Written Comments to Senate Special Committee on Aging to be included in the record of the hearing

Equity Predators: Stripping, Flipping, Packing Their Way to Profit

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Members of the Senate Special Committee on Aging, on behalf of our low-income clients, the **National Consumer Law Center**[1] thanks the Special Committee for this opportunity to provide comments on the issue of predatory lending. Our comments include specific recommendations for action to address the widespread problems caused by equity predators.

Fifty eight percent of older Americans who are below the federal poverty level[2] own their homes.[3] (Exhibit 1.) This reflects the declining income of a large portion of the homeowner population following retirement. As elderly people often have need for more income, yet have substantial equity in their homes, they are popular targets for home equity fraud scams.

THE CAUSES

Though home equity lending abuses are not new, the 1980s and 1990s witnessed a major upswing. In the past fifteen years, "equity-skimming," or "equity-theft" has become a major threat to many homeowners -- particularly to the elderly. A number of marketplace and policy factors have converged to contribute to this problem:

Deregulation: In tandem with the appreciation of real estate values, the deregulation of consumer lending in the 1980s left the door wide open for unscrupulous operators. Federal laws passed in 1980 and 1983 preempted both state usury ceilings on mortgage lending secured by first liens (whether purchase money or not),[4] as well as state limitations on risky "creative financing" options, such as negatively amortizing loans.[5]

Federal deregulation also set the stage for many states to remove rate caps and other limitations on other home lending -- including second mortgage lending. Whatever the overall merits of economic deregulation, it undeniably unleashed the greedy instincts of unscrupulous operators all over the country. In keeping with the conventional wisdom of free market theory, "the market" was supposed to take care of any problems. Unfortunately, there are market failures, and predatory home equity lending provides a good example of one. Even though interest rates have declined, these lenders have not lowered their rates, and for a number of reasons, competition and market forces do not operate according to theory on these loans.

The rise in real estate values: The inflation in real estate values in the 1980s created much new wealth -- the equity pool. While real estate values have remained stable in the 1990's (or declined in a few areas of the country), the equity acquired from the brisk rise in values in the 1980s continues to make aging homeowners a prime target of predatory lenders.

Since real-estate secured lending -- particularly owner-occupied residential real estate -- has historically been among the safest kind of lending, creditors of all stripes strove to develop or increase their portfolio of real-estate secured loans.[6] Legitimate lenders simply sought increasingly secure loans. The marginal lenders -- the equity skimmers -- looked to this new equity pool as something to enrich them.

In turn, the appreciated value of the property led to "asset-based lending" -- that is, loans made based on the value of the security, rather than on the borrower's ability to repay. This has been common in commercial lending, but is generally unsuitable for consumer loans. Most borrowers are simply wage-earners who look to their regular income to repay their debts. The amount of equity in the collateral is only relevant to the ability to repay a loan if the borrower intends to liquidate the collateral. In short, "asset-based lending" is a legitimate-sounding justification to ignore sound underwriting principles, and make unaffordable loans.

Equity skimmers generally write loans with repayment terms which borrowers could not hope to meet over the long haul: monthly payments which are 70% or more of monthly income[7] (or, in one case we have seen, monthly payments more than monthly income[8]); or large balloon payments which the borrower has no realistic hope of making. The loans are made because the lender cannot lose: either the borrower will repay the loan at a high interest rate or be forced into refinancing into a new, profitable loan; or, too often, the lender will recoup the amount of the loan and costs through the foreclosure process.[9] It is significant to note that the number of foreclosures in the United States has *tripled* since 1980.[10]

The rise in the secondary mortgage market: Some high-rate mortgage lenders, particularly home improvement contractors, have historically operated by assigning installment contracts they write to other lenders, such as finance companies or banks. But the 1980s added a new wrinkle -- bundling mortgage loans into large portfolios and selling them on the secondary mortgage market. This enabled mortgage companies specializing in home equity lending -- unregulated in many states -- to operate much more profitably. Since there was a "back-end" income stream, they could operate with little capitalization base. They could obtain a line of credit from a major bank; originate predatory loans, taking out very high up-front fees; then dump the loans onto the secondary market.

The secondary market structure is good for an equity-skimmer who originates the loans. This lender can charge enormous up-front fees, be careless about underwriting, and then pass the consequences along to the buyers on the secondary market. If the loan defaults it is the new creditor's problem. Buyers on the secondary market have found this is a profitable business scheme as well: they save the expense of originating loans; and, in the rare case where the borrower has the wherewithal to hire a lawyer and allege the originator of the loan defrauded them, or engaged in usury or other violations of the law, the buyer of the loan on the secondary market can hide behind a holder in due course defense.[11] The result is that the loans must generally be repaid regardless of fraud or other legal problem in the inception of the loan.

The securitization of home equity loans: The 1990s saw the phenomemonal growth in the use of asset-based securities to fund an ever-increasing supply of mortgage credit. Asset-backed securities are debt or investment securities which are backed by receivables such as credit card, automobiles, or home equity loans. They are similar to mortgage-back securities which are the foundation for the secondary mortgage market. Investors are repaid the principal amount of their investment plus interest. Sales of asset-backed securities generally increased from $65 billion in 1993 to $167 billion in 1996, an incredible leap of $102 billion in three years.[12] Securitization helps to fund equity lenders by creating new capital through the securitization process.

