Chapter I.   Executive Summary

In April, the home ownership rate reached a record high with 67.1% of American families owning their own homes. A total of 70.7 million American families owned their homes in the first quarter of the year – more than at any time in American history.

Despite these gains, too many low- and moderate-income families have seen the dream of home ownership become a nightmare because of predatory or abusive lending practices. These practices are concentrated in the subprime mortgage market, where record numbers of Americans are refinancing their homes for consumer credit purposes. Subprime lending serves an important role, by providing loans to borrowers who do not meet the credit standards for the prime mortgage market. Some borrowers in the subprime market, however, may be particularly vulnerable to abusive lending practices.

This report details the recommendations of the Department of Housing and Urban Development (HUD) and the Department of Treasury for legislative and regulatory action to combat predatory lending, while maintaining access to credit for low- and moderate-income borrowers. In addition, the report describes regulatory and policy changes that HUD is implementing to combat predatory lending. The recommendations contained in this report are based, in significant part, on information gathered by the HUD-Treasury National Predatory Lending Task Force.   Secretary Cuomo announced the Task Force in March 2000, in response to inquiries made by Senator Mikulski in the context of a VA/HUD Appropriations Subcommittee hearing. Secretary Cuomo and Secretary Summers jointly convened the Task Force in April 2000.

The Task Force drew its members from a wide range of parties interested in and affected by predatory lending, including consumer advocacy groups; industry trade associations representing mortgage lenders, brokers, and appraisers; local and state officials; and academics. Task Force members collected information about predatory lending and provided testimony on the effects of predatory practices through a process that included field forums held in Atlanta, Los Angeles, New York, Baltimore and Chicago.

What is Predatory Lending?

Although home mortgage lending is regulated by state and federal authorities, none of the statues and regulations governing mortgage transactions provides a definition of predatory lending. Predatory lending -- whether undertaken by creditors, brokers, or even home improvement contractors -- involves engaging in deception or fraud, manipulating the borrower through aggressive sales tactics, or taking unfair advantage of a borrower's lack of understanding about loan terms. These practices are often combined with loan terms that, alone or in combination, are abusive or make the borrower more vulnerable to abusive practices.

Predatory lending generally occurs in the subprime mortgage market, where most borrowers use the collateral in their homes for debt consolidation or other consumer credit purposes. Most borrowers in this market have limited access to the mainstream financial sector, yet some would likely qualify for prime loans. While predatory lending can occur in the prime market, it is ordinarily deterred in that market by competition among lenders, greater homogeneity in loan terms and greater financial information among borrowers. In addition, most prime lenders are banks, thrifts, or credit unions, which are subject to extensive federal and state oversight and supervision, unlike most subprime lenders.

Throughout the HUD-Treasury forums, there was substantial evidence of too-frequent abuses in the subprime lending market. These abuses tended to fall into four main categories:

Loan Flipping – Some mortgage originators refinanced borrowers' loans repeatedly in a short period of time. With each successive refinancing, these originators charged high fees, including sometimes prepayment penalties, that stripped borrowers' equity in their homes.

Excessive fees and "packing" – While subprime lending involves higher costs to the lender than prime lending, in many instances the Task Force saw evidence of fees that far exceeded what would be expected or justified based on economic grounds, and fees that were "packed" into the loan amount without the borrower's understanding.

Lending without regard to the borrower's ability to repay – One troubling practice involved lending based on borrowers' equity in their homes, where the borrowers clearly did not have the capacity to repay the loans. In particularly egregious cases, elderly people living on fixed incomes had monthly payments that equaled or exceeded their monthly incomes. Such loans quickly led borrowers into default and foreclosure.

Outright fraud and abuse – In many instances, abusive practices amount to nothing less than outright fraud. We heard many stories from borrowers who testified at the regional forums of fraud perpetrated by unscrupulous mortgage brokers, lenders, home improvement contractors, appraisers, and combinations thereof. Unscrupulous actors in these markets often prey on certain groups – the elderly, minorities, and individuals with lower incomes and less education – with deceptive or high-pressure sales tactics.

The Subprime Mortgage Market

Predatory lending occurs primarily in the subprime mortgage lending market, which has grown rapidly over the past several years. Subprime loan originations increased from $35 billion in 1994 to $160 billion in 1999. The subprime market share increased from less than 5 percent of all mortgage originations in 1994 to almost 13 percent in 1999. Securitization of subprime mortgages has developed in the past few years and has contributed significantly to rapid growth of the market. Issuance of securities backed by subprime mortgages increased from $11 billion in 1994 to $83 billion in 1998. In 1998, 55 percent of subprime mortgages were securitized, falling back to 37 percent in 1999.

By providing loans to borrowers who do not meet the credit standards for borrowers in the prime market, subprime lending provides an important service, enabling such borrowers to buy new homes, improve their homes, or access the equity in their homes for other purposes. A majority of mortgages in the subprime market are used for consumer debt rather than housing purposes. As the HUD-Treasury Task Force forums demonstrates, however, the subprime market can be fertile ground for predatory lending activities. As documented by this report, predatory lending practices can occur at any stage of the loan process and be undertaken, or at least facilitated, by any of the many participants in a particular transaction.

Research conducted by HUD in connection with Task Force activities found that subprime lending tends to be concentrated in low-income and minority communities. Notably, HUD found that, even after controlling for neighborhood income (although without controllnig for credit history or risk), people living in predominantly African-American communities refinance in the subprime market much more often than people living in predominantly white communities.

Current Legal Context

Among the laws designed to protect consumers in mortgage lending are the Truth in Lending Act (TILA), the Home Ownership and Equity Protection Act (HOEPA), and the Real Estate Settlement Procedures Act (RESPA). In connection with transactions such as mortgages on a personal residence, TILA requires disclosure of essential terms, including the finance charge, the finance charge expressed as an annual percentage rate, and the total of all loan payments. For a subset of refinancings and closed-end home equity loans that are particularly high-cost, HOEPA requires additional disclosures and restricts some loan agreement provisions (e.g., prepayment penalties, balloon payments, and negative amortization) that can cause unique hardships to high cost loan borrowers. Private remedies for violations of TILA and HOEPA include, in appropriate circumstances, rescission and damages. RESPA requires disclosure of settlement costs, bars payments by settlement service providers for business referrals and unearned fees, limits amounts that can be held in borrowers' escrow accounts, and requires that borrowers be informed of mortgage servicing transfers and of lenders' business arrangements with affiliated settlement service providers.

Recommendations for New Legislation and Regulations

Treasury and HUD believe that new legislation and new regulation are both essential components of a coordinated strategy to combat predatory lending. The proposals set forth in this report address four specific areas: (1) Consumer Literacy and Disclosure; (2) Harmful Sales Practices; (3) Abusive Terms and Conditions; and (4) Market Structure.

(1) Consumer Literacy and Disclosure

Victims of predatory lending typically suffer from a lack of understanding of the mortgage loan process generally, and the specific terms of the loan they are entering into in particular. A consumer's lack of understanding makes him or her more vulnerable to abusive lending. HUD and Treasury recommend that Congress enact legislation providing that:

> *Creditors be required to inform all HOEPA loan applicants of available home counseling programs prior to closing, and to recommend that such applicants seek counseling. The creditor would be required to provide the prospective borrower with a list of certified counselors in their area. HUD will study the most effective means of expanding access to counseling and its effectiveness.*

A 1998 report by HUD and the Federal Reserve Board concluded that the reform of the existing disclosure and enforcement scheme under the Real Estate Settlement Procedures Act (RESPA) and the Truth in Lending Act (TILA) could improve consumer understanding and facilitate meaningful loan shopping. Building on the recommendations in that report, HUD and Treasury recommend that Congress:

> *Amend RESPA and TILA to make information provided to consumers about the costs of credit and settlement services more reliable, more timely, and more helpful in comparison shopping.*
>
> *Amend Section 8 of RESPA to permit a creditor to provide consumers with a "guaranteed cost" package, guaranteeing both settlement costs, as well as loan rate and points, to enable consumers to effectively shop for the best price.*
>
> *Impose an accuracy standard, or tolerance, on permissible variations from the Good Faith Estimate required under RESPA.*
>
> *Require creditors to inform all borrowers of their credit scores and the indices for those scores on request.*
>
> *Enact essential reforms to the mortgage process, including combining and coordinating the timing of RESPA/TILA disclosures and establishing new or enhanced remedies, including civil penalties, for nondisclosure, misdisclosure, or other RESPA, TILA or HOEPA violations.*
>
> *Expand enforcement of HOEPA, RESPA, and TILA and create additional remedies under these laws.*

(2) Harmful Sales Practices

<u>Targeting Predatory Loans to Specific Populations</u>

The Task Force forums suggested that minorities, women, and the elderly bear the brunt of abusive mortgage lending practices, particularly in predominantly minority or low-income neighborhoods that do not have access to mainstream sources of credit. To ensure that the potential civil rights implications of predatory lending receive the attention they deserve, HUD and Treasury recommend that:

Congress fund the President's request for fair lending enforcement and for funding of state, local, and private agencies with the capacity to effectively combat predatory lending practices that disadvantage minorities, women, and the elderly.

