Comments of the National Consumer Law Center[1] and the Consumer Federation of America to Federal Deposit Insurance Corporation re FDIC Draft Staff Guidance

"How to Avoid Purchasing or Investing in Predatory Mortgage Loans"

January 31, 2001

On behalf of its low-income clients, the National Consumer Law Center[1] and the Consumer Federation of America[2] submit the following comments to the FDIC regarding its proposed guidance regarding how institutions can avoid purchasing or investing in predatory mortgage loans.

First, we want to congratulate the FDIC for taking the courageous and innovative first step toward addressing predatory mortgage lending. Clearly, the FDIC recognizes that there is a grave problem throughout the U.S., particularly affecting low income and minority households and neighborhoods. While many regulators recognize the gravity of the predatory lending problem, the appropriate – and politically feasible – method of addressing the problem still appears elusive. In these comments, we recommend that FDIC continue is joint work with the other federal regulatory agencies to address predatory lending. All agencies should adopt a bold, comprehensive and specific series of regulations to change the mortgage marketplace to accomplish the following:

- Predatory mortgage practices are either specifically prohibited, or are so costly to the mortgage lender that they are not economically feasible.
- Necessary credit is made available with appropriate rates and terms to all Americans.

The problem of predatory lending was not created by a single act of Congress or an individual regulatory action by a federal agency, nor – unfortunately – can it be solved by a similarly simple solution. Instead, we must all step back and examine the full extent of the problem and its various causes. The solution, we believe, lies in the appropriate combination of regulatory and legislative efforts. The FDIC's proposed guidance is an essential ingredient of this comprehensive scheme.[3]

FDIC's memorandum does an excellent job of identifying the characteristics of predatory loans. The memorandum also proposes a comprehensive method of determining whether predatory loans were made by particular originators or are included in securities. Based on our extensive experience with predatory mortgage lending we offer refinements and specific suggestions to the memorandum.

General Comments

Subprime vs. Predatory: When do higher prices create higher risks?

Before providing our specific recommendations on ways to refine the recommendations made by the FDIC, it is necessary to address a common misconception about subprime mortgage loans: That the higher interest rates and fees charged in subprime loans are necessarily justified by the higher risks and costs associated with making these loans.

Many subprime lenders justify higher fees and interest rates as necessary based on the risk of loss from loans to consumers with blemished credit. However, the typical structure of subprime loans creates minimal risk of loss due to either a default or a foreclosure. Indeed, the higher pricing itself actually *creates* more risk.

Risk of Default. There are two types of risk involved in mortgage lending. The first is the risk of default. As defaults do not necessarily result in foreclosure (and, in fact, the industry agrees that most defaults are self-corrected by borrowers, particularly within the first three months from default), lenders have traditionally recouped any losses incurred because of the default from late fees. Late fees are structured to compensate creditors for expenses incurred when payments are made late, such as dunning notices, and for the loss of use of the principal which was due. Late fees in the mortgage context are usually 5% of the payment then due. If the monthly payment is $1,000, the late fee is $50. Given the collection of late fees, the risk of loss due to a mere default is negligible.

Risk of Foreclosure. The more serious loss could arise if the defaults continue and result in a foreclosure sale. In this instance, the lender stands to lose only if the sale brings less than the combination of the balance due on the mortgage plus the costs and fees incurred in the foreclosure. As foreclosure sales generally recoup less than fair market value of the property, mortgage lenders traditionally protect against this risk by requiring a loan-to-value ratio no greater than 80%. When the loan-to-value ratio is greater than 80%, private mortgage insurance of some sort is generally required.

Subprime lenders, however, usually insist that the loan-to-value ratio be no greater 60-75%. This ratio insures little or no loss in case of foreclosure sale. As a result, when the loan-to-value ratios are so low, the risk of loss due to foreclosure also does not justify the increased pricing in the subprime market.