Prime and “sub-prime” mortgage market: The credit industry refers to “A” and “A-” borrowers (those with good credit histories) as “prime,” and “B’ and “C” borrowers (those with no credit history or poor credit history) as “subprime.” “Subprime” homeowners are the hot new market of the 1990s.[13] The earnings of small-volume subprime mortgage lenders are matching or surpassing the earnings of conventional mortgage lenders with significantly greater loan volume.[14] The securitization of home equity loans is a driving force behind the subprime market popularity. A segment of the subprime market includes the predatory lenders which are the subject of this hearing.

One myth upon which some lenders thrive is that higher interest rates, points, and fees must be collected from riskier borrowers in order to cover the increased risk. Thus, some subprime lenders believe they can charge exorbitant rates, fees, and costs and excuse such behavior under the rubric of “high risk.” While this has some validity in the nonmortgage market, mortgage lending can be essentially risk-free when the loan is secured by the home and the loan-to-value ratio is 80% or less. If a loan made on this basis goes to foreclosure, the lender will generally cover 100% of its losses because there is enough equity in the home to pay off the principal balance as well as any foreclosure costs. It is with this in mind that many predatory lenders require at least a 65-75% loan-to-value ratio to provide themselves with a *greater* cushion than the prime market. Since many predatory lenders also load the loan principal with credit insurance costs, the risk to the lender if something unexpected happens to the borrower is even further reduced. Predatory lenders create a "win/win" situation. They will make an enormous profit from the revenue stream created by the repayment of these loans and suffer no loss if default occurs.[15]

Further, the additional cost of a high rate mortgage can make a "high risk" loan a self-fulfilling prophecy because the higher costs become the fuel for failure. As has been recognized by the industry, higher ratios between monthly payments and income are one predictor of a higher risk of default. Many of the high cost loans provided to low income borrowers appear to have debt to income ratios designed to create default, or forced refinancing of the loan.

"Tax Reform:" The amendment of the tax laws which retained the deductibility of interest only for home-secured loans added to the massive increase in home-equity debt. Many consumers and taxpayers are not well-equipped to calculate how the tax savings would weigh against the extra interest to be paid. Yet that is a sales pitch given by many creditors, and many homeowners listen to that siren-call.

Cultural & Business Mores: Finally, these economic and legal changes happened in a context of shifting cultural attitudes. The business ethic was that "anything goes," and greed was no longer the subject of opprobrium, but rather viewed as an engine for growth. Unfortunately, home equity lending became one of the targets for the speculators.

THE VICTIMS

The problem of mortgage scams and home improvement scams is not limited to certain regions. We have seen them from almost every state in the nation. But there are certain factors which make it worse in some areas:

- areas which had the greatest increase in real estate values tend to have more home equity lending problems;
- the more permissive the legal environment (i.e. the less regulation), the greater the problem.

Most poignantly, the more vulnerable the population, the greater the problem. Thus the less educated and less sophisticated are particularly victimized by these lenders; as are the elderly (who often have a lot of equity in their homes); and those whose other borrowing options are blocked, or who perceive themselves as having no options.[16]

THE PERPETRATORS

When one looks at both the "sins of commission" and the "sins of omission," there is a great deal of culpability across the spectrum.

"Tin Men:" Fraudulent home-improvement contractors, particularly the door-to-door operators, have long been a major source of complaint about abusive home-secured loans. They have been with us always, and probably always will. But as to whether they are isolated actors, or are commonplace, depends upon whether the ultimate sources of the financing -- and the regulatory environment -- encourage or discourage oppressive business practices.

In addition to needing a source of financing to run their business at the outset, these contractors must have an outlet for their credit sales, as generally they cannot afford to carry the credit accounts themselves. Thus, they will either arrange for lenders to make direct loans, with the proceeds to pay off the sales; or will write financing contracts themselves, to be immediately assigned by prearrangement to a lender. In some instances, it may be the ultimate financier who drives the operation, in essence using the contractor as a "bird-dog" to drum up mortgage business for it.[17]

These ultimate lenders can be mortgage companies (which may or may not be regulated by the state); often they are finance companies (which are regulated by the state); or banks (which are regulated by either the state or a federal agency, depending upon their charter.) It is the cooperation of the ultimate financing sources which keep a contractor in business. Thus the lender is in a position to help assure that legitimate value be given for the money, or to help compound the problem by trying to disassociate themselves from any complaints the borrower may have about the contractor or his work.[18] Unfortunately, many ultimate lenders, despite their heavy involvement in facilitating the transaction, choose the latter course.[19]

Mortgage companies: As was noted above, the 1980s witnessed the growth of second mortgage lending companies -- many of which received notoriety: Landbank Equity; First American Mortgage Company; Freedlander. In many states, these companies were not (and still are not) regulated. The earlier discussion about the secondary mortgage market explains how these companies generally operated.

The 1990s, however, saw a decrease in the frequency of second mortgage loans as many lenders began to see the benefits of being the first lienholder. Those benefits include:

1)To assure repayment in the event of a foreclosure, mortgage lenders want to be in first position relative to other lienholders;

2) First lien mortgages are not subject to usury and points restriction under most states' laws due to the federal preemption created by the Depository Institutions Deregulation and Monetary Control Act of 1980. Many states, however, still regulate second mortgage loans to varying degrees.