The Federal Reserve Board take steps to increase the information lenders must report under the Home Mortgage Disclosure Act (described more fully below under part (4), Market Structure).

Loan Flipping

Loan flipping is the practice of repeatedly refinancing a mortgage loan without benefit to the borrower, in order to profit from high origination fees, closing costs, points, prepayment penalties and other charges, steadily eroding the borrower's equity in his or her home. HUD and Treasury recommend that Congress amend HOEPA to:

Prohibit the refinancing of any existing mortgage with a new loan covered by HOEPA within 18 months of the preceding loan's origination unless the new loan provides the borrower with a tangible net benefit, as defined by the Federal Reserve Board.

Permit a creditor that refinances an existing mortgage with a HOEPA loan within 18 months to charge points and fees only on the amount of the new advance.

Restrict the imposition of modification or deferral fees in HOEPA loans unless the modified loan has a significantly lower Annual Percentage Rate (APR) or is not a HOEPA loan.

HUD and Treasury also recommend that the Federal Reserve Board consider taking steps to prohibit loan flipping using its existing authorities.

Asset Based Lending

HOEPA prohibits lenders from engaging in a "pattern or practice" of making mortgage loans based solely on the value of the property securing the loan, without considering the borrower's capacity to repay. A borrower who has received an asset-based loan may have substantial difficulty proving that the lender engaged in a pattern or practice of making such loans. HUD and Treasury recommend that Congress amend HOEPA to:

Eliminate the pattern or practice requirement in HOEPA's provision restricting asset based lending.

Authorize the Federal Reserve Board to establish by regulation to establish a "safe harbor" for lenders based on a maximum debt to income ratio and residual income guidelines, within which there is a conclusive presumption of lender compliance.

Require the Board to identify by regulation the criteria and processes that lenders must utilize in evaluating a "borrower's ability to repay under HOEPA.

Mandate retention of written documentation in the loan file of the borrower's income and other information that the lender considered in making the loan.

The Federal Reserve Board should consider using its existing authority under HOEPA to more precisely define the scope of the restriction on asset-based lending.

<u>Broker, Appraiser, and Home Improvement Contractor Misconduct</u>

In many cases of predatory lending, lenders work closely with unscrupulous mortgage brokers, home improvement contractors, and/or appraisers in originating abusive high cost loans. HUD and Treasury believe that extending the reach of HOEPA to encompass these actors will help to eliminate many of these practices. Specifically, we recommend that:

Congress require mortgage brokers originating HOEPA loans to provide borrowers with a disclosure documenting all information the broker relied on in making or arranging the loan and all fees paid to the broker in connection with the loan, and requiring the disclosure to be signed by the broker and the borrower at least 3 days prior to closing.

Congress expand the definition of a "creditor" under HOEPA to include all individuals or entities that control the activities of the loan originator.

Congress make a lender liable for the malfeasance of a mortgage broker or home improvement contractor when the latter acts as the lender's agent, or the lender knew or had reason to know of the malfeasance.

Congress require that all appraisals associated with HOEPA loans be performed by a licensed or certified appraiser.

The federal government assist in the development of model laws at the state level for registration and licensing of brokers, contractors, and appraisers and work with localities to support local predatory lending task forces.

<u>Lenders' Failure to Report Full Payment History to Credit Bureaus</u>

Some lenders may not be reporting borrowers' good credit histories to the national credit bureaus, in order to "capture" those borrowers from competitors. When subprime mortgage lenders do not report full payment histories, borrowers may not be able to establish or repair their credit history. HUD and Treasury recommend that Congress:

> *Amend the Fair Credit Reporting Act to require reporting lenders to provide borrowers' full payment histories for all mortgage products.*

(3) Abusive or Deceptive Loan Terms and Conditions

<u>Expanding the Scope of HOEPA</u>

Only a small number of loans in the subprime market currently are covered by HOEPA. Thus, few borrowers who are potential victims of predatory lending currently benefit from HOEPA's protections. HUD and Treasury recommend that Congress extend the reach of HOEPA by:

> *Lowering the Annual Percentage Rate (APR) trigger, and establishing separate triggers for first and second lien loans.*
>
> *Including* all *points and fees in the points and fees trigger, including prepayment penalties financed in a new loan, all amounts paid to brokers, financed insurance premiums, and other fees paid to third party settlement service providers.*
>
> *Lowering the points and fees trigger.*
>
> *Including purchase money mortgages, open-end home equity lines of credit, and reverse mortgages under the statute.*

HUD and Treasury also recommend that the Federal Reserve Board use its existing statutory authority under HOEPA to lower the APR trigger to 8 percentage points above comparable Treasury securities and include additional fees in the points and fees trigger.

<u>Single Premium Insurance Products</u>

Credit life insurance and similar products pay off a borrower's remaining mortgage debt if the borrower dies or is otherwise rendered incapable of meeting his or her loan obligation. When sold in a "single premium" or "lump sum," all premiums for the policy are collected in advance and typically added to the principal loan balance, increasing the overall cost of the insurance. HUD and Treasury believe that the charging and financing of single premiums is unfair, abusive, and deceptive, and recommend that Congress enact legislation:

> *Prohibiting the sale of single-premium insurance products in all mortgage transactions.*

Requiring written notification to borrowers of cancellation or rebate rights for all monthly premium insurance products sold in conjunction with a mortgage transaction.

HUD and Treasury also recommend that the Federal Reserve Board use its existing authority to restrict unfair, deceptive, and abusive practices to prohibit the sale of single premium insurance products in connection with mortgage transactions.

<u>Prepayment Penalties</u>

The existence of prepayment penalties in high cost loans can inhibit borrowers from refinancing at a interest lower rate when their credit status improves or rates turn downward. HOEPA currently prohibits a prepayment penalty for a borrower whose monthly debt obligations exceed 50% of his or her gross monthly income or where the same creditor provides the funds with which repayment is made. HOEPA also restricts the application of prepayment penalties to a five-year period after loan origination. HUD and Treasury recommend that Congress:

Shorten the period of time in which a prepayment penalty may be assessed on a HOEPA loan, and restrict the size of prepayment penalties, so that these restrictions would (1) curb predatory lending, and (2) not unduly inhibit the flow of credit to subprime borrowers.

Exempt specific prepayment circumstances from penalties, e.g., when the borrower moves, sells the property, defaults, or elects to accelerate loan payments by up to 20 percent annually.

Require creditors to offer HOEPA loan applicants the choice between a loan with a prepayment penalty and a loan without such a penalty.

<u>Balloon Payments</u>

Unscrupulous lenders may use balloon payments to induce borrowers into loans with attractive monthly payments without informing the borrower of the existence of the balloon or its long-term consequences. HOEPA restricts the existence of balloon payment mortgages to loans with terms of five years or more. HUD and Treasury recommend that Congress:

Restrict the timing of balloon payments under HOEPA to no fewer than 15 years.

<u>Mandatory Arbitration</u>

Mandatory arbitration clauses require, as a condition of receiving a loan, that a borrower agree to resolve any and all disputes arising out of the loan through arbitration, rather than litigation. Mandatory arbitration may severely disadvantage HOEPA borrowers. Because of the potential for such clauses to restrict unfairly the legal rights of the victims of abusive lending practices, HUD and Treasury believe that Congress should:

Prohibit mandatory arbitration for HOEPA loans.