Given that the way subprime lenders structure their loans, there can be little justification for the increase in pricing seen too often in the subprime market. Even in the lowest rated subprime mortgage loans, annual losses rarely exceed 3%, which does not justify interest rates significantly more than that over prime rate loans. Certainly there is no justification for the huge differential in points, fees and costs charged. While some increases in the interest rate may be justified if late fees do no adequately cover the loss due to default, the large rate (four or more points above the prime) and fees (4% or higher of the principal) is simply gouging.

Thus, regulators should not adopt the assumption that borrowers with some credit blemishes should always be priced significantly higher than those with A credit.

Real Risk of Loss. Although lending to consumers with blemished credit does not by itself create the potential for losses sufficient to justify the increased prices and many of the practices in the subprime mortgage industry, there is still considerable risk of loss to investors. The risk of loss comes from actions challenging the predatory activities, not from borrowers' failure to comply with the contract terms.[4] However, this risk of litigation resulting from the lender's bad acts should certainly not justify higher charges.

Categorizing Predatory Loan Characteristics

The telltale signs of a predatory mortgage can be divided into three categories: objective[5] criteria, subjective[6] criteria, and other criteria which require a review of the totality of the circumstances in the individual transaction; each of which requires a different analysis to determine and to address.

- **Objective Criteria** – These elements of predatory mortgage loans are easy to identify from the loan paper; they are charges or terms of the loan which, either individually, or in combination with other objective characteristics of a particular loan, are predatory. These elements, while problematic, are generally legal under current law:
    - the financing of a high number of points and fees
    - the sale of single premium credit insurance
    - negative amortization
    - the existence of prepayment penalties
    - the inclusion of mandatory arbitration clauses

Whether a lender makes loans with *objective* predatory characteristics is fairly simple to determine. Lenders could be required to answer a questionnaire from a bank regarding whether it makes loans with any of these characteristics. The only issue then becomes which characteristics – or combination of characteristics – the bank chooses to use to determine whether loans are predatory.

This issue can – and should – be categorically addressed by the FDIC, in a manner which makes this determination relatively simple and safe for banks. Banks should simply take the position that the existence of the named predatory lending characteristics on a loan will disqualify that loan from being purchased, or included in

securities purchased or backed by the bank.

- **Subjective Criteria** – These elements are also predatory, but are more fact specific – to determine their existence in a particular loan one generally would need to delve into the particular circumstances surrounding the making of the loan, and often the financial situation of the borrowers. Most of the subjective elements of predatory lending are already generally illegal under state law:[7]
    - fraud
    - unfairness or deception
    - contract unconscionability given the totality of the circumstance

The existence of discrete instances of *subjective* predatory lending characteristics does not prove that *all* loans that lender is making are predatory, only that there was predatory behavior in the particular loan in which this occurred. However, the existence of these subjective criteria in some loans made by a lender is a strong indication that other loans are predatory as well. Thus, information indicating that these subjective characteristics exist in a lender's portfolio should – by itself – be grounds to stop purchasing loans from this originator.

- **Criteria Based on the Circumstances of the Loan:** There are a number of elements of predatory lending that the FDIC has identified which are clearly acceptable terms in the prime market – where competition generally works to place the parties on a more equal bargaining basis – but are predatory in the context of the other factors at play in a subprime loan:[8]
    - Balloon payments
    - Making a loan based on the collateral rather than the income of the homeowner – this problem is generally characterized by "no doc" loans.

We believe that the FDIC could somewhat simplify its Memorandum, therefore, by establishing a more specific formula for the determination of whether a loan is predatory based on objective criteria. The existence of subjective criteria should be considered as an external method of checking for predatory loans. The loan-based criteria will have to be evaluated in Step Three of Part Two, as set out in the FDIC Memorandum.

Part Two: How to Avoid Purchasing Predatory Loans

While the list and progression of steps are a logical way to proceed, there may be some confusion to banks regarding two issues: 1) exactly what the bank is looking for, and 2) how many of the elements in each of the steps are necessary to do due diligence within that step. We propose some clarifications to both.