3) To assure first lien status, predatory mortgage lenders convince homeowners to refinance their current mortgages (whether or not the current mortgage is a less expensive loan with better terms) and consolidate unsecured debt into a home-secured loan.[20] This mightily increases the principal amount of the loan. By doing so, the lenders earn more from charging points. For example, 5 points on a $15,000 home improvement loan yields only $750; whereas, the same number of points will yield $2,500 on a $50,000 refinancing and home improvement loan.

The rush to be the first lienholder leads to an increase in some of the age old abuses: loan padding; frequent refinancings; and the refinancing of more favorable loans into less favorable ones.

As with the "tin men," it is frequently regulated lenders -- banks and thrifts -- which provide the wherewithal for these companies to survive. Again, there are degrees of culpability among these "enablers." Some may actually know what kind of operation the mortgage lenders are running. Others simply choose to ignore the red flags in these transactions, and buy up the paper anyway.[21] The more "the legitimate" lenders opt to purchase these kinds of loans with an "ostrich" approach to their investment, the easier it is for the predatory lenders to flourish.

Finance companies:[22] Finance companies moved into home equity lending in a big way in the past 15 years. Some of the finance companies have been particularly bad at "loan-padding:" -- inserting costly add-ons onto loans, making them much more expensive for borrowers.[23] Finance companies are regulated (with varying degrees of success) by the states, but some are subsidiaries of banks, which, in turn, are regulated by either the states or a federal agency, depending upon their charter.

The supporting cast: Mortgage brokers have played a major role in steering borrowers into bad loans. As their fees are a percentage of the loans, there is a "reverse competition" effect which encourages them to hook borrowers up with expensive, loan-padding lenders. Brokers are paid in either (or both) of two ways: directly by the borrower in the form of cash or by financing the broker fee as part of the loan; and/or by the lender in the form of a yield spread premium which is repaid by the borrower over the term of the loan in the form of a higher interest rate. The lender payments to brokers not only drive up the cost of mortgage loans, but also create reverse competition. The result is that brokers are provided incentives to steer borrowers to the lenders that pay brokers the *most* rather than to the lenders which give borrowers the most favorable terms.

Many of these brokers advertise as if they are market-rate lenders and do not disclose their true role -- or their commissions -- until loan closing. By that time many borrowers have lost their leverage to object or walk away. Loan brokers are not regulated in many states, and some regulation which does exist is token only.

Banks and thrifts: As the above discussion indicates, even if banks and thrifts are not directly engaging in predatory business practices, it often is their ultimate financial support which enables the predatory lenders to operate on the scale we have seen in recent years.

PREDATORY MORTGAGE LENDING ABUSES

These abuses are carefully chronicled in the written testimony of William J. Brennan, Jr. and will be only briefly described here:

- **Home improvement scams,** which are home loans stemming from unsolicited sellers of home improvements in which the work is generally overpriced, and rarely performed adequately;
- **Mortgage broker kickbacks** which result in higher priced loans than the borrowers qualify for with their lenders;
- **Steering to high rate lenders**;
- **Lending to people who cannot afford to repay;**
- **Falsified loan applications** such that the loan originator pads the borrower's income to make the loan qualify, yet which leads to unaffordable payments for the borrower;
- **Incapacitated homeowners;**
- **High interest rates** which are far more than are justified by the alleged additional risks and costs of providing credit to homeowners with lower credit scores;
- **Balloon payments terms** for which the borrower has no way to meet without refinancing the loan at excessive costs or losing the home;
- **Negative or non-amortizing loans,** such that even after making loan payments for years the borrowers end up owing *more than* was originally borrowed;
- **Padded closing costs,** which can often be fees for settlement services two or three times as high as are charged middle income homeowners;
- **Credit insurance packing** with high priced pre-paid term credit insurance which add thousand of dollars in unnecessary costs to loans for borrowers who could obtain more reasonably priced credit insurance if paid on monthly basis;
- **High and unfair prepayment penalties;**
- **Mandatory arbitration clauses,** which frequently require only the borrower to submit to it and not the lender and which can force a homeowner to pay large sums for their concerns to be addressed by arbitrators who have no incentive to follow consumer protection laws, and whose decisions are not reviewable by any court;
- **Repeated refinancings** which have the effect of bleeding the homeowners equity from the home by *increasing* the amount borrowed exponentially in each refinancing without providing any benefit to the borrower;
- **Spurious open end loans** whereby the lender is allowed to avoid making the more comprehensive disclosures required by closed end credit, and thereby avoid any chance of the homeowner asserting the right of rescission, as well as completely avoiding the restrictions under the Home Ownership and Equity Protection Act, regardless of the cost of the loan;
- **Paying off low interest mortgages** such as purchase money loans with FHA with much higher interest rate loans;
- **Refinancing unsecured debt** for which the borrower could not lose the home, with high interest rate debt which must be paid to avoid foreclosure;
- **125% loan to value loans** which effectively prohibit borrowers from selling their homes or filing bankruptcy to escape unaffordable debt, without losing their home;

CONSEQUENCES OF HIGH COST MORTGAGES -- LOSS OF THOUSANDS OF HOMES

It is significant that **foreclosures have increased by approximately 300% since 1980**. (Exhibit 3.) *These numbers do not include the thousands of homes which are turned over to lenders voluntarily (called deeds in lieu) or are sold for less then their value to avoid foreclosure.* The bottom line is that millions of Americans are losing their homes because of unaffordable home mortgages.