<u>Financing of Points and Fees</u>

Financing points and fees may disguise the true cost of credit to the borrower, especially for high interest rate loans. Restricting the financing of points and fees for HOEPA loans would cause these costs to be reflected in the interest rate, enabling borrowers to better understand the cost of the loan, and to shop for better terms. Accordingly, Congress should:

Restrict the financing of points and fees on HOEPA loans to no more than the greater of 3 percent of the loan amount and a de minimus *dollar amount.*

(4) Market Structure

<u>Data Collection</u>

Most publicly available information about home mortgage lending is reported by lenders pursuant to the Home Mortgage Disclosure Act (HMDA) and the Federal Reserve Board's Regulation C, which implements that act. The data collected under HMDA, however, suffer from a number of inadequacies, which limit the data's utility in formulating policies to combat abusive lending practices. HUD and Treasury recommend that:

The Federal Reserve Board amend Regulation C to require collection of additional data items under HMDA, including (a) information on loan price (APR and cost of credit); (b) whether the loan was a manufactured home loan; (c) loan-to-value ratio; and (d) borrower debt-to-income ratio for HOEPA loans.

The Board revise Regulation C to repeal the "10 percent" rule to increase the number of lenders reporting under HMDA, and collect information on the "parent" of the reporting institution, and whether the loan was originated by a broker.

Congress amend HMDA to grant HUD the authority to impose sanctions and penalties against lenders not otherwise subject to federal supervision who fail to report, report incompletely, or misrepresent data pursuant to the Act.

<u>The Prime Market</u>

Prime lenders, and banks and thrifts generally, could play an important role in curbing predatory practices. To this end, HUD and Treasury recommend that:

> *The regulators publish guidance to award banks and thrifts CRA credit for offering products that "promote" qualified borrowers from the subprime to the prime mortgage market, and to deny banks and thrifts CRA credit for their origination or purchase of loans that violate applicable lending laws.*
>
> *The regulators consider, in the context of CRA examinations, banks' and thrifts' other market activities that may support predatory lending.*
>
> *The Federal Reserve Board consider exercising its authority to conduct risk-based examinations of subprime lenders that are subsidiaries of bank holding companies.*

<u>The Secondary Market</u>

By providing a source of funding, those who purchase or securitize high cost subprime loans may, knowingly or unknowingly, support the activities of predatory loan originators. HUD and Treasury recommend that:

> *Secondary market participants recognize their legal obligations to comply with HOEPA, TILA and fair lending laws as assignees of these loans, and put in place processes to ensure their compliance with these laws.*
>
> *The incidence of HOEPA loans in mortgage-backed securities pools be disclosed by the lender to the rating agency, bond insurer, and/or issuer of security, and be disclosed by the securitizer in the offering documents.*

Congress enact legislation to clarify, as necessary, the authority of HUD and the Federal Housing finance Board as the mission regulators of the Government Sponsored Enterprises (Fannie Mae, Freddie Mac and the Federal Home Loan Banks) to prohibit the purchase by each of these entities of predatory loans. Regulations in this area should address the restrictions already voluntarily undertaken by Fannie Mae and Freddie Mac.

<u>Foreclosure Prevention</u>

Not all states may adequately protect consumers from abusive practices in connection with foreclosures. Consumers in the subprime mortgage market may benefit from better notices with regard to foreclosure, and from increased protections against foreclosure under state laws. Borrowers in the high-cost loan market may be most in need of procedures to help them avoid foreclosure. HUD and Treasury recommend that:

Congress enact new federal legislation establishing notice requirements that maximize opportunities for borrowers to cure a delinquency or arrange other financing.

The Task Force work with states to develop model legislation, patterned on "best practice" state laws, to provide consumers with substantive pre-foreclosure protections.

<u>FHA Initiatives</u>

HUD has developed a series of new Federal Housing Authority (FHA) initiatives based on both its work with the Baltimore Task Force and the evidence developed at National Predatory Lending Forums. The new initiatives address predatory practices targeted at FHA and its borrowers, including inflated appraisals, fraudulent underwriting, property flipping and other lending abuses.

FHA's reforms to protect homeowners from predatory lending focus on two main areas: (1) providing relief to FHA borrowers already in distress, especially those who have been victimized by abusive lending; and (2) strengthening FHA endorsement and fraud detection procedures to prevent predatory practices from occurring in the first place. These initiatives build on FHA efforts to streamline operations and eliminate abusive practices.

To assist victims of predatory lending, FHA is launching a new initiative to directly fund foreclosure avoidance counseling in selected "Hot Zones" for FHA homeowners in default. Those areas will also be assigned FHA loss mitigation specialists to work with lenders and borrowers. The FHA may also provide other assistance to borrowers, such as by directing mortgage lenders to write down a mortgage that has been inflated as a result of a fraudulent appraisal to a level consistent with a fair market appraisal or other actions.

FHA will take action to stop predatory practices from undermining the ability of FHA to promote housing opportunity. FHA will institute an automated system to review the sales price history of properties prior to approval of FHA insurance. This new system will identify and stop abusive appraisal practices before the loan is endorsed. In addition, FHA will form "Swat Teams", modeled on the Baltimore team, to target abusive appraisal practices in areas with a high concentration of FHA foreclosures. Finally, FHA is launching a new Appraisal Watch System, similar to the Credit Watch system now targeted to lenders, to identify appraisers with a record of faulty appraisals and abusive practices, terminate them from FHA programs, and, if appropriate, pursue legal action.

In some instances, the new initiatives will be immediately available on a national basis. In other instances, FHA will operate pilots in Baltimore and other selected "Hot Zone" cities (defined as those with excessively high default and claim rates) to further test and refine the concept before moving to national implementation. In all cases, this new Fraud Protection Plan will better protect FHA, FHA borrowers and the communities FHA serves from the harmful effects of predatory practices in the home finance market.

Additionally, FHA will expand consumer education about predatory lending through improved housing counselor software, a predatory lending prevention best practices meeting with Fair Housing groups and a national public service ad campaign.

Recommendations for Appropriations

It was clear from the five public forums and the testimony of the experts on our National Task Force that funding would help in our fight against predatory lending. HUD and Treasury believe that funding in the following areas would be especially appropriate: (a) Foreclosure Counseling, (b) Local Fair Housing Initiatives, (c) Regulatory Enforcement and (d) Legal Services.

Foreclosure Counseling – HUD's home counseling program provides counseling services to over 250,000 consumers each year. Congress should fully fund the President's budget request for Housing Counseling Assistance in the FY 2001 appropriation to assist an additional 150,000 consumers.

Local Fair Housing Initiatives – HUD's Fair Housing Initiative Program (FHIP) funds private, nonprofit fair housing groups to help HUD monitor, enforce, and educate the public about the Fair Housing Act. Congress should fully fund the President's FY 2001 FHIP funding request and target funding for private enforcement and education.

Regulatory Enforcement – Congress should fully fund the President's requested increase in the budget for the Federal Trade Commission. Full funding will help the agency to meet the urgent need to increase its focus on combating abusive home mortgage lending practices.

Legal Services – By increasing the training and expertise of Legal Services Attorneys, we will help more consumers avoid predatory lenders. Congress should fully fund the President's request in this area.

Chapter II. Introduction and Background

Thanks to the robust economy of the past several years, more American families than ever before have been able to buy their own homes – an astounding 67.1 percent. To get the money to buy their homes, refinance their mortgages or meet other expenses using their home equity, nine out of 10 families turn to the prime mortgage market, which generally provides borrowers with many choices and the lowest mortgage rates.

Some families have problems in their credit history, however. Because they have overused consumer credit, or experienced a family illness or a spell of unemployment, they may have missed paying their bills in the past. If the credit applicant is young or lacks credit history, there may be insufficient basis for the prime lender to make a loan. These families can turn to the subprime lending market, where, for higher interest rates and generally higher up-front fees, they can still access home mortgage credit.

Subprime mortgages generally are made to individuals and households with impaired or limited credit histories, or high debt relative to their income. The subprime mortgage lending market has grown rapidly over the past several years. Between 1994 and 1999, subprime mortgage lending increased almost five fold -- growing from a $35 billion industry in 1994 to a $160 billion industry in 1999. Expanded access to credit for different levels of credit-worthy consumers has been a favorable development in the economy.

However, there is a growing body of anecdotal evidence that an unscrupulous subset of these subprime actors – lenders (often those not subject to federal banking supervision), as well as mortgage brokers, realtors, and home improvement contractors – engage in abusive lending practices that strip borrowers' home equity and place them at increased risk of foreclosure. The explosive growth of subprime mortgage lending has thus created a corresponding increased potential for abuse of consumers. The existence of these practices is especially troubling to the extent that, as findings from a recent HUD report indicate, subprime lending is most heavily concentrated in lower-income and predominantly minority neighborhoods.[1] Predatory lending has contributed to the rapid growth in foreclosures in many inner-city communities, and foreclosures can destabilize families and entire neighborhoods.