Step One: Learn about the Originators

1st Recommendation: *Add Review of Loan Underwriting to Step One.*

The most important change we recommend is to bring the "**Loan Underwriting"** review, currently in Step Two, and make it a necessary element of all initial reviews for predatory lending. Unless, the originator is required to answer specific questions about its practices, and the types of loan provisions it includes in its loans, several detrimental results may occur.

First, relying on the information gathered in Step One may not provide timely notice to the bank of predatory lending problems. It generally takes months, if not several years, for a particular originator's predatory lending practices to percolate into legal action, or even a sizeable number of consumer complaints to government monitory agencies. So even if a bank has dutifully performed every one of the elements in Step One, it may find itself a defendant in a lawsuit for predatory lending practices.

Second, for some loans, this activity may be likened to closing the barn door after the horse has escaped. It is a backwards way for a bank to protect itself from at least some known and accepted predatory practices. It makes more sense for the FDIC to identify some redline predatory characteristics – within the objective criteria – which would then allow banks to state to all originators that they will simply not purchase loans with these characteristics.[9]

2nd Recommendation: *Within the Underwriting Review, specify the following specific loan terms as predatory, and recommend that banks not purchase loans which include these objective characteristics*.

The Memorandum has identified in several places loan terms which are predatory. The following, specific and objective criteria have been identified on several occasions by a variety of governmental agencies as being predatory, including the FDIC in this Memorandum:

1. Financing of Points and Fees. Loans in which more than 3% of the total loan amount of up-front points and fees.

-Explanation: As the worst abuse to the consumer in a predatory mortgage is the equity stripping which results from the financing of high points and closing costs, a key indicator of predatory loans should be the financing of excessive points and closing costs.[10]

2. Loans in which credit insurance is financed. Loans in which the lender financed, directly or indirectly, any credit life, credit disability, credit unemployment or credit property insurance, or any other life or health insurance, or any payments financed by the lender directly or indirectly for any debt cancellation or suspension agreement or contract. However, insurance premiums or debt cancellation or suspension fees calculated and paid on a monthly basis should not be considered financed by the lender.[11]

Explanation. Credit insurance is a big ticket item in each individual loan.[12] Nationally, consumers spend as much as $8 billion per year on credit insurance, often with little understanding of what they have bought.[13] This volume of business conceals billions of dollars in consumer overcharges,[14] 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. As a result, 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.[15]

3. ***Loans with prepayment penalties.*** Banks should avoid loans with a prepayment penalty a) later than 24 months after consummation, and b) greater than of 3% of the loan amount *that was not financed as up front costs or fees when the original loan was first made.*

Explanation. The rationale for this is that 3% is sufficient to cover the lender's costs for making the loan; anymore than that is unnecessary equity stripping. In this scheme the lender has the option of whether to charge all or parts of the 3% up front or if there is an early prepayment of the loan.

The prohibition in Paragraph One, against financing points and fees only works if it is accompanied by a protection on the back-end of the loan: a prohibition against prepayment penalties. Without such a prohibition, predatory mortgage lenders will still be able to strip equity and will not be forced to make their loans actually competitive.

Subprime lenders claim that borrowers voluntarily choose prepayment penalties to reduce their interest rates. Borrower choice cannot explain, however, why some 80% of subprime loans currently charge prepayment penalties and only 2% of conventional loans do (almost all in California).[16]

The real reason is that conventional mortgage markets are competitive and sophisticated borrowers have the bargaining power to avoid these fees; borrowers in subprime markets often lack sophistication or are desperate for funds and simply accept the penalty that lenders insist that they take.

4. *Loans which contain mandatory arbitration clauses.* Loans which contain a mandatory arbitration clause that limits in any way the right of the borrower to seek relief through the judicial process for any and all claims and defenses the borrower may have against the lender, broker, or other party involved in the loan transaction.

