatory lending would lead to approximately 2.2 million foreclosures among subprime mortgages.[2] At the time, our report was denounced by the mortgage industry as absurdly pessimistic. Sadly, the system was even more

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[1] *See* Jan Schildbach, Deutsche Bank Research, *Direct fiscal cost of the financial crisis*, (May 14, 2010), available at http://www.dbresearch.de/PROD/DBR_INTERNET_EN-PROD/PROD0000000000257663.pdf.

[2] *See* Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest, *Losing Ground: Foreclosures in the Subprime Market and Their Costs to Homeowners*, (December 2006), available at http://www.responsiblelending.org/mortgage-lending/research-analysis/foreclosure-paper-report-2-17.pdf

loaded with risk than we reported, and the damage has been far worse, spreading from the subprime sectors to Alt-A loans, catalyzing a housing-led recession and triggering historic levels of unemployment.

At the end of last year, CRL released a report entitled *Lost Ground* that builds on our pre-2007 research to conclude that the country is not yet halfway through the foreclosure crisis.[3] This research shows that for mortgages made during the 2004 to 2008 lending boom, 8.3% were at least 60 days delinquent or in the foreclosure process as of February 2011. This represents another 3.6 million households that could possibly lose their homes. This is on top of the 6.4% of mortgages – totaling 2.7 million households – identified in CRL's study that have already gone through foreclosure. Because our research focused only on 2004 to 2008 originations, these estimates are likely to be on the conservative side. For example, Moody's has reported the completion of 5 million foreclosures or short sales already.

Lost Ground also demonstrates the link between abusive lending practices – which exploded between 2004 and 2007 – and higher foreclosure rates and serious delinquency rates. Loans originated by a mortgage broker, containing hybrid or option ARMs, having prepayment penalties, and featuring high interest rates (subprime loans) were all significantly more likely to be seriously delinquent or foreclosed upon than a 30-year fixed-rate mortgage without a prepayment penalty.

Research that controls for borrower characteristics confirms this link between abusive lending practices and foreclosure rates. In a study conducted by the University of North Carolina at Chapel Hill and CRL, the authors found a cumulative default rate for borrowers with subprime loans to be more than three times that of comparable borrowers (e.g., those with low FICO scores and high LTVs) who received prime loans through a Self-Help lending program.[4] Furthermore, the authors found that adjustable interest rates, prepayment penalties, and mortgages sold by brokers were all associated with higher loan defaults. In fact, when risky features were layered into the same loan, the resulting risk of default for a subprime borrower was four to five times higher than for a comparable borrower with the lower- and fixed-rate mortgage from a retail lender.

The costs of this steering and predatory lending have been particularly high for African-American and Latino borrowers. *Lost Ground* found that foreclosures and mortgage delinquencies continue to have had a disproportionate impact on African-American and Latino borrowers. It is critical to emphasize that this disproportionate impact persists even when

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[3] *See* Debbie Gruenstein Bocian, Wei Li, Carolina Reid, and Roberto G. Quercia, *Lost Ground, 2011: Disparities in Mortgage Lending and Foreclosures*, (November 2011), available at http://www.responsiblelending.org/mortgage-lending/research-analysis/Lost-Ground-2011.pdf.

[4] *See* Ding, L. et al. (2011). "Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models," *Journal of Real Estate Research* 33(2): 245-77.

comparing borrowers with higher incomes. CRL's research also demonstrates that African-American and Latino borrowers were much more likely to receive mortgages with the harmful features described above. For example, African-American and Latino borrowers with FICO scores above 660 were three times as likely to have a high interest rate mortgage than white borrowers in the same credit range.

2. Financial Reform – Including the Creation of the Consumer Financial Protection Bureau – is Good for Consumers as well as for Safety and Soundness

Self-Help is one of the country's largest community development financial institutions, and our mission is to create ownership and economic opportunity for all. Our two credit union affiliates, the state chartered Self-Help Credit Union and the federally chartered Self-Help Federal Credit Union, now manage $950 million in assets on behalf of nearly 90,000 members across North Carolina and California. In addition, Self-Help has provided over $6 billion in capital to more than 74,000 families of modest means, small businesses, and non-profit organizations. The credit unions have combined to help more than 4,700 families become homeowners and have originated more than 13,000 responsible auto and personal loans. Overall, 82% of Self-Help's borrowers have been low-income and 45% have been people of color.