The purpose of this Report is to recommend proposals for legislative and regulatory action to combat predatory lending practices. In addition, the report describes some regulatory and policy changes that HUD has already implemented to address the growing problem of predatory lending.

A. The HUD-Treasury Task Force

The recommendations of the Department of Housing and Urban Development ("HUD") and the Department of Treasury ("Treasury") contained in this report are based, in significant part, on the information that HUD and Treasury gathered through the National Task Force on Predatory Lending ("HUD-Treasury Task Force"). The Task Force was initially convened by HUD Secretary Andrew

[1] *Unequal Burden: Income and Racial Disparities in Subprime Lending in America*, HUD, April 2000.

Cuomo in late March 2000, in response to a Baltimore field hearing held by Senator Mikulski's VA/HUD Appropriations Subcommittee on March 27 to discuss the issue of "real estate flipping" in that city. Secretary Cuomo announced the formation of the Task Force in his testimony before the Senate VA/HUD Appropriations Subcommittee on March 30. At the hearing, Secretary Cuomo committed to hold at least four regional forums around the country to discuss the problem of predatory lending and to develop detailed recommendations for legislative action for release in June.

Recognizing that predatory lending was a multifaceted issue with substantial consequences for the lending industry, Secretary Cuomo invited Treasury Secretary Lawrence Summers to co-chair the Task Force. The HUD-Treasury Task Force held its first meeting on April 12, 2000. The mission of the Task Force members has been to collect information about predatory lending, provide data on the impacts of predatory practices, and comment individually on existing proposals for reform in order to make recommendations for legislative action to Congress - the recommendations that are contained in this Report. The Task Force drew its members from a wide range of parties interested in and affected by the predatory lending issue, including representatives of consumer advocacy groups; industry trade associations representing mortgage lenders, brokers, and appraisers; local officials; and academics. A list of the HUD-Treasury Task Force members is attached as Appendix A.

Between late April and the end of May, HUD and Treasury convened five forums around the country for Task Force members. Forums were held in Atlanta, Los Angeles, New York, Baltimore, and Chicago. Each of the forums was structured to solicit information about both local and national aspects of the predatory lending problem, with input from both industry and consumer representatives. In order to focus the discussion, each forum had a specific theme:

- Atlanta, Georgia - The Impact of Predatory Lending on Minorities
- Los Angeles, California - The Elderly and Predatory Lending
- New York, New York - Funding Sources for Predatory Lending
- Baltimore, Maryland - The Role of Other Key, Non-lender Players
- Chicago, Illinois - State and Local Initiatives to Curb Predatory Lending

During the HUD-Treasury Task Force process, HUD adopted several proposals for reform particularly related to Federal Housing Administration ("FHA") loans, discussed in detail in Section IX of this report.

B. Other Federal, State and Local Efforts

In addition to the efforts of the HUD-Treasury Task Force, this report was informed by several past and current efforts undertaken by federal, state and local governments to address predatory lending issues.

<u>The HUD/Fed Report</u> – HUD and the Board of Governors of the Federal Reserve System ("the Board") carefully reviewed the Real Estate Settlement Procedures Act (RESPA) and the Truth in Lending Act (TILA) to simplify and improve requirements under these laws for mortgage loans and to

determine, among other things, if these laws provided adequate protection against abusive lending practices. This process resulted in a July 1998 report to Congress (the "HUD/Fed Report") with proposals for legislative and other actions to combat predatory practices. The Report concluded that the most effective attack on predatory lending would be a multifaceted approach, including new legislation, strengthened federal and state enforcement, voluntary industry reforms, and consumer education and counseling. Specifically, HUD and the Board jointly recommended adoption of new substantive legislative protections, in particular, curbs on balloon payments and front-loaded credit insurance premiums. In the Report, HUD made several additional recommendations including increasing the Home Ownership Protection Act (HOEPA) coverage combined with prohibitions against loan flipping and other abusive practices. This Report builds upon and updates the HUD/Fed Report's analysis and recommendations.

> The Clinton-Gore Plan for Financial Privacy and Consumer Protection – In May 1999, President Clinton, Vice President Gore and the Treasury Department set forth a series of proposals that the Administration believed should be part of a comprehensive consumer protection agenda. The Clinton-Gore agenda included a call for action against subprime lending abuses, including expanded protections in the home equity lending market, expanded enforcement tools, improved home mortgage lending reporting, and improved regulator guidance on subprime lending. Many of the recommendations that formed this part of the agenda were drawn from the 1998 HUD/Fed Report.

Federal/State Enforcement – The Department of Justice, the Federal Trade Commission and State Attorneys General have brought several enforcement actions in recent years against subprime lenders for violations of TILA, the Home Ownership and Equity Protection Act (HOEPA), federal fair lending laws and state laws/regulations. These cases revealed some of the more pervasive abuses in the high-cost mortgage market, including: lending to borrowers without regard to their ability to repay; failing to provide required disclosures; targeting low-income and minority neighborhoods for high-cost loans; and general fraud and misrepresentation.

Other State/Local Legislative Efforts – Growing evidence of abuses in the subprime mortgage market has led states and localities to mount their own legislative and regulatory efforts to curb predatory lending. Legislators in at least eight states introduced bills in recent sessions to restrict terms on certain classes of higher-cost mortgages and to prohibit certain abusive lending practices. In 1999, North Carolina adopted a law, effective July 2000, that: has thresholds for loans that are lower than HOEPA; limits prepayment penalties, balloon payments and financing of points and fees on high-cost loans; and prohibits abusive practices such as asset-based lending and loan "flipping." The New York State Department of Banking has issued a proposed regulation similar to the North Carolina statute. At the local level, the city of Chicago has proposed ordinances that would prohibit the city from contracting with lenders or affiliates of lenders who engage in certain abusive practices relating to the origination of high-cost loans.

The Interagency Task Force on Predatory Lending – In the fall of 1999, several federal agencies, including the Board, the Treasury Department's Office of the Comptroller of the Currency and Office of Thrift Supervision, the Federal Deposit Insurance Corporation, the National Credit Union

Administration, the Federal Housing Finance Board, the Federal Trade Commission, the Department of Justice and HUD, established the Interagency Task Force on Predatory Lending. The purpose of that task force was to promote vigorous and coordinated enforcement of federal fair lending and consumer protection laws. The participants are now drafting an "Interagency Policy Statement on Predatory Lending Practices," which is intended as a statement of the agencies' general position on the federal fair lending and consumer protection laws for purposes of administrative enforcement of those statutes. In addition to this effort, the National Economic Council has been conducting an interagency working group on predatory lending. Moreover, Treasury has chaired an interagency group on fair lending issues since 1998.

Chapter III. Summary of the Problem

A. What is Predatory Lending?

Along with the benefits that have come from the expanded availability of credit in the subprime market, there is also evidence of growing abuses. In many neighborhoods, abusive practices threaten to erode the enormous progress that has been made over the past several years in revitalizing neighborhoods and expanding home ownership. In many instances, the consequences for borrowers, foreclosure in particular, have been disastrous.

Although diverse laws apply to home mortgage lending, none of the relevant statutes and regulations governing mortgage transactions provides a definition of predatory lending. Public debate around the issue of predatory lending has focused on practices and loan terms that alone, or in combination, are abusive or put borrowers at a high risk of abuse.

In a predatory lending situation, the party that initiates the loan often provides misinformation, manipulates the borrower through aggressive sales tactics, and/or takes unfair advantage of the borrower's lack of information about the loan terms and their consequences. The results are loans with onerous terms and conditions that the borrower often cannot repay, leading to foreclosure or bankruptcy.

Defining the practices that make a loan predatory, however, is a problematic task. Any list of predatory practices is destined to be incomplete because bad actors are constantly developing new abusive practices, sometimes to evade new government regulation. Furthermore, a list does not consider the context in which the alleged abuse has occurred. Some practices may be considered abusive in the context of high-cost subprime loans; other practices may be deemed unacceptable in all contexts; and others – while not necessarily abusive for all high cost borrowers – are abusive in the borrower's situation or because the borrower was misled or deceived . For these reasons, it is worth considering some overarching characteristics of predatory loans. These characteristics are discussed in detail in Chapter VI.