Explanation. Over the last few years, some lenders with concern about consumer litigation are including mandatory arbitration clauses in consumer credit contracts. Predatory lenders use arbitration clauses as a shield to prevent consumers from litigating their claims in a judicial forum, where a consumer friendly jury might be deciding the case. Arbitrators, who typically handle disputes between two businesses, are unfamiliar with consumer protection laws, and may be unsympathetic to consumers.

Arbitration also limits discovery in most cases, which benefits the creditor, not the consumer, and the arbitration may cost the consumer far more than bringing an action in court. By comparison, indigents in many jurisdictions can file court actions *in forma pauperis*. And consumers lose their rights to appeal the decision maker's erroneous interpretation of the law. This allows arbitrators to ignore state or federal consumer protection statutes and judicial precedent. Consequently, any comprehensive law or regulation addressing predatory mortgage lending must include a prohibition against mandatory pre-dispute arbitration clauses.

Summary. Discouraging the purchase of mortgages with these features will not affect the prime mortgage market in any significant way. The subprime mortgage market would be pushed to offer loans with terms similar to those provided to prime borrowers, simply with interest rates slightly higher. As Fannie Mae and Freddie Mac are often pointing out, *real* risk based pricing involves only a matter of a few points in the interest rate for riskier loans. Subprime borrowers should have the same terms, with slightly higher costs associated with them – reflected solely in the interest rate – as prime borrowers.

3rd Recommendation: *When information yielded from community sources in Step One indicates serial complaints regarding subjective criteria, such as unfair or deceptive trade practices, fraud, or abusive collection practices, that should be sufficient evidence to stop purchasing loans from a particular originator.*

Unlike the objective criteria, proof of fraud, or even unfair or deceptive trade practices is difficult, costly, and emotionally draining for the consumer. Advocates who regularly represent consumers generally consider two or three similar complaints about a single originator to be substantial evidence of a serious problem.[17] In order for a lawsuit alleging one of these subjective criteria to result in a court decision, a number of high barriers must be overcome. These include: a homeowner finding an an attorney with an expertise in consumer law; the attorney having the resources to bring the action, and pursue it to fruition, without compensation; the existence of some independent proof of the fraud or unfair or deceptive practice (so that the case does not boil down to a “he said, she said” dispute); a homeowner/plaintiff with the emotional strength to go through a long, arduous and emotionally draining fight where he or she will be embarrassed, intimidated and often harassed; the legal ability to hold the current holder of the loan liable for the bad acts of the originator; and finally, a judge with the patience to address an array of labyrinthian and technical consumer laws.

However, once a case with substantial fraud, unfair or deceptive trade practices, or abusive collections practices, makes it through this of obstacle path, it is likely to cost the defendant substantially in actual and punitive damages.[18] Thus, it is wise, not only from a policy perspective, but also for safety and soundness reasons, for banks to avoid purchasing loans with subjectively predatory characteristics. The best indicator of those characteristics are the *unresolved* complaints made to government and non-government agencies such as consumer Better Business Bureaus, legal services offices, consumer protection divisions of the state Attorney General’s office, and local non-profit housing and consumer assistance groups.

As a result, if serious complaints of these predatory activities have been made to local groups, no further investigation should be necessary. Those complaints should be considered sufficient evidence of a problem to steer the bank away from purchasing loans from these originators.

4th Recommendation. *Refine the characteristics of predatory loans in Step Three: Review of Loan Files.*

There are a number of considerations that should be added to the Step Three – Review of a Sample of Loan Files, in addition to those that are outlined in the FDIC Memorandum in Step Three:

- *Indicators of Bait and Switch Tactics.* In a non-predatory loan a comparison of the RESPA required Good Faith Estimate (GFE) and the HUD 1 disclosures should not reveal significant differences in the points, fees and closing costs. In predatory loans, there are often gross differences in the points and other costs. Additionally, yield spread premiums should be disclosed in the (GFE), and their sudden appearance on the HUD 1 is an indicator of abuse.[19] Finally, the combination of large yield spread premiums with large closing costs, particularly including fees paid to mortgage brokers, is a clear indication of overpayment, and significant potential liability.[20]

