Proposal For Predatory Mortgage Reform [1]

Presented to Predatory Lending Forum

by the National Consumer Law Center[2]

February 23, 2000

Overview of Proposal for Mortgage Reform

Legislation to prevent abusive mortgage lending should regulate the mortgage industry so that the market encourages loans which are not only profitable for lenders and investors, but are also good for consumers. It is the goal of this proposal to promote a healthy subprime mortgage industry which profits from loans to consumers which are good for consumers. If this proposal is successful, the ensuing subprime mortgage market will discourage mortgage loans which are not positive for consumers. The result should be a dynamic mortgage industry for subprime lenders and borrowers. Some loans made in the current climate will not be made; many others will be made with fairer terms which promote homeownership, rather than defeat it.

Our proposal to deal with predatory mortgage lending has a four important elements:

1. The Home Ownership and Equity Protection Act (HOEPA) should be expanded to apply to more loans, and stricter prohibitions should apply.
2. Protections should be established for consumers in home improvement loans.
3. Federal protections should be established in foreclosure proceedings.
4. Mandatory arbitration should be prohibited.

The essential core of this proposal is in the expansion of HOEPA protections to prohibit the financing of points, fees and credit insurance premiums, and the charging of prepayment penalties.

We do *not* propose to put a cap on the points or fees that can be charged for high rate loans, only that lenders be prohibited from financing them. Presumably, for most borrowers, prohibiting the financing of these charges will be the same as prohibiting the charges altogether, but this will not necessarily mean that these loans cannot be made. It will only mean that these fees will be rolled into the interest rate charged the borrower -- the lender will pay the fees and recoup them through the interest payments on the loan. The rate of interest charged borrowers will increase, but the borrower’s equity ownership in the home will be preserved. These loans will be structured exactly the same as the "no cost” mortgage loans provided to prime borrowers all the time.

There are indisputable advantages flowing from the prohibition against the financing of any points, fees or credit insurance premiums:

- *No equity will be stripped from the home.* The amount of money that the borrower directly receives, or is paid on the borrower's behalf will be the full loan amount, and nothing more. Every payment the borrower makes will reduce the loan amount. If there are repeated refinancings, the loan amount will *not* rise. The equity in the home is no longer the source of financing the loan -- the loan can only be financed through the borrower's income.
- *The lender will have the incentive to make these loans affordable.* Currently, a typical predatory mortgage transaction creates thousands of dollars of immediate profit to the lender upon sale of the loan to an investor. When the borrower refinances the loan, the lender sees a substantial profit, providing an incentive to the lender to encourage refinancings, regardless of whether the borrower can actually afford to repay the refinanced loan. Yet, if the lender only reaps a benefit from the loan through the *payments* the lender has a clear incentive to make sure that the borrower can afford the payments.

- *The market will work to keep the interest rate on these loans competitive.* So long as the borrower has not invested a significant amount of money in each loan -- as is done when thousands of dollars in points and fees are financed -- there is little to stop the borrower for shopping for a lower rate loan when his credit improves, or interest rates fall - just as is done in the prime market. As a result, when the loan is first made the wise subprime lender will make the rate only high enough to cover the costs, the real risk, and a reasonable profit. If more is charged, the borrower will be able to refinance at a lower rate with a competitor.

Consider the following high cost loan:

Borrower receives:	$30,000	
Borrower pays:		
10 Points	3,000	($3,000 all profit to lender)
Closing Costs	2,000	($1,500 profit to lender)
Credit Insurance	2,200	($1,000 commission to lender)

Total Loan Amount $37,200 $5,500 - immediate profit to l lender upon sale of loan to investor

Interest Rate of 12% 30 year term Monthly payment -$383

Consumer owes after 36 payments - $36,741.

So long as there is sufficient equity in the home (and there generally is plenty), the lender *benefits* if the borrower defaults. A default provides the lender with reason to make a new loan, charge more points and fees and is another immediate opportunity to turn a quick profit. Yet, the refinanced loan would be for an amount at least $6,000 more, with the same interest rate of 12%, and the consumer will have that much less equity in the house.

However, if the lender could charge as high an interest rate as desired, but could not finance the up-front costs and fees, the same loan might look like this:

Borrower receives $30,000

No points, fees or charges are financed

Total Loan Amount $30,000 $0 - immediate profit by lender upon sale of loan to investor

Interest Rate of 15% 30 year term Monthly payment -$379

Consumer owes after 36 payments - $29,804.

This lender has much less incentive to flip this loan then the lender in the first example. Indeed, the lender only has incentive to make sure that borrower can in fact repay the loan. The profit from the loan will only flow from the payments.

Proposed Substantive Protections to be Included in any Mortgage Reform Legislation.

The government, and the housing and lending industries have done an excellent job in recent years in expanding programs to establish new homeownership opportunities for low-income families. The next challenge is to enhance the long term sustainability of the homeownership experience for these families. The ultimate success of homeownership as an asset building strategy will be measured by the degree to which new homeowners are able to afford proper maintenance, avoid foreclosures, build equity in their homes, and use their equity effectively as wealth.