Evidence of predatory lending practices generally arises from the subprime mortgage market. While predatory lending can occur in the prime market, such practices are for the most part effectively deterred by competition among lenders, greater homogeneity in loan terms and the prime borrowers' greater familiarity with complex financial transactions. In combination, these factors make prime borrowers more likely to shop for the best loan terms and less likely to fall victim to predatory loans. In addition, many prime lenders are banks, thrifts, and credit unions that are subject to extensive oversight and regulation by federal and state governments.

The subprime market, in contrast, provides much more fertile ground for predatory lending practices. Several factors contribute to this result.

- The characteristics of many subprime borrowers make them more easily manipulated and misled by unscrupulous actors. Many subprime borrowers who have had difficulty obtaining credit in the past may underestimate their ability to obtain new sources of credit, which may make them more likely to accept the first offer of credit they receive, rather than shop for a loan with the best possible terms. In addition, subprime borrowers may be more in need of immediate funds due to the heightened challenge of meeting household and emergency expenses on their lower incomes.

- Many subprime borrowers live in low-income and minority communities that are comparatively underserved by traditional prime lenders. As a result, many of these communities suffer from insufficient competition among lenders, so that better loan terms may be harder to find, or persons may be unaware of them.

- The subprime mortgage and finance companies that dominate mortgage lending in many low-income and minority communities, while subject to the same consumer protection laws, are not subject to as much federal oversight as their prime market counterparts – who are largely federally-supervised banks, thrifts, and credit unions. The absence of such accountability may create an environment where predatory practices flourish because they are unlikely to be detected.

Another reason why creating a definitive list of predatory lending practices is problematic is that it fails to convey that predatory lending is as much a function of the manner in which the loans are made as the oppressive terms that they contain. Moreover, the predatory nature of many loans typically is not the result of a single loan term or feature, but a series of features that in combination, impose substantial hardships on the borrower.

A few examples from the testimony presented by victims of predatory lending at the HUD-Treasury Task Force's regional forums provide a flavor of the kinds of deceptive and manipulative sales techniques reportedly used, as well as some of the specific terms and oppressive features contained in predatory loans.[2]

Ms. J., who is 71 years old, testified at the Chicago forum. According to Ms. J., she received a phone call from a mortgage broker, who promised her that he would refinance her two existing mortgages, provide her with $5,000 in extra cash and lower her monthly payments. Ms. J. needed cash to repair her kitchen, so she agreed to meet. The broker visited Ms. J. at her home. Ms. J. maintains that he gained her trust by claiming that he liked her as a person and he wanted to help senior citizens because his own father had recently died of cancer. Later, the broker returned to Ms. J.'s house to have her sign the mortgage loan papers. Ms. J. said that she could not read the documents carefully because she suffers from vision problems and has a limited education. Ms. J. said she signed the mortgage loan documents based on the broker's promises and representations that the mortgage loan would provide her with cash to repair her kitchen and lower her monthly mortgage payments.

[2] HUD and Treasury take no position on the truth or accuracy of witness testimony. The agencies only report here testimony that was presented by borrowers at the regional forums and documentation some of those borrowers provided to the Task Force.

Ms. J. received a $90,100 mortgage with an APR of 14.819%. The mortgage loan contained a 15 year balloon note that required a final payment of $79,722.61 (due when she was 86 years old). Ms. J. paid 10% of the loan amount, or $9,100 as a broker's fee. The monthly payment increased to approximately 80% of her monthly income. Ms. J. did not receive any money from the proceeds of this transaction.

Ms. J.'s account highlights several practices common in predatory lending:

- Use of "bait and switch" tactics to defraud the borrower.
- Use of balloon payments that require refinancing.
- Structuring loans that the borrower cannot afford.
- The fact that the elderly and minorities are frequently victimized by predatory lenders.
- Aggressive solicitation of residents of low-income and minority neighborhoods, which may be underserved by conventional lenders.
- Excessive fees.

Ms. M, a 53 year old Haitian-American woman, testified at the New York City forum. According to Ms. M., a home improvement contractor came to her door soliciting home repairs. Ms. M. had a leaking roof and needed some other home repairs. Ms. M. stated that the contractor pressured her into contracting for additional home repairs that were unnecessary as a condition to getting a loan. According to Ms. M., the contractor informed her that he could get her a loan to complete the home repairs even though she had to pay off some other debts. The home improvement contract totaled $36,200. Ms. M. asserted that the contractor began gutting her house approximately a month prior to the loan closing and the 3 day rescission period ended. As a result, Ms. M. felt that she had no choice but to sign the mortgage loan documents in order to pay for the repairs. About a month after the loan closing, the contractor stopped coming to her house. Ms. M. felt that the contractor did not complete the work as promised, and the work that was completed was generally inadequate. Ms. M. contacted the lender to find out why the contractor stopped working on the repairs, and the company indicated that the contractor had been paid in full. Ms. M. has no recollection that she signed a check or any other document to verify that she approved payment to the contractor.

Through the home improvement contractor Ms. M. obtained the mortgage loan from the lender for $79,000 with monthly payments reaching approximately $970. She said she did not receive any closing documents until she contacted the lender more than a week after closing to ask for the amount of her monthly payment. The lender received 10 points, or $7,900, as well as a $695 application fee. The mortgage loan's interest rate is fixed at 14 ½% with an APR of 16.498%, along with a balloon payment of $71,812.64 due 15 years after the origination date. The mortgage loan also includes a prepayment penalty if paid off during the first 12 months. Ms. M.'s loan qualifies as a HOEPA loan, but she never received any HOEPA disclosures. The loan was sold to another lender.

Ms. M.'s account highlights several practices common in predatory lending:

- The role of unscrupulous home improvement contractors in originating predatory loans through aggressive solicitation of unnecessary services and collaboration with unscrupulous lenders.
- The prevalence of fraud by home improvement contractors who frequently perform substandard work or fail to complete tasks after being paid in full from loan proceeds.
- The high fees charged by some lenders who provide little or no actual service to the borrower.
- The failure of unscrupulous lenders to comply with existing laws, like HOEPA, designed to protect subprime borrowers entering into high cost loans.

Ms. H., a widowed 81 year old African-American homeowner who lives in Washington, D.C. testified at the Baltimore forum about her experience. In 1999 she was induced by a mortgage broker to refinance an existing $118,000 mortgage loan into a new loan for $129,000.

Ms. H. testified that the broker persuaded her to take the new loan by claiming it would retire existing unsecured debt, lower her monthly payments, cover her real estate taxes and insurance, and lower her interest rate. None of these assertions was true. In fact, Ms. H.'s new loan did not pay off any unsecured debt, raised her monthly payments, did not cover her tax and insurance obligations, and, after a two year period, will significantly increase her interest rate. Moreover, the new loan provided Ms. H. with absolutely no other tangible benefit of any kind. Not only were no unsecured debts paid off, but she received no cash out from the loan. The mortgage broker, however, made $3,850 as a result of the transaction.

The same mortgage broker had originated Ms. H.'s prior mortgage loan, taken out in 1997. That loan contained a substantial pre-payment penalty if paid off in less than three years; thus, Ms. H. paid significant sums in the form of a prepayment penalty, in addition to her closing costs, on the 1999 refinancing. The mortgage broker's combined compensation on the two loans exceeded $12,000.

Ms. H.'s account highlights several practices common in predatory lending:
- The tendency of predatory lenders to engage in "loan flipping" – successively refinancing loans with little or no resulting benefit to borrowers, but generating substantial fees for brokers.
- How repeatedly refinancing points and fees charged with the origination of each loan can reduce the borrower's equity in her home.
- The inclusion of prepayment penalties in predatory loans to discourage refinancing at more favorable rates or at least to generate additional fees should refinancing occur.

Mr. C. testified at the Baltimore forum about his experience. Mr. C. purchased a home from a property owner/seller. According to Mr. C., the property owner/seller suggested that he apply for an FHA mortgage to cover the $115,000 sales price and the closing costs. The property owner/seller referred Mr. C. to a lender in a close business relationship with the property owner/seller. The lender arranged FHA financing for the purchase price and all settlement charges, including the lender's origination costs.