- *Unjustified Balloon Payment Terms.* The FDIC recommends only that banks look at short-term balloon loans. We recommend that the overall percentage of balloon loans in the loan pool be evaluated. Balloon mortgages are justifiable, if at all, for a narrow group of borrowers who are making an informed decision to obtain a reduced interest rate in return for the balloon feature, and who anticipate selling or refinancing prior to the balloon due date. Some predatory lenders have pools with 50% or more balloon loans, which cannot be justified. There should also be a clearly documented connection for a balloon loan with some sort of price break or other benefit to the borrower, including some documentation as to how the borrower will pay the balloon payment.
- *One Way Only – Up – Variable Rate Loans.* Another ploy in some predatory loans is to make variable loans which have rates that only go up, never go down. All too often, we see subprime mortgage loans that have rates which rise, but have no provisions allowing the rates ever to decrease. Also, some of these predatory loans have high margins, generally 4 points or more, far greater than the 1 to 2 points over a standard index that are seen in variable rate mortgages in the prime market.
- *Evaluation of Ability to Repay the Loan.* It has been well recognized that predatory mortgages are often based on the collateral, rather than the income of the borrowers. "No-doc" loan programs are indicative of this problem. While the no-doc loan product was developed for self-employed borrowers, it has too often loans been used to hide the fraudulent activities of the loan originator. Any originator making more than 10% of its loans under "no-doc" programs should be able to provide detailed information about how it prevents fraud and monitors these categories of loans for excessive defaults.
- *Evaluation of High Rates.* A pool of subprime mortgages should have a relatively narrow range of interest rates, from 50 basis points to 400 basis points or so above comparable conforming mortgage rates. The FDIC memo says that banks "should be able to recognize questionable fees and excessive rates." However, some banks may have little or no experience with subprime mortgages. Pricing data is not widely reported, or even advertised, so that the "normal" or "typical" subprime mortgage interest rates, and points are very difficult to ascertain. Even in the riskiest subprime loan pools, annual losses should not exceed 1% of outstanding balances, so that rate differentials of more than 400 basis points are indicative of non-competitive pricing. The FDIC memo should suggest these specific guidelines.[21]

Part Three: How to Avoid Investing Securities Backed by Predatory Loans

5th Recommendation: *Add to Step One, a specification that certain loan terms are predatory, and require certification from the issuer that the loans in the pool do not contain these predatory terms.*

The FDIC Memorandum sets out a good method of analysis on this issue. Our most important recommendation in Part Three is to add the use of objective criteria outlined in our Second Recommendation to Step One in Part Two. Issuers should be required to certify that no loans within the pool include any of the predatory terms as defined above – under our second recommendation. This simple addition will go a long way to stopping the grossest abuses in predatory lending, and protecting banks from potential liability for engaging in or facilitating this damaging practice.

Conclusion
On behalf of the low income clients of the National Consumer Law Center and the member organizations of the Consumer Federation of America, we appreciate this opportunity to comment on the FDIC's efforts to address predatory lending. We would be happy to provide more ideas, citations for our references, specific examples of litigation or cases, or any other information that might be deemed useful.

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Appendix 1

Example of Home Equity Bleeding

Typically a subprime loan will look like this:

Assume a home value of:	$110,000
Borrower receives:	$70,000
Borrower pays:	
6 Points	4,200 ($4,200 profit to lender)
Closing Costs [22]	2,500 ($1,500 profit to lender)
Credit Insurance	2,200 ($1,000 commission to lender)
Total Loan Amount	$78,900 - $6,700 - immediate profit to lender upon sale of loan to investor
Interest Rate of 12%	30 year term
Monthly payment	$811.58
Consumer owes after 36 payments	$77,927
After 60 payments, the balance is	$77,056