There are a number of reasons for this. Data shows that most foreclosures are caused not by homeowner mismanagement, but rather by unexpected life events which are beyond the homeowner's control such as loss of job, illness, death or divorce.

Census data establishes that more than 1/3 of households in the lowest 40% of income range will experience a loss of income of at least 33% for one month in a given year. Income disruptions obviously increase the likelihood of mortgage defaults especially since the same lower income households also have low savings rates and high debt to income ratios. As family debt increases as a percentage of income,[24] families are increasingly vulnerable to the exigencies of unforeseen income decreases or increases in expenses. Problems which would be manageable for a family whose housing costs constitute 20% of the monthly budget are unmanageable when those costs are 40% of the total household expenses.

Additionally, there has been a major expansion of home equity lending, thus creating an additional pressure on the homeowner's budget. The median amount outstanding on mortgage debt for a typical family rose 30% between 1989 and 1995. Yet the number of foreclosures executed on American homes increased by 300% in the same time period.

For these reasons, the federal government cannot rely on the marketplace -- or self-regulation by the mortgage finance industry -- to police lending secured by the home. While Americans enjoy a strong home lending industry, the appropriate degree of regulation should not hamper legitimate lenders, while it will serve to protect the most vulnerable homeowners from losing their homes.

RECOMMENDATIONS

The problem of predatory home equity lending has a multitude of sources, and the solutions will have to come on many fronts. We have developed a catalogue of recommendations to address both the overall problem and individual pieces of the overall pattern.

1. Interest rate ceiling and limitations on other charges:

As a result of an anomalous mismatch between statutory usury ceilings and market rates in the late 1970s, the entire concept of rate caps became anathema to lenders and regulators. Consequently, we threw the baby out with the bath water.

In 1827, the Virginia Supreme court observed that "It has been a good deal the fashion of late, to decry the policy and justice of our laws regulating the rate of interest....It may be permitted to observe, however, that if the experience of the ages, and the general opinion of mankind, deserve weight in legislation, their voice is in favor of usury laws. They have prevailed in all civilized countries, and in all time."[25]

The experience of the "deregulation decade" simply proves the point. The heartbreak caused by the spiraling increase in abusive home loans and foreclosures proves that rate caps are needed to protect the trusting, the unsophisticated, the unwary, and the necessitous consumer from "the oppression of usurers and monied men, who are eager to take advantage of the distress of others"[26] now no less than 150 years ago. The 1970s problem of a mismatch between statutory cap and market rate is easily resolved by the imposition of a statutory ceiling which can float with a specified market-related index.

Furthermore, the usury ceiling should be combined with limitations on additional non-interest charges (points, brokers fees, closing costs, credit insurance, bogus escrows, etc), which will curb loan-padding. In the absence of a federal cap, the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDA) should be amended to permit states to reintroduce rate caps on home equity loans should they choose.[27]

2. Regulate Loan Terms Based on Cost of Loan.

In 1994, Congress passed the Home Ownership and Equity Protection Act (HOEPA) to prevent some predatory lending practices after reviewing compelling testimony and evidence presented during a number of hearings that occurred in 1993 and 1994.[28] The new law created a special class of regulated closed-end loans made at high rates or with excessive costs and fees. Rather than cap interest rates, points, or other costs for those loans, the protections essentially prohibit or limit certain abusive loan terms and require additional disclosures. HOEPA's provisions are triggered if a loan has an APR of 10 points over the Treasury bill for the same term as the loan, or points equal to more 8% of the amount borrowed.

It was hoped that HOEPA would reverse the trend of the past decade which had made predatory home equity lending a growth industry and contributed to the loss of equity and homes for so many Americans. However, experience over the last two and a half years has shown that while HOEPA has made a start at addressing the problems, there are still yawning chasms of unprotected borrowers subject to the abuses of high cost home equity lenders.

The 2 most significant problems with HOEPA:

1) EPA does not in any way *limit* what the lender can charge as up-front costs to the borrower. It is the excessive, combined fees -- in closing costs, credit insurance premiums, and points -- which deplete the equity in abusive loans. These excessive, combined fees are charged over and over, each time the loan is refinanced. And with each refinancing, the homeowner's equity is depleted by these charges because they are all financed in the loan. The effect of this situation is to *encourage* lenders to refinance high cost loans because they reap so much immediate reward at each closing. If the law limited the amount of points and closing costs that a lender could finance in high cost loans, this incentive to steal equity would be stopped cold.

2) Inerest rate trigger for HOEPA is too high, causing many abusive lenders who want to avoid HOEPA strictures to make high cost loans just under the trigger. The effect is that there are no protections whatsoever against these very high cost loans which are just under the HOEPA triggers.

But, otherwise, HOEPA has some good ideas. It is based on the economic rationale that the higher the charges for the loan, the more regulation is necessary and appropriate. By passing HOEPA, Congress has already recognized two essential truths: that there are some loans for which the marketplace does not effectively apply restrictions; and government must step in to provide balance to the bargaining position between borrowers who either lack the sophistication to avoid bad loans or do not believe they have a choice if they want the credit.