The property was grossly over-appraised. Actual comparable properties in the area were appraised in the $75-85,000 range. Mr. C. stated he later learned that the property owner/seller had purchased the property less than a year earlier for $32,000. The property owner/seller then made cosmetic improvements to the house and put it on sale for $115,000. As a result of the transaction, Mr. C. now owes a mortgage of $115,000 for a property that is worth tens of thousands less. Should he be unable for any reason to make the payments, the lender will make a claim against the Federal Housing Administration for the amount of the inflated mortgage.

Mr. C.'s account highlights several practices common in predatory lending:

- "Asset flipping," the practice of purchasing a home and then reselling it at a dramatically increased cost to an unsuspecting borrower.
- The role that appraisers can play in originating predatory loans by generating fraudulent appraisals that prompt borrowers to take out loans that are larger than would be necessary to purchase the property at a fair value.
- The incentive for predatory lenders who collaborate with asset flippers to structure loans that the consumers cannot afford if the mortgage is insured by the FHA, so that the lender can collect on the FHA insurance after foreclosure.

While these lists is not exhaustive, it provides a flavor for the real life hardship that predatory lending inflicts on individual borrowers and their families.

Throughout the HUD-Treasury forums, there was consistent evidence of abuses in a segment of the subprime mortgage market that echoed the experiences of Ms. J., Ms. M., Ms. H. and Mr. C. These abuses tended to fall into four main categories:

- Loan Flipping - Some mortgage originators refinanced borrowers' loans repeatedly in a short period of time. With each successive refinancing, these originators charged high fees that reduced borrowers' equity in their homes. While fees in the subprime market can be expected to exceed those in the prime market, borrowers in some instances were charged upwards of $5,000 for each refinancing, sometimes as much as 10 percent of the loan amount (as in the case of Ms. J.), quickly draining the equity in their homes. Lenders also structured high-cost loans with terms that forced lower-income borrowers to refinance a loan multiple times. With mortgage loan flipping, the end results of default and foreclosure are often devastating.

- Excessive fees and "Packing" – While subprime lending carries higher costs to the lender than prime lending, in many instances the Task Force saw fees that far exceeded what would be expected or justified based on economic grounds. Many of these fees were charged by mortgage brokers, home improvement contractors and other third parties, in addition to the lender. Borrowers often did not realize how expensive their loans were, as the fees were added into the amount financed rather than paid up-front, and may not have been adequately disclosed to the borrower.

  Additionally, some lenders levied excessive fees that were not disclosed to the borrower – including fees for ancillary services whose cost is not included in the calculation of the cost of credit

– the annual percentage rate. For instance, borrowers were sold products such as single-premium credit life insurance without their knowledge. Ms. M., for example, was completely unaware that she was being sold such a product. The costs of these products were “packed” into the borrower’s loan amount, raising their price and disguising their true cost to the borrower.

- Lending without regard to the borrower’s ability to repay - One troubling practice the Task Force saw involved lending based on borrowers’ equity in their homes, where the borrowers clearly did not have the capacity to repay the loans. Some lenders may have sought to recover the loan principal by foreclosing on the borrower’s home. There were also cases where income figures or other data were apparently falsified by an unscrupulous broker and not adequately verified by the lender. In particularly egregious cases, loans were made to elderly people living on fixed incomes where the monthly payments equaled or exceeded their monthly income. Such loans quickly led borrowers into default and foreclosure actions.

- Outright Fraud - In many instances, abusive practices amount to nothing less than outright fraud. The Task Force heard many stories of fraud from borrowers who testified at the regional forums. For example, in the Baltimore forum the Task Force was `introduced to the practice that is known as “asset flipping” described above. In these instances, an unscrupulous investor buys a dilapidated house, makes superficial repairs, and conspires with an appraiser and a mortgage broker or other originator to inflate the appraised value of the property. To facilitate sale at a fraudulently inflated price, the seller and broker will sometimes doctor the loan application and settlement documents. Many of the borrowers who are victims of this scheme cannot afford to repay or refinance the mortgage based on the inflated price, and these loans may go into default and foreclosure quickly. Appraisers and others engaging in this fraudulent practice are helping to send first-time home buyers and whole communities into economic ruin.

Through the regional forums and through other research, HUD and Treasury have seen certain patterns emerge in the use of these predatory practices:

First, unscrupulous actors in these markets are often preying on certain identifiable groups – the elderly, minorities, and individuals with lower incomes and less education. In many instances these individuals are not sufficiently experienced or knowledgeable about complex financial transactions to understand their potentially devastating implications, or are not offered the range of financial products available to other borrowers.

- Evidence from the government’s case against subprime lender Delta Funding indicates that brokers for Delta loans nearly exclusively solicited low-income individuals in minority neighborhoods for high-cost mortgage loans. The Attorney General presented evidence that while the median income of all borrowers served by Delta was about $34,000, the company did little to no business in predominantly white neighborhoods where homeowners made $35,000 or less.

HUD’s own research has shown that even after controlling for income, black borrowers and borrowers in predominantly black neighborhoods are more likely to refinance their mortgages in the subprime market than white borrowers and borrowers in white neighborhoods. Because evidence suggests that abusive lending practices are concentrated in the subprime lending market, black borrowers may be at higher risk for encountering these practices. In its national report, titled Unequal Burden: Income and Racial Disparities in Subprime Lending in America, HUD found that subprime refinance loans accounted for one half (51 percent) of refinance loans in predominantly black neighborhoods (those census tracts where blacks comprise more than 75 percent of the population). By contrast, subprime loans accounted for only 9 percent of the refinance loans in predominantly white neighborhoods (those tracts where whites comprise more than 85 percent of the population). In other words, subprime loans for refinancing were five times more likely in black neighborhoods than in white neighborhoods.[3] Additional research focusing on each of the five cities in which HUD and Treasury held regional forums reached similar findings.[4]

The finding of higher subprime concentration for black neighborhoods remained when neighborhood income was taken into account. Almost two-fifths of refinance loans in upper-income black neighborhoods were subprime, compared with only five (5) percent in upper-income white neighborhoods and twenty (20) percent in low-income white areas. These data show that homeowners in upper-income black neighborhoods were twice as likely as homeowners in low-income white areas to rely upon subprime loans for refinancing.[5]

Second, borrowers in these markets often have limited access to the mainstream financial sector. Some borrowers who would likely qualify for a prime loan are not accessing credit at a bank. There may be a substantial number of borrowers currently borrowing in the subprime market who could qualify for a prime loan.[6] The Task Force saw evidence that older borrowers, having held prime mortgages from a bank for many years, received higher cost subprime loans to pay for repair work on their homes. In some inner-city areas, this may reflect the fact that banks have receded over time, and have been replaced by finance companies not subject to federal bank supervision. Subprime lenders may also effectively be capturing borrowers in these markets, effectively blocking borrowers from accessing the prime market. For example, borrowers' lack of access to the prime market may reflect a failure on the part of subprime lenders to report fully the payment history of their borrowers. This practice prevents borrowers from amassing a positive credit history that, over time, may allow them to obtain credit in the prime market.

[3] As explained in Chapter IV, HUD's analysis focused primarily on home refinancing loans as they account for most (over 80 percent) subprime loans.

[4] See Unequal Burden in Atlanta: Income and Racial Disparities in Subprime Lending, April 2000; Unequal Burden in Los Angeles: Income and Racial Disparities in Subprime Lending, May 2000; Unequal Burden in New York: Income and Racial Disparities in Subprime Lending, May 2000; Unequal Burden in Baltimore: Income and Racial Disparities in Subprime Lending, May 2000; and Unequal Burden in Chicago: Income and Racial Disparities in Subprime Lending, May 2000.

[5] These data, however, do not control for differences in the credit characteristics of individual borrowers.

[6] A 1996 unpublished draft report prepared by Freddie Mac found that for 10 to 35 percent of the subprime loans analyzed, the borrowers may have been eligible for a prime-rate loan. Freddie Mac's analysis relied on a sample of 15,000 subprime mortgages originated by four financial institutions.

These access problems remain despite the significant growth in mortgage lending nationwide by banks, thrifts and their affiliates to lower-income and minority borrowers and communities between 1993 and 1998. As documented in a recent Treasury report, these institutions increased their lending to low- and moderate-income borrowers and areas from $75 billion in 1993 to $135 billion in 1998 – an 80 percent increase.[7] As a result, the share of mortgage originations by banks, thrifts and their affiliates that went to these borrowers and communities grew from 25 percent in 1993 to 28 percent in 1998. Eight-four (84) percent of the growth in these institutions' lending to lower-income borrowers and areas occurred among lenders specializing in prime mortgage lending. Over the same time period, mortgage lending by these institutions to lower-income black borrowers grew by 76 percent, over twice the rate of increase for lower-income white borrowers.