In this case, the homeowner has paid $8,900 in home equity to obtain $70,000 in funds. Typically, this loan will be refinanced several times. Often, homeowners are solicited by loan brokers when they are current on their payments to offer “new” credit and promise to consolidate debt, reduce monthly payments, and, sometimes, to lower the interest rate. Typically, this refinancing will occur within three years. Assuming this loan is refinanced at the end of three years, with a $4,000 extension of new credit the new loan might look like this:

Borrower receives:	$4,000 in “new money”
Balance due on old loan:	$77,927
Costs of New Loan:	
5 Points	$4,100 ($4,100 profit to lender)
Closing Costs	$2,500 ($1,500 profit to lender)
Credit Insurance	$2,400 ($1,100 commission to lender)

Total Loan Amount	$86,927 - $6,700 - immediate profit to lender upon sale of loan to investor
Interest Rate	11.75%
30 year term	
Monthly payment	$877.45
Consumer owes after 36 payments	$85,798
After 60 payments, the balance is:	$84,794

Typically, this loan will be refinanced several times, until there is no more home equity in the home. Only then – when the equity has been completely depleted, will foreclosure be pursued, instead of refinancing. At that point, on that last loan made by the lender, the lender may lose money. But over the course of the credit relationship, the lender will have stripped tens of thousands of dollars from the home, the homeowner will have spent tens of thousands of dollars attempting to keep their home. In the end, only the lender and the investor will benefit, the homeowner and the neighborhood will not.

These problems existed for many years prior to the passage of the Home Ownership and Equity Protection Act, and have since grown exponentially. We attach as Appendix 2 examples of legal but predatory loans. We saw these problems in the 1980s, Congress recognized these problems in the early 1990s. As should be is obvious from the substantial testimony and news stories, these problem loans continue to grow unabated.

Appendix 2

Summary Examples of Predatory Mortgages[23]

An elderly homeowner in Minnesota whose loan was flipped several times by a major lender. New points were imposed on each occasion and none were rebated upon refinancing.[24] The lender charged this homeowner 1 cent under 10 points (computed on the amount financed) prior to HOEPA. In the 1996 refinancing, the homeowner paid points which were 1 cent under the 8% HOEPA trigger. Because points were not rebated, the effective interest rates on these loans were much higher than the APR due to prepayment early in the term. The 1996 loan yielded a 26.813% APR based upon the fact that points were not rebated and the loan was prepaid in February, 1997.[25]

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 countable points are 5% which do not alone exceed the 8% trigger. Credit insurance is not currently included in the HOEPA points and fees trigger If the credit insurance charge is added to the points, the total of over 10% easily triggers HOEPA protections.

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%. This problem is evidenced made to two homeowners in Baltimore, Maryland. The homeowners are paying an APR of 19.2% on the first lien loan and 10 points. [26] The second lien loans reveals a 24% APR. When the HUD-1 Settlement Statements for both loans are compared, it is clear that the cash owed by the homeowners to pay for settlement costs (line 303) on the first loan is the same amount which is financed by the second loan.

Another homeowner is paying an APR of 14.59% on the first lien and 10 points (calculated in the same way as the homeowners described above). The second lien loan reveals a 24% APR. When the HUD-1 Settlement Statements for both loans are compared, it is clear that the cash owed by the homeowner to pay for settlement costs (line 303) on the first loan is paid by the cash to be disbursed by the second loan.[27] Significantly, these homeowners report that they did not realize there would be two loans prior to settlement.

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 statements. Further, 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. This is a practice of a lender doing business in the Baltimore, Maryland area. 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.

At least one major lender is beginning to refinance its already existing portfolio of closed-end loans with a new "credit line account." The initial APR is just under the APR HOEPA trigger but it could easily exceed the trigger shortly thereafter, depending upon the index that is used. The maximum annual interest rate allowed on the account is 21%. In many loans, the initial advance was very close to the credit line limit suggesting that the loan may be a disguised closed-end transaction. These loans typically have high initial interest rates - such as the 15.5% charged to some borrowers – in addition to the 3 points the borrowers were charged.