The HOEPA structure is essentially good: apply prohibitions and restrictions to higher cost loans, and leave lower, more reasonably priced loans free from regulation. We propose to leave this basic structure in place while filling in the gaps.

First, rather than have only one set of triggers which determine whether a loan is either regulated or not, home loans should be regulated on a more graduated basis. Very high cost loans should have prohibitions similar to (or more stringent than) those applied to current HOEPA loans. Loans which are high cost, but not as expensive as those covered by HOEPA should also be regulated, but to a lesser extent. Lower cost loans -- such as those which are commonly offered to prime borrowers as well as to subprime borrowers by non-abusive lenders -- would not be regulated whatsoever.

The federal law would thus recognize three categories of home lending: Category 1 loans would have unregulated terms because the price of these loans was less than the trigger for Category 2 loans. Category 2 loans would be those overpriced loans which are priced at rates higher than provided by non-abusive lenders; these loans would be regulated to a limited extent. Category 3 loans would be those loans which fall into a very high price range and which, like current HOEPA loans, would be closely regulated. The effect of this two-tiered approach to determine the level of regulation would be to ensure that even those expensive loans which fell just under the trigger for HOEPA loans would still have some degree of regulation.

The exact numerical triggers which would determine whether a loan fell into the high cost or into the lower priced but still expensive category should be carefully determined. The interest rate triggers would be floating -- a certain amount over the Treasury bill for an equivalent term as the loan -- just as HOEPA is now. There should also be triggers based on the percentage of the loan charged in up-front costs, based on points, and all closing costs.

Additionally, a key, and essential new regulation which would apply to both categories 2 and 3 loans would be a limitation on the financing of points and closing costs. Lenders providing category 3 loans -- the most expensive -- would be prohibited from financing any points or closing costs. Lenders providing the less expensive, but still overpriced loans -- category 2 -- would be limited in the amount of points and closing costs that could be financed.

Points and Fees Trigger. Finally, the points and fees trigger should include all points, fees, and insurance charges. Under current HOEPA law, there are confusing rules to determine which fees and insurance charges are included in the trigger for up-front costs. [29]

For example, this trigger does not include "reasonable" charges if they are not retained by the creditor and are not paid to a third party affiliated with the creditor. Fees for appraisals performed by unaffiliated third parties are not be counted if only the direct cost is passed on to the borrower. On the other hand, such a fee is counted if the cost is padded. Determining what is a "reasonable" for purposes of triggering coverage, however, is a difficult burden for consumers to meet. The closing costs trigger should include all points and all fees for closing costs.

Credit Insurance. Credit insurance is a big ticket item in each individual loan.[30] Nationally, consumers spend as much as $2.5 billion per year on credit insurance, often with little understanding of what they have bought.[31] This volume of business conceals overcharges of $900 million[32] to $1.2 billion,[33] where 40 to 50% of the premiums are paid to lenders as commissions. The marketplace has created reverse competition because credit insurance premiums are paid up front for term insurance policies which cover the whole or a significant portion of the loan term and lenders receive a commission based on the size of the credit insurance premium. Thus, lenders are rewarded for selling the *most expensive* forms of credit insurance, rather than the least costly to the consumer. Hence, unsophisticated consumers spend thousands of extra dollars for credit insurance which provides negligible value to them.

The remedy for the reverse competition established by the marketplace: only allow credit insurance to be sold when the premiums can be paid monthly, along with the loan payments, and the credit insurance can be canceled at any time.[34]

3. Eliminate holder-in-due course status for assignees and purchasers of home equity loans.

Purchasers of negotiable instruments, such as promissory notes, have enjoyed the benefits of the holder in due course rule since the 1800s.[35] The holder in due course doctrine protects assignees of a negotiable instruments from liability for the wrongdoing performed by the original lender or an assignee upstream, even though the borrower might be harmed.

Thus, regardless of any such wrongdoing, the consumer's obligation to pay the assignee downstream continues as long as the assignee purchased the loan without notice of the fraud or other misconduct. In the mortgage context, the homeowner is left to pay the mortgage despite having perfectly valid claims and defenses arising out of the transaction. Particular problems arise because some fly-by-night contractors or mortgage originators are insolvent, or they disappear (and reincorporate under a new name or file bankruptcy) at the first hint of litigation.

Since 1976, the Federal Trade Commission has limited the rule for the purchase of consumer goods or services.[36] The purpose of the Rule is to give consumers the right to assert claims and defenses against creditors in situations where a seller provides or arranges financing and then fails to perform its obligations. The Rule rightly shifts the risk of seller misconduct to creditors who could either absorb the costs of misconduct or return the costs to sellers.[37]

While the Rule created some protection for consumers in this context, it is limited in several ways. First, the consumer rights provided by the Rule depend upon seller compliance in placing a required notice in the loan document. Second, recovery by the consumer for seller wrongdoing is limited to the amount paid under the consumer credit contract. Third, there is no private right of action to enforce the Rule.

Recognizing the problems created for homeowners in the mortgage context, in 1994, Congress provided some protection for mortgage borrowers against the misconduct of the original lender by creating assignee liability if the loan is a high rate loan as defined in HOEPA.[38] However, the damages that a mortgage borrower can obtain against the assignee are limited to the sum of the total remaining indebtedness due on the loan plus the total paid by the consumer.