Even before the financial crisis and housing market collapse, Self-Help and CRL had been at the forefront calling for proper regulation of abusive lending practices. Federal regulators should have been policing the marketplace and creating fair rules of the game. Instead, the agencies responsible for protecting depositors, shareholders, taxpayers, borrowers, and the general financial system failed. They stood by as predatory practices and dicey lending became commonplace, ravaging the mortgage market and setting off a chain reaction of financial devastation.

It was in the context of these massive federal regulatory failures that Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act, which included the creation of an independent Consumer Financial Protection Bureau. The history of the financial crisis is one in which prudential regulators – tasked with evaluating both safety and soundness and consumer protection concerns – largely focused on short-term profitability as an illusory proxy for safety and soundness, giving short shrift to consumer protection. By creating the CFPB, Congress wisely consolidated the consumer protection functions of the federal prudential regulators into one independent agency with a mission to protect borrowers from abusive financial practices. This will not only benefit borrowers, it will also help ensure the long-term sustainability of financial institutions.

Self-Help and CRL supported passage of the Dodd-Frank Act, including the creation of the CFPB in Title X and the Mortgage Reform and Anti-Predatory Lending Act in Title XIV. This support was out of recognition that proper regulation is necessary in order to have a marketplace that is safe for consumers of all incomes and for the ongoing safety and soundness of financial institutions themselves. It also reflects Self-Help's mission and belief in serving borrowers with affordable products that help families build wealth.

The mortgage reforms of the Dodd-Frank Act will prevent a reoccurrence of the mortgage crisis. They include limiting upfront points and fees to 5% for non-HOEPA loans; significantly limiting prepayment penalties; prohibiting compensation for mortgage originators based on loan terms other than principal balance (i.e., yield-spread premiums); prohibiting single premium credit insurance and mandatory arbitration; requiring that escrows be included for higher-price mortgage loans; requiring that lenders document income; and giving lenders incentives to offer safer, low-fee qualified mortgages. In addition, Congress gave the CFPB examination and enforcement authority over non-bank mortgage brokers and nonbank mortgage lenders and also provided the CFPB with rulemaking authority on national servicing standards. These efforts will not only level the playing field among industry actors, but they will also ensure that consumers have improved access to mortgage products and services that build wealth instead of stripping equity.

Much attention has been paid in recent months on the regulations resulting from the passage of Dodd-Frank. I think, however, it is worth emphasizing that the largest threats to Self-Help's operations – and to our depositors and borrowers – were the causes and outcomes of the 2008 financial crisis. In the aftermath of the crisis, we have had to focus our resources on helping customers and borrowers deal with the challenges of the current economy over making new loans, although this focus is changing as the economy improves. In contrast, Self-Help has not faced increased regulatory compliance costs as a result of Dodd-Frank to this point. Because Self-Help, along with most smaller depository financial institutions, does not engage in proprietary trading, for example, the Dodd-Frank provisions on this issue have not affected our credit unions. Instead, Self-Help's ongoing regulatory resources in the years following the financial crisis have continued to focus on areas such as Bank Secrecy Act requirements, although these obligations are not related to the financial crisis itself.

It would be overly simplistic to give the impression that Self-Help will never face regulatory compliance costs associated with Dodd-Frank requirements, but Self-Help does not anticipate this being an undue burden in the future. In addition, Self-Help's two credit unions and our depositors will benefit from a post-Dodd-Frank level playing field where large financial institutions and non-bank entities are supervised by the CFPB, which is particularly notable for those non-bank entities facing supervision for the first time. Furthermore, the regulatory reforms

included in Dodd-Frank will also help prevent future financial crises if they are implemented and enforced appropriately.