The market does not work to provide protections for consumers from abusive mortgage loans, because too often it is financially remunerative for lenders to encourage equity stripping and then foreclosure. Foreclosing on a home will force a sale which almost always yields less than the home's true value, allowing the creditor to purchase the home at a discounted rate and realize yet another profit when the home is sold at full value at a later date. Not only is there always significant collateral protection on home loans, there is the very real emotional attachment that homeowners have in their homes, making the home loan the first to be repaid, and the last to be defaulted upon. There is thus generally very little risk in any loan which is secured by a home.

We propose three substantive provisions along the following lines be added to the law:

1. The Home Ownership and Equity Protection Act should be expanded to apply to more loans, and stricter prohibitions should apply.
2. Protections should be established for consumers in home improvement loans.
3. Federal protections should be established in foreclosure proceedings.

1. Expansion of HOEPA.

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.[3] This 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.[4]

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 four 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 three most significant problems with HOEPA:

1. HOEPA 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. The interest 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.
3. HOEPA does not apply to open end loans. When HOEPA was passed in 1993, there were few predatory open end mortgage loans being made. In the past seven years, that picture has changed. It has become apparent, that open end credit provides another vehicle for mortgage abuses. There is no longer any reason to exclude open end mortgage loans from HOEPA's coverage. More importantly, unless open end loans are brought within the scope of HOEPA, the failure to regulate them will simply push the bad actors into that market.

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.

A Tiered Approach. 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.

Limitation on Financing of Points and Fees. Additionally, a key 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.

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.[5]

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 a difficult burden for consumers to meet. The closing costs trigger should include all points and all fees for closing costs.

Financing Credit Insurance Premiums. Credit insurance is a big ticket item in each individual loan.[6] Nationally, consumers spend as much as $2.5 billion per year on credit insurance, often with little understanding of what they have bought.[7] This volume of business conceals overcharges of $900 million[8] to $1.2 billion,[9] 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.[10] *The Federal Reserve Board and HUD have endorsed this proposal.*[11]

Prohibiting Prepayment

Penalties. The prohibition against financing points, fees and credit insurance premiums only works if it is accompanied by a protection on the backend of the loan: a prohibition against prepayment penalities. 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 70% of subprime loans currently charge prepayment penalties and only 2% of conventional loans do (almost all in California). 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.

2. More Protections Should Be Established for Consumers in Home Improvement Loans.

Recognizing the high number of abuses which flow from home improvement loans, federal law should establish new protections applicable to all *home improvement loans* secured by the home. This home improvement law would ensure that a) homeowners have an effective method of enforcing their warranty rights, and b) lenders are held responsible for the actions of home improvement contractors. The new law would not limit consumers' rights under existing federal and state laws and regulations governing these contracts.

One of the primary problems which arise from home improvement loans is the application of the 'holder in due course" rule. This rule generally applies to purchasers of negotiable instruments, such as mortgage loans.[12] The holder in due course doctrine protects assignees of a negotiable instruments from liability for the wrongdoing performed by the original lender though the borrower might be harmed.

Thus, generally regardless of a home improvement contractor's wrongdoing, the consumer's obligation to pay the lender/assignee 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 home improvement transaction. Problems often arise because some home improvement contractors are insolvent, or they disappear (and reincorporate under a new name or file bankruptcy) at the first hint of litigation.

In 1976, the Federal Trade Commission passed a rule limiting the holder in due course doctrine for the purchase of consumer goods or services.[13] The purpose of the FTC Holder 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 FTC Holder Rule rightly shifts the risk of seller misconduct to creditors who could absorb the costs of misconduct.[14] While the FTC Rule created some protection for consumers in this context, it is limited in several ways. First, the consumer rights provided by the FTC 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 FTC Rule.

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

3. Federal Protections Should Be Established in Foreclosure Proceedings.

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.

- 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 and simply proceed to foreclosure.

4. Mandatory arbitration clauses should be prohibited.

Over the last few years, including mandatory arbitration clauses in consumer credit contracts has become standard operating procedure...more often than not. Creditors 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, whotypically handle disputes between two businesses, are unfamiliar with consumer protection laws, and may be unsympathetic to consumers. Creditors also prefer arbitration because their exposure to punitive damage awards is dramatically reduced, and the threat of class actions is generally nullified.

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 decisionmaker's erroneous interpretation of the law. This allows arbitrators to ignore state or federal consumer protection statutes and judicial precedent.

Consequently, any comprehensive law addressing predatory mortgage lending must include a prohibition against mandatory pre-dispute arbitration clauses.

---

[1] This proposal is adapted from testimony to a joint hearing before two subcommittees of the House Banking Committee on September, 16, 1998, presented on behalf of NCLC's low income clients, as well as the Consumer Federation of America, Consumers Union, the National Association of Consumer Advocates, and the U.S. Public Interest Research Group. These proposals for the overall structure, as well as the details, of mortgage reform are the products of thousands of hours of analysis by attorneys and advocates from around the nation who have devoted their careers to representing consumers.

[2] This proposal is presented by Margot Saunders, Managing Attorney, National Consumer Law Center. For further information about this topic, contact her at Margot@nclcdc.org or Elizabeth Renuart, NCLC’s expert on predatory lending, Elizabeth@nclcdc.org.

[3] *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).

[4] 15 U.S.C. § 1602(AA)(1)(B).

[5] *Id.*

[6] 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.

[7] *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).

[8] *Id.* at 3.

[9]*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).

[10] 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).

[11] 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] 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).

[13] 16 C.F.R. § 433.

[14] Forrester, *supra* Footnote 22, at 1108.