If the holder in due course doctrine were eliminated for assignees and purchasers of home equity loans (and they were potentially liable for *all* of the claims and defenses which the borrower had against the originator), the industry will be forced to do engage in self-policing. If holders will clearly be liable for the claims the borrowers have against the originators, they will more carefully screen those with whom they do business. That, in turn, should help dry up the financial lifeline that has enabled the predatory mortgage companies to operate.

Some would argue that applying the limitation on the holder rule would reduce the amount of credit available to everyone, because creditors would be afraid to buy loans when they could be held liable for mistakes that were made by their predecessor in the credit chain. This is very unlikely. The protection provided by limiting the holder rule has applied to the automobile financing system for two decades. And, as one can see by perusing the classified section on "Cars for sale," the auto financing market is thriving. Applying the limitation of the holder rule to all assignees of a home loan would certainly not dry up the legitimate home equity lending market.

4. Federal Law Should Prohibit Unfair and Deceptive or Unconscionable Acts and Practices in the Making of a Home Loan.

Congress should flatly and unequivocally state that unfair, deceptive and unconscionable practices in the making of a home loan should be illegal. Although many states have laws prohibiting unfair acts and practices, too often these laws do not apply to loans secured by real estate, loans made by some types of lenders, or loans over a certain size[39] Creating a laundry list of specific activities which are illegal or restricted would simply invite resolute lenders to transform their practices in ways to avoid falling into the definitions of specific prohibited acts. Instead there should be a broad prohibition.

The following are just a few examples of unfair and deceptive practices for which we have documentation:

- Some high rate lenders require homeowners to sign two loans, one which refinances debt, and the other, a smaller second mortgage, to finance the lender costs from the first loan. The APR on the first lien loan may be under the HOEPA APR trigger. But the APR on the second lien loan is a whopping 24%.
- Some lenders solicit borrowers with the promise that the borrowers can consolidate all of their debt into one payment which will cost less and save money over the term of the new mortgage. At settlement, when the borrower realizes that this claim is false, the lender or settlement agent for the lender promises that the loan will be refinanced on better terms in 6 months to a year. Further, borrowers are told, this is standard practice. Borrowers are induced to enter into the loan by these verbal statements. Many borrowers are not in a position at that point to refuse the bad deal because they have paid appraisal, application or other fees or are in danger of losing their homes. Of course, the bad loan is never refinanced or, if it is, the same lender re-charges points and fees, thus gouging the borrower yet again.

- Some lenders will get homeowners to sign loan applications which inflate their incomes or add other information to the application unbeknownst to the homeowners in order to satisfy underwriting requirements. Frequently, the homeowners do not see these applications in their final form until settlement when they are asked to sign numerous documents in a rush. Or homeowners are asked to sign loan applications that are not completely filled in. The lender later adds additional information. This causes borrowers problems for two reasons: first, credit is extended when the borrower does not have the true ability to repay which leads to foreclosure; and second, the holder throws the "fraud" on the application back at the borrower later to defeat any complains that the borrower has against the loan.

5. Protections from Foreclosure.

Given the alarming increase in foreclosures over the past two decades, federal law must provide some additional protections to borrowers losing their homes to foreclosure. There are however, several things that the federal law can do to help save homes, which would not unduly interfere with the private mortgage market:

- **Increased support for housing counselors and mandatory notice regarding their availability**. Good housing counselors can facilitate loan workouts that preserve home ownership, prevent foreclosure, and reduce costs for lenders. Fannie Mae, Freddie Mac, and the FHA have implemented loss mitigation tools to avoid foreclosure and housing counselors are an essential part of that process. All mortgage lenders should be required to provide some support for housing counselors and notice of the availability of housing counselors should be required before any foreclosure can proceed.

- **Lenders should provide homeowners with the opportunity to pay off the arrearage and avoid foreclosure.** Although this seems obvious and in the best interest of both parties, this is not always done. Lenders should be required to give notice to defaulting homeowners of the amount past due and the amount needed to avoid foreclosure prior to the addition of fees. The notice should list the various workout options available. These options have been accepted by Fannie Mae, Freddie Mac, and the FHA as appropriate loss management tools in the industry. Lenders should also be required to attempt to avoid foreclosure through various loan workout mechanisms. Further, a lender should not be permitted to unreasonably reject a workout proposal.

In sum, at the least, three substantive requirements would apply to all foreclosures of all mortgages:

a. Increased support for non-profit, independent housing counselors who can help homeowners navigate the loss mitigation rules that are now required of FHA, Fannie Mae and Freddie Mac lenders.

b. A federal notice must be provided to the homeowner *before any foreclosure can proceed*, notifying the homeowner of the following:

> (1) That housing counselors are available, how to reach them, and that the counselor may be able to help avoid a foreclosure by facilitating a workout;
>
> (2) The actual amount in default, along with the sum of all interest and fees due, which must be paid to avoid a foreclosure;
>
> (3) A list of possible workout options which might be considered.

c. Lenders should be prohibited from proceeding with a foreclosure if a reasonable workout option has been rejected.

Conclusion.

As is evident from the testimony presented at the hearing and these comments, the ills that plague older Americans due to predatory mortgage lending have not abated since Congress last addressed them in 1994. Given the stream of financing available due to the strength of the secondary mortgage market, the rise of securitization, and the profits to be made, the industry has no incentive (or desire) to police itself. For these reasons, Congress must once again step in to help those vulnerable homeowners who have few or no choices in the lending marketplace.