While the benefits of these Dodd-Frank provisions to level the playing field far outweigh the costs of adapting to this new regulatory system, it is also important to highlight that Dodd-Frank made several accommodations for smaller financial institutions in creating the CFPB's new authorities. This includes exempting small financial institutions with less than $10 billion in assets from CFPB supervision. Instead, all consumer protection supervision for these smaller institutions will remain with their prudential regulator. The CFPB is also required to evaluate and consider the impact of future rulemaking on small financial institutions, and the mortgage bill includes several accommodations to the needs of community banks. Additionally, Dodd-Frank requires the CFPB to reduce future regulatory burdens by streamlining regulations, such as CFPB's "Know Before You Owe" initiative to combine TILA and RESPA mortgage disclosures.

In addition to Dodd-Frank reforms, I should also mention reforms that have occurred because of the Credit Card Accountability, Responsibility and Disclosure Act (CARD Act). This legislation is another example of how improved oversight both benefits consumers and levels the playing field among lenders. Just yesterday, CRL released a new research report *Predatory Credit Card Lending: Unsafe, Unsound for Consumers and Companies* that examined marketing and pricing practices prevalent in the credit card industry before the CARD Act eliminated them.[5] These practices—which were often done in a deceptive, non-transparent way—included imposing high-cost penalty interest rates even when a consumer paid his card on time, manipulating indexes to calculate interest rates to the disadvantage of card holders, and shortening billing cycles to trigger late fees. The CRL report shows that credit card losses in the current downturn increased faster at banks engaged in such practices. That's because these predatory practices were not used as risk-management tools, as lenders claimed at the time. Instead, CRL's research shows, these predatory fees and rates didn't reflect the likelihood that a consumer would default but *were* the risk that drove consumers into default.

It is also worth noting that we found that these deceptive practices were concentrated among the largest credit card lenders, while smaller lender practices were much more transparent. And previous CRL research shows that CARD Act reforms have made pricing clearer, without making credit scarcer or more expensive.

In sum, strong consumer protections make pricing more transparent and lenders more financially stable. That's good for consumers, companies and the economy.

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[5] *See* Joshua M. Frank, *Predatory Credit Card Lending: Unsafe, Unsound for Consumers and Companies*, (May 2012), available at http://www.responsiblelending.org/credit-cards/research-analysis/Unsafe-Unsound-Report-May-2012.pdf.

3. **Upcoming Regulations on Mortgage Lending Will Level the Playing Field for Consumers.**

Before closing my testimony, I want to highlight the importance of the CFPB's pending rulemaking on Dodd-Frank's Ability to Repay and Qualified Mortgage provisions. The Ability to Repay provision requires lenders to make a "reasonable and good faith determination" of a homeowner's ability to repay a mortgage. Dodd-Frank then goes one step further and creates the Qualified Mortgage category of loans with sufficiently safe features so as to meet an ability to repay presumption.

The purpose of these Dodd-Frank provisions are to ensure that homeowners have broad access to 30-year, fixed-rate, fully amortizing loans with limited up-front fees instead of products with high fees and deceptive terms that borrowers cannot afford. Implementation of these provisions will improve the mortgage lending market for homeowners, particularly low-income homeowners and individuals of color who were disproportionately steered into high-cost and unaffordable loans in the years leading up to the 2008 financial crisis.

As the CFPB considers its final rulemaking on the Ability to Repay and Qualified Mortgage regulations, CRL has supported a rulemaking that 1) specifies a broad qualified mortgage definition to encompass the vast bulk of the market; 2) establishes bright lines providing lenders with certainty about whether a mortgage can be designated as a qualified mortgage; and 3) determines that qualified mortgage status is a rebuttable presumption and not a safe harbor from any future liability concerning lender requirements to determine a borrower's ability to repay a mortgage.

On the points raised above, there is broad consensus among both consumer advocates and lenders that the CFPB should write a broad Qualified Mortgage definition with clear standards. Such a definition will permit smaller institutions to make and sell loans to all of their creditworthy customers with the transparent terms they have always used, and with a reduced risk of litigation. Qualified Mortgage and Ability to Repay regulations adhering to these parameters will produce benefits that far outweigh the implementation costs to mortgage lenders.

Thank you again for the opportunity to testify, and I look forward to answering your questions.