Third, these practices are most often coupled with the deceptive or high-pressure sales tactics of unscrupulous mortgage brokers, home improvement contractors, realtors/developers or lenders themselves. Unscrupulous actors may take advantage of a borrower's lack of financial sophistication or vulnerable situation. They may hide disclosures from borrowers, begin work on a borrower's home and then "bait and switch" with new loan terms before the loan is closed, finance fees without borrowers' knowledge, or lead them to believe that they must purchase products such as credit insurance in order to close the loan.

B. The Effects of Predatory Lending

The dramatic growth in foreclosure actions in some neighborhoods that has accompanied the growth in subprime lending over the last several years suggests the potentially damaging effects of lending abuses. As explained later in Chapter IV, subprime borrowers are more likely to be become seriously delinquent in their payments. These delinquencies can, and in some cases do, lead to foreclosure actions against borrowers.

Although the vast majority of subprime borrowers pay on time and keep their homes, evidence from a number of cities demonstrates that foreclosure actions have grown at a disturbing rate in inner-city neighborhoods. In Baltimore, for instance, foreclosure petitions filed for homes increased from 1,900 in 1995 to over 5,000 in 1999. As detailed in Chapter IV, a large portion of the subprime mortgage market is accessed for consumer credit purposes, such as consumer debt consolidation or the financing of other non-home expenses. The rapid growth in foreclosures raises concern that subprime borrowers may not adequately appreciate the fundamental risk of converting unsecured consumer credit into home-secured credit: the downside risk is no longer just bankruptcy, but loss of a home. Consumers need to weigh this risk, and their overall abilities to repay, before refinancing mortgages or taking out home equity loans, and need to manage their finances carefully if they do.

[7] Litan, Robert et al. *The Community Reinvestment Act After Financial Modernization: A Baseline Report*. US Department of the Treasury, April 2000.

Similarly, lenders should not lend to borrowers that do not have the capacity to repay the loans that the lender offers. The speed with which the subprime loans in these communities have gone to foreclosure suggests that some lenders may be making mortgage loans to borrowers who did not have the ability to repay those loans at the time of origination. HUD studied foreclosure petitions filed for homes in Baltimore during the first three months of 2000. It found that the mean time between the origination and foreclosure petition dates for subprime loans was only 1.8 years, as compared to 3.2 years for prime and FHA loans. Over a quarter of the petitions filed in that time period were for loans originated in 1999.[8] Studies of subprime foreclosures in Chicago and Atlanta reached similar findings.[9]

Greater levels of foreclosures can have devastating effects for individual families. For individual families, foreclosure results in the loss of the home, a family's most valuable asset. Many subprime borrowers with blemished credit already have a tenuous hold on homeownership. Elderly homeowners may lose the chance to spend their final years in their homes, and often have no realistic chance of financial recovery.

In an area where predatory practices may be driving families into foreclosure, the impact can be concentrated and felt throughout the community. Foreclosed homes frequently remain vacant for a prolonged period of time, during which they are poorly maintained. These vacant homes can contribute to neighborhood instability in terms of depressed property values and increased crime. Testimony from neighborhood development advocates documented the difficulty they have encountered in trying to encourage businesses to locate in neighborhoods where foreclosed properties remained vacant.

[8] Unequal Burden in Baltimore: Income and Racial Disparities in Subprime Lending, May 2000.

[9] NTIC, Preying on Neighborhoods: Subprime Mortgage Lenders and Chicagoland Foreclosures, September 1999; Abt Associates Inc., Analyzing Trends in Subprime Originations and Foreclosures: A Case Study of the Atlanta Metro Area, February 2000.

Chapter IV. Background on the Subprime Mortgage Market

Subprime mortgage lending is both part of the mortgage market and part of the consumer credit market. Subprime mortgages generally are made to individuals and households with impaired or limited credit histories, or high debt relative to their income. Subprime mortgages also are made to creditworthy borrowers with variable or hard-to-document income. A subprime mortgage may be a first mortgage (for either purchasing a home or refinancing an existing mortgage), a second mortgage, or a home equity line of credit.[10]

Generally, subprime mortgages serve as a source of home-collateralized consumer credit, and thus can also be thought of as part of the subprime consumer credit market. The primary purpose of over 50 percent of first lien subprime mortgages and up to 75 percent of second lien subprime mortgages is debt consolidation and/or general consumer credit, not home purchase, home improvement or refinancing the rates and terms of a mortgage.[11] The consumer credit market encompasses non-mortgage credit such as automobile loans and credit card loans, and the subprime portion of it generally refers to loans made to borrowers with impaired credit histories.

The Task Force focused on the subprime mortgage market, so this Report is limited to a discussion of subprime mortgage lending. The Task Force concentrated on subprime mortgage lending because it is in this market that concerns about predatory practices are greatest, and the consequences of such practices are the most severe.

Organization of Section. Section A establishes the main role of subprime lending. Section B describes the rapid growth of subprime mortgage lending and the loan and borrower characteristics of subprime mortgages. Section C discusses the major actors in the subprime market, from the lenders that originate loans to the investors that ultimately fund these loans. Section D examines the impact of subprime lending on urban neighborhoods and reports information on foreclosure of subprime loans. Section E offers some concluding observations.

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[10] Much of the data in this chapter are drawn from the following sources: various publications of Inside Mortgage Finance Publications, Bethesda, MD; the Mortgage Information Corporation, San Francisco, CA; data provided to HUD and Treasury by the National Home Equity Mortgage Association (some of which was derived from research prepared by SMR Research Corporation, Hackettstown, NJ and by David Olson Research, Columbia, MD); and HUD's analysis of mortgage data reported under the Home Mortgage Disclosure Act (HMDA). The Mortgage Information Corporation (MIC) maintains a database of subprime loan originations which contains about 1.5 million loans from many of the top 25 subprime lenders. Their quarterly newsletter, "The Market Pulse", publishes a number of statistics that allow a comparison of the performance of subprime loans to other types of loans.

[11] Data on first lien subprime mortgages are from MIC (Mortgage Information Corporation) and data on second liens are from the National Home Equity Mortgage Association.

A. The Role of Subprime Mortgage Lending

Subprime mortgage lending provides a source of funds for credit-impaired borrowers and other borrowers that are unable to obtain credit in the prime market. While subprime lending often involves lending to borrowers with past credit problems, the subprime market is more than that. A borrower may not qualify for a prime loan, yet may be eligible for a subprime loan, for reasons other than past credit performance. For example, a borrower may have a good credit history but have high monthly debt payments relative to income. Or, a borrower may have few or no assets other than current income to support loan payments. A borrower may also be self-employed, have variable income, or simply want to limit disclosure of their financial situation. These conditions may make it difficult for a borrower to obtain credit at prime rates, yet a subprime lender may be willing to take on the added risk in exchange for a higher interest rate. Consequently, there is no standard industry definition of a subprime loan, and the market may be defined in different ways by different analysts.

In most respects, lending in the subprime mortgage market follows the same principles as lending in other markets. Basic economic theory, not to mention common sense, tells us that a lender will only lend money to a borrower if the lender expects to be repaid. That repayment has two components: the return of the original amount lent (the principal), and compensation for the opportunity cost of lending the money and for taking the risk that the loan is not repaid as promised (the interest rate charged).[12] While a lender will not make a loan unless he or she expects to be repaid, clearly not all borrowers present a lender with the same risk of default. Thus, not all borrowers are charged the same interest rate for the same type of loan.

When a borrower applies for a mortgage, the lender assesses a borrower's capacity to repay the mortgage. This is called "underwriting" the loan. To underwrite a loan, a lender collects information on a borrower's income, assets, and financial obligations. A lender also evaluates a borrower's past credit history, typically using data obtained from credit reporting agencies. This history tells a lender about a borrower's past performance in repaying debt obligations and is an important indicator of a borrower's creditworthiness. Experience and statistical models demonstrate that a borrower who has missed loan payments or defaulted on loans in the past or simply has no credit history of any kind is a riskier prospect than an individual with an unblemished history of loan repayments.