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[1] The National Consumer Law Center is a nonprofit organization specializing in consumer credit issues on behalf of low-income people. We work with thousands of legal services, government and privates attorneys around the country, representing low-income and elderly individuals, who request our assistance with the analysis of credit transactions to determine appropriate claims and defenses their clients might have. As a result of our daily contact with these practicing attorneys we have seen examples of predatory lending to low-income people in almost every state in the union. It is from this vantage point--many years of dealing with the abusive transactions thrust upon the less sophisticated and less powerful in our communities--that we supply this testimony today. *Cost of Credit* (NCLC 1995), *Truth in Lending* (NCLC 1995) and *Unfair and Deceptive Acts and Practices* (NCLC 1997), are three of twelve practice treatises which NCLC publishes and annually supplements. These books as well as our newsletter,*NCLC Reports Consumer Credit & Usury Ed.,* describe the law currently applicable to all types of consumer loan transactions.

[2] In 1996, the federal poverty level for a family of four was just $16,050.

[3] Nationally, 39% of households below the federal poverty level own their homes. (Exhibit 2.) There are more than 5,000,000 low-income homeowners in the United States. The home ownership rate is particularly significant for low-income older Americans.

[4] Depository Institutions Deregulation and Monetary Control Act of 1980, § 501 (DIDA), codified at 12 U.S.C. § 1735f-7a.

[5] The Alternative Mortgage Transaction Parity Act of 1982 (AMTPA). 12 U.S.C. § 3800, *et seq.*

6] The portion of homeowners with home equity loans more than doubled between 1977 and 1988. In 1977, 5.4% of homeowners had such loans; in 1988, 11% (6.5 million families) had home equity loans. Canner & Luckett, "Home Equity Lending," 75 Fed. Reserve Bull. 333 (May, 1989).

[7] *See e.g., Family Financial Services v. Spencer*, 677 A.2d 479 (Conn. App. 1996)(predatory second mortgage had a monthly payment of $733.33 where the borrower already had a first mortgage with a monthly payment of $1011.00 but monthly *income* of only $1126.67).

[8] In this case, where default was absolutely predictable and inevitable as of the first payment on a 12-month balloon note, the contract provided for extremely high late charges plus a 42% default interest rate. Thus, at the end of the 12 month term, the lender could claim a lien on the property that was approximately $50,000 greater than the original principal plus 22% interest provided for in the note.

[9] In fact, state laws on foreclosure almost universally allow foreclosing creditors to buy the property at a significant discount from fair market value and then to resell it at full value, pocketing the difference.

[10] *See* Exhibit 3.

[11] The holder in due course doctrine generally gives assignees or other subsequent holders of negotiable instruments (such as promissory notes) immunity against legal claims and defenses that the borrower may have had against the original creditor. *See* discussion, *infra.* Some also bought the loans with a recourse arrangement, whereby they would return non-performing loans to the originator, giving them yet further protection against risk -- at least until the originator went bankrupt.

[12] “The Asset-Backed Securities Market: The Effects of Weakened Consumer Loan Quality,” FDIC Regional Outlook, Second Quarter 1997.

[13] “Subprime Lender is the Place to Be,” National Mortgage News, Sept. 22, 1997. Even the “D” market is being explored by some lenders. *See* “Countrywide Credit to Offer Mortgages to High-Risk Groups,” The Wall Street Journal, Jan. 7, 1998.

[14] *Id.*

[15] *See generally* Julia Patterson Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government’s Promotion of Home Equity Financing*, 69 Tulane L. Rev. 373 (1994).

[16] This factor helps explain the disparate impact of predatory lending felt by minority borrowers and people living in minority neighborhoods. *See, e.g.* Kathleen Keest, "Second Mortgage Lending: Abuses and Regulation," (NCLC for the Rockefeller Family Fund 1991); “Nature Abhors a Vacuum: High-rate Lending in Redlined, Minority Neighborhoods,” 9 NCLC Reports *Consumer Credit &Usury Ed.* (May/June 1991).

[17] This was the heart of the claim in *Baker v. Harper*, in which a mortgage company was ordered to pay $45

million to 5 families. See "Alabama Jury Orders Lender to Pay $45 Million in Fraudulent Lending Case," 57 BNA Banking Rept. 270 (Aug. 12, 1991).

[18] *See, e.g.* "Spiking and Loan-Splitting in Home Improvement Contracts: Artful Dodges," 26 Clearinghouse Review 415 (Aug. 1992). Where the sale of home improvement goods and services is involved, the Federal Trade Commission's "holder rule" (16 C.F.R. § 433) provides that a related financier has vicarious liability for any claims or defenses the consumer has against the seller.

[19] More and more frequently, the same principals direct both sides of the business. But they try to disguise the connection, so as to try to claim the borrower's obligation to pay is distinct from the contractor's obligation to perform its part of the contract.

[20] The median amount of outstanding mortgage loans rose about 30% over the six-year period from 1989 to 1995. Over the same period, the median value of a primary residence rose only 4.8%. The much larger rise in the size of mortgage debt suggests that debt consolidation through refinancing is now the primary reason for home equity borrowing. *See* "Family Finances in the U.S.: Recent Evidence from the Survey of Consumer Finances," Federal Reserve Bulletin, January 1997; "Trends in the Home-Equity Asset-Backed Market are Important to Banks," FDIC Regional Outlook, Third Quarter 1997.