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.

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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 1996) and Unfair and Deceptive Acts and Practices (NCLC 1991), 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]The Consumer Federation of America is a nonprofit association of some 270 pro-consumer groups, with a combined membership of 50 million people. CFA was founded in 1968 to advance consumers' interests through advocacy and education.

[3]We urge the FDIC to continue to participate with the other federal credit regulators (Office of the Comptroller of the Currency, Office of Thrift Supervision, Federal Reserve Board and the National Credit Union Administration) to generate a comprehensive scheme to combat predatory lending.

The OTS has already embarked on this course by considering changes to regulations under the Alternative Mortgage Transactions Parity Act. *See* Advance Notice of Proposed Rulemaking, Docket Number RIN 2550-AB37, 12 C.F.R. Part 560, No. 2000-34, July, 2000.

The Federal Reserve Board has also begun to address the problem of predatory lending within its rubric, by proposing changes to the Home Ownership and Equity Protection Act, and new prohibitions under its unfair trade practice authority within the Truth in Lending Act. *See* Proposed Rule, 12 CFR 226, Regulation Z, Docket No. R-1090.

We have a host of very specific suggestions on these and other efforts of the federal agencies, as well as proposed changes to the federal law, which we would be happy to provide.

[4]For example, United Companies and First Alliance Mortgage Company filed bankruptcy in recent years largely to protect themselves from litigation precipitated by predatory practices.

[5] By "objective" we mean the Webster Dictionary definition #2: having actual existence or reality, based on observable phenomena.

[6] By "subjective" we mean the Webster Dictionary definition #1 : personal, relating to an individual circumstance.

[7] The subjective criteria listed by the FDIC include: misleading or fraudulent marketing; abusive collection and aggressive foreclosure practices; and underwriting based on the value of the collateral rather than a borrower's ability to repay. This latter criteria is only specifically illegal if the loan is covered by HOEPA, or if the loan is governed by North Carolina law (*see,* N.C.G.S. § 24-1.1E.). However, there are a number of activities typically engaged in by lenders who typically do this, such that this criteria can be also be dealt with in the objective criteria category. See discussion in section on ___, below.

[8]As a result, these factors are neither illegal per se like the subjective criteria, nor can they be targeted as being always predatory, as can the objective criteria.

[9] While we would prefer the bright-line rule that banks would simply not purchase loans with certain characteristics, it might also be possible for banks to purchase some loans with some of the characteristics for a lower price – making them less profitable to the originator; or with recourse – requiring the originator to buy back the loan if litigation results.

[10]The points and fees trigger must include all points, fees, and insurance charges, but the prohibition on financing more than 3% also applies to *all* points and fees. Under current HOEPA law, there are confusing rules to determine which fees and insurance charges are included in the trigger for up-front costs. For example, under current law, the trigger excludes "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 would 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 difficult. It is simplest for the closing costs trigger to include all points and all fees for closing costs.

Points and fees must be defined as: (a) all items listed in 15 U.S.C. § 1605(a)(1) through (4), except interest or the time-price differential; (b) all charges listed in 15 U.S.C. § 1605(e); (c) all compensation paid directly or indirectly to a mortgage broker, including a broker that originates a loan in its own name in a table-funded transaction; (d) the cost of all premiums financed by the lender, directly or indirectly for any credit life, credit disability, credit unemployment or credit property insurance, or any other life or health insurance, or any payments financed by the lender directly or indirectly for any debt cancellation or suspension agreement or contract, except insurance premiums calculated and paid on a monthly basis shall not be considered financed by the lender. Total loan amount means the principal of the loan minus the points and fees.

[11]The Federal Reserve Board and HUD specifically endorsed this proposal in their Report to Congress in July, 1998. Board of Governors of the Federal Reserve System, Department of Housing and Urban Development, *Joint Report to the Congress Concerning Reform to the Truth in Lending Act and the Real Estate Settlement Procedures Act,* July, 1998, at 74.