[21] Unlike the home improvement sales financing contracts, the FTC "holder" rule does not apply to straight loans, so these assignees can try to assert a holder-in-due course defense to claims the borrower may raise based on the originator's wrong-doing.

[22] Finance companies, such as Beneficial, ITT Financial, and others, are what used to be thought of as "small loan" companies, though in many states today they can make relatively large, mortgage secured consumer loans. It has been our experience that finance companies tend to keep the home equity loans they make (refinancing them frequently), rather than using the secondary market.

[23] "Insurance-packing" is one of the more common means of loan padding favored by finance companies. For a description of the practice, see National Consumer Law Center, Cost of Credit Chap. 8 (1995 and Supp.). For a good example of how it can distort the price of credit to a borrower, see *Besta v. Beneficial Loan Co. of Iowa*, 855 F.2d 532 (8th Cir. 1988). In that loan, insurance packing enabled the lender to skim an extra $3000 from what was really a $1400 loan. In one loan seen at the Center, the very same scheme was used to skim an extra $23,000 from a loan.

[24] The Federal Reserve Board concludes that one in nine families face debt payments that are higher than 40% of annual income. The rate rises to one in six families among those earning less than $25,000 per year. "Family Finances in the U.S.: Recent Evidence from the Survey of Consumer Finances" at 21, Table 14, *Federal Reserve Bulletin*, January 1997. *See* Pearlstein, "Trendlines: The Fed's Knowledge of Wealth", *Washington Post*, p. E1 (1/23/97).

[25] *Whitworth & Yancy v. Adams,* 5 Rand 333, 335, 26 Va. 333 (Va. 1827).

[26] *Id*.

[27] It will be also necessary to assure that a state's law is not further subject to preemption by a sister state with less inclination toward consumer protection through the "exportation" doctrine as a result of recent interpretations of § 521 of DIDA, 12 U.S.C. § 1831d. *Cf. Greenwood Trust v. Commonwealth of Massachusetts*, 971 F.2d 818 (1st Cir. 1992).

[28] *Problems in Community Development Banking, Mortgage Lending Discrimination, Reverse Redlining, and Home Equity Lending, Hearings Before the Senate Committee on Banking, Housing and Urban Affairs*, 103d Cong., 1st Sess. (Feb. 3, 17, 24, 1993); *Hearing on S. 924 Home Ownership and Equity Protection Act , before the Senate Banking Committee,* 103d Cong., 1st Sess. (May 19, 1993); *The Home Equity Protection Act of 1993, Hearings on H.R. 3153 Before the House Committee on Banking, Finance and Urban Affairs,* 103d Cong., 2d Sess. (March 22, 1994).

[29] 15 U.S.C. § 1602(aa)(1)(B).

[30] For individual borrowers, the costs of a credit insurance policy are huge in relation to the loan amount. For example, a Georgia homeowner paid $2,200 for a credit life insurance policy sold to her in connection with a home-secured loan with a principal of $40,606.26. The cost of this insurance added over 5% to cost of the loan. Nevertheless, this loan is not covered by HOEPA because the credit insurance premiums are allowed to be excluded from the closing cost trigger in HOEPA under current law.

[31] *Credit Life Insurance Hearing Before the Subcommittee on Antitrust, Monopoly and Business Rights of the Senate Committee on the Judiciary*, 96th Cong., 1st Sess. 48 (1979) (statement of Robert Sable).

[32] *Id.* at 3.

[33] *Id.* at 7 (testimony of James Hunt). *Credit Life Insurance: The Nation's Worst Insurance Rip Off*, Statement of Consumer Federation of America and National Insurance Consumer Organization (June 4, 1990), updated (May 20, 1992 and July 25, 1995).

[34] Allegations of coercion in the sale of what is suppose to be a "voluntary" product have been the subject of federal enforcement cases and private litigation. *In re USLIFE Credit Corp. & USLIFE Corp.*, 91 FTC 984 (1978), *modified on other grounds* 92 FTC 353 (1978), rev'd 599 F.2d 1387 (5th Cir. 1979); *Lemelledo v. Beneficial Management*, 674 A.2d 582 (N.J. Super. Ct. App. Div. 1996).

[35] Morton J. Horwitz, The Transformation of American Law, 1780-1860, at 213-215. A promissory note is an unconditional promise to pay a fixed amount of money, with or without interest, that is payable to order or to bearer, is payable upon demand or at a definite time, and does not state any other undertaking. U.C.C. § 3-104(a), (e) (1990). The actual note or loan document signed by a borrower secured by a mortgage is ordinarily considered a negotiable instrument and bought and sold on the secondary mortgage market. For a more in depth discussion of this doctrine, *see* Julia Patterson Forrester, *Constructing a New Theoretical Framework for Home Improvement Financing*, 75 Or. L. Rev. 1095, 1103-09 (1996).

[36] 16 C.F.R. § 433.

[37] Forrester, *supra* note 35, at 1108.

[38] 15 U.S.C. § 1641(d).

[39] For a compilation and description of the state UDAP statutes, *see* The National Consumer Law Center, Unfair and Deceptive Acts and Practices App. A (4th ed. 1997).