[12] 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.

[13] Mary Griffin & Birny Birnbaurm, *Credit Insurance: The $2 Billion a Year Rip-Off,* Consumers Union and the Center for Economic Justice (Mar. 1999) (from 1195 to 1997, more than $17 billion of credit insurance was sold in the U.S., excluding private mortgage insurance). This is up from $2.5 billion in 1979. *See 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).

[14]*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).

[15] 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 US LIFE Credit Corp. & US LIFE 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).

[16] *See* Gail McDermott, Leslie Albergo, Natalie Abrams, Esq., NIMS Analysis: Valuing Prepayment Penalty Fee Income Standard & Poor's, News Release, Jan. 4, 2001. *Also see,* North Carolina Coalition for Responsible Lending, Prevalence of Prepayment Penalties, available at http://www.responsiblelending.org/PL%20-%20Coalition%20Studies.htm citing data obtained in an interview with the Mortgage Information Corporation and the industry newsletter, *Inside Mortgage Finance*, and the following articles on conforming mortgages: "*Freddie offers a new A-, prepay-penalty program,*" Mortgage Marketplace, May 24, 1999; Joshua Brockman, "*Fannie revamps prepayment-penalty bonds,*" American Banker, July 20, 1999.

[17] This information is based on the extensive experience of NCLC's attorneys representing individual homeowners in predatory mortgage cases, as well as working with similar advocates in communities across the nation.

[18]*Union Mortgage Co. v. Barlow,* 595 So. 2d 1335 (Ala. 1992) ($6 million verdict for fraud upheld); *Williams v. Aetna Fin. Co.* 700 N.E.2d 859 (Ohio 1998) ($1.5 million verdict for fraud upheld).

[19]Policy Statement on Legality of Lender-Paid Broker Fees, Department of Housing and Urban Development, 64 Fed. Reg. 10079 (Mar.1, 1999).

[20]*See e.g. Moses v. Citicorp Mortgage, Inc.* 982 F.Supp. 897 (E.D.N.Y) 1997 (claim under RESPA § 2607(a) stated where borrowers paid application and origination fees to broker and lender paid broker an additional $1,913.40; allegations of duplicative fees fees also states a claim under § 2607(b).) *See also,* National Consumer Law Center, *The Cost of Credit: Regulation and Legal Challenges* (2ed. 2000) § 11.3.1.5.

[21] A wide spread of interest rate in a lender's portfolio is indicative of a lender that allows brokers or loan originators to charge interest rates above par or matrix rates. Pricing discretion in turn is almost invariably associated with uncompetitive, discriminatory and predatory pricing.

[22]HUD estimates that over 50% of all mortgage loans involve a broker. *See* HUD News Release of Sept. 17, 1997 accompanying HUD's announcement of proposed changes to Regulation X regarding broker fees proposed in 62 Fed. Reg. 53912 (Oct. 16, 1997). In over 50% of mortgages loans, closing costs includes a broker's fee. In the interests of simplicity of this example, we have not identified and included either broker's fee.

[23] Exhibits providing the evidence for the loans detailed below were presented to the Federal Reserve Board at hearings regarding the Home Ownership and Equity Protection Act, Docket No. R-0969, June 17, 1997, by Elizabeth Renuart, Staff Attorney, National Consumer Law Center.

[24]The loans prior to 1996 contained a provision purporting to rebate unearned points. Application of the formula, however, never results in a rebate unless the prepayment occurs within the first year of the loan.

[25] The homeowner could no longer afford to make the monthly payments that increased with each refinance and was forced to sell his home. He paid off the lender in February 1997.

[26]The 10 points were calculated on the principal amount of the loan. If, instead, the amount financed is used, the number of points charged is 11.

[27] One homeowner reports that she did not receive all of the cash allegedly disbursed by the second loan even after the closing costs from the first loan were paid.