Subprime lending generally has the following characteristics:

- Higher risk – Lenders experience higher loan defaults and losses by subprime borrowers than by prime borrowers.

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[12] Repayment generally comes from payments made by the borrower but can also be wholly or partly recovered by foreclosure on the borrower's house. The transactions costs associated with foreclosure often are substantial to the lender and hence leave the lender with a loss on the loan. However, one type of lending practice associated with predatory lending (typically referred to as asset-based lending), involves loans made to individuals with large amounts of equity in their home but little capacity to repay the loan.

- Lower loan amounts – On average, loans in the subprime mortgage market are smaller than loans in the prime market. Estimates for average subprime loan size ranging between $58,000 and $85,000, as compared to an average of $133,000 for all mortgages.

- Higher costs to originate – Subprime loans may be more costly to originate than prime loans, as they often require additional review of credit history, a higher rate of rejected or withdrawn applications, and fixed costs, such as appraisals, that represent a higher percentage of a smaller loan.

- Faster prepayments – Subprime mortgages tend to be prepaid at a much faster rate than prime mortgages.

At least in part as a result of the above characteristics, subprime loans tend to have significantly higher fees and rates than for prime loans. (Even if the fees were the same for prime and subprime loans, since subprime loans generally are smaller than prime loans, the fees would be higher as a percentage of the loan amount.)

Within the subprime mortgage market, interest rates charged vary widely. The borrower's credit rating, the loan-to-value ratio, and whether the loan is a first or second lien factor into the loan rate. Generally, borrowers that present less risk receive lower interest rates. For example, the National Home Equity Mortgage Association reports that highest subprime credit classification (referred to as A-) generally pay only about one-half of a percentage point above prime rates while the lower classifications (referred to as C and D) pay as much as 4 percentage points above prime rates. Data from the Mortgage Information Corporation showed that, in the third quarter of 1999, 17 percent of subprime borrowers paid more than 4 percentage points above prime rates.[13]

B. Growth and Characteristics of the Subprime Market

Over the last decade, subprime lending has grown at a tremendous rate. This section documents the rapid growth in subprime lending and describes the types of subprime mortgages and the socioeconomic characteristics of subprime borrowers.

1. The Growth of the Subprime Market

Both industry estimates and data reported under the Home Mortgage Disclosure Act (HMDA) show a substantial growth in the subprime market since 1994.[14] According to one industry estimate, subprime loan originations increased from $35 billion in 1994 to $160 billion in 1999.[15] As a

[13] Mortgage Information Corporation, Market Pulse, 1999Q3.

[14] HMDA requires most mortgage lenders to report demographic characteristics of loan originations and applications to the federal government.

[15] Mortgage Market Statistical Annual for 2000, Inside Mortgage Finance Publications, Inc., vol. II, pages 1-2. Inside Mortgage Finance estimates that the total dollar volume of subprime loans outstanding at yearend 1998 was $426 billion. (Mortgage Market Statistical Annual for 1999, Vol. I, p. 111).

percentage of all mortgage originations, the subprime market share increased from less than 5 percent in 1994 to almost 13 percent in 1999. By 1999, outstanding subprime mortgages amounted to $370 billion, which was approximately 8 percent of the $4.8 trillion in single family residential mortgage debt.[16] Table 3.1 illustrates the growth in subprime lending.

Table 3.1: Subprime Mortgage Originations

Year	Subprime Originations	Total Originations	Subprime Originations as a Percent of Total Originations
1994	$35.0	$773.12	4.5 %
1995	$65.0	$635.77	10.2 %
1996	$96.5	$785.33	12.3 %
1997	$125.0	$859.12	14.5 %
1998	$150.0	$1,430.0	10.5 %
1999	$160.0	$1,275.0	12.5 %

Source: Inside Mortgage Finance, Mortgage Market Statistical Annual 2000, Volume II, p. 1-2.
Note: Origination data is reported in billions of dollars.

The substantial growth in subprime lending is also evident from HMDA data.[17] The number of home purchase and refinance loans reported under HMDA by lenders specializing in subprime lending increased almost ten-fold between 1993 and 1998 -- from 104,000 in 1993 to 997,000 in 1998. Home refinancing loans make up about 80 percent of the subprime loans reported to HMDA.[18] Between 1993 and 1998 the number of subprime refinance loans increased from close to 80,000 to almost 790,000.

[16] Mortgage Market Statistical Annual for 2000, vol. I, p. 125; and Federal Reserve, Flow of Funds 3/10/2000, Table L.218, p. 94.

[17] HMDA data does not specifically report information on subprime lending. To analyze the subprime market with HMDA data, HUD has developed a list of subprime lenders that are required to report under HMDA. For more information see Randall M. Scheessele, 1998 HMDA Highlights, Housing Finance Working Paper No. 9, Office of Policy Development and Research, HUD, October 1999.

[18] Subprime lenders are also active in the home improvement market. Home improvement loans of subprime lenders were excluded from these comparisons.

Table 3.2: Number of Subprime Refinance Loans Reported Under HMDA

Year	Number of Subprime Refinance Loans
1993	79,693
1994	126,776
1995	158,395
1996	320,239
1997	551,396
1998	789,696

Source: HMDA data as reported by HUD, Unequal Burden: Income and Racial Disparities in Subprime Lending in America, April 2000.

Several factors contributed to the rapid growth of the subprime mortgage market, some of which will be described in greater detail later in this chapter. Among the factors contributing to this growth are:

- a rise in consumer credit problems, including the rising level of credit card debt and high consumer bankruptcy rates;

- the Tax Reform Act of 1986, which eliminated the deductibility of most consumer interest payments except for mortgage interest;

- increased capital flows to the subprime credit market, driven by the entrance of capital market investors through securitization of subprime loans; and

- the increased popularity of subprime first mortgages (prior to the 1990s, subprime mortgage lending generally meant second mortgages).

2. Subprime Mortgages and How They Are Used

Subprime mortgage lending used to be a second lien mortgage line of business but the majority of subprime mortgages are now first lien mortgages. While there is little hard data on how consumers use the proceeds of subprime mortgage loans, various surveys show that the primary purposes of such loans are debt consolidation and general consumer credit. Relatively few subprime mortgages are used to purchase a house, although the portion of subprime mortgages being made for that purpose has been increasing.

Up to the early 1990s, the subprime mortgage market was characterized by small balance, second lien loans.[19] A key development in the 1990s was the increased popularity of first lien mortgages in the subprime market. Indeed, data from the Mortgage Information Corporation shows that by 1999 more than three out of every four loans in the subprime mortgage market were first liens. Still, that same data also shows that the vast majority of these subprime first lien mortgages – 82 percent – were used for refinancing as opposed to purchasing a home. Of these refinance loans, a majority (59 percent) were "cash-out," indicating that borrowers used these loans for home improvement, for making other consumer purchases or for consolidating other forms of debt.

Similarly, a survey by the National Home Equity Mortgage Association found that approximately 45 percent of subprime home equity loans (second lien) are used for debt consolidation, 30 percent for covering medical, educational, and other expenses, and 25 percent for home improvement.

Subprime refinance mortgages have lower loan amounts than prime refinance mortgages. According to 1998 HMDA data, the median loan amount for a subprime refinance mortgage was $63,000 compared to $98,000 for a prime refinance mortgage.[20] Fixed-rate mortgages account for the majority of subprime mortgage originations but adjustable-rate mortgages account for a higher percentage of subprime mortgages than mortgages overall. Fixed-rate mortgages accounted for 60 percent of subprime mortgages in 1999 compared to 70 percent of mortgages overall.[21]

3 . Subprime Mortgage Lending, Consumer Debt and Bankruptcy

The data presented above clearly indicate that subprime mortgage loans are often used to consolidate debt or to fund other non-home purchases. As an important part of the consumer debt market, borrowing in the subprime market may have two opposing effects on consumer bankruptcy. First, subprime borrowing offers individuals in difficult financial situations a way to access their housing wealth to meet their financial needs; this additional liquidity can help people get through a bad period and avoid bankruptcy. Second, subprime borrowing allows consumers to consume their entire housing wealth over time, which could leave them in truly dire circumstances with no choice but to declare bankruptcy.

Household data are not available that combine information on subprime borrowing and bankruptcy. Nevertheless, we can gain some understanding of the possible impact of subprime lending on bankruptcy filings by examining the changing financial conditions of low-income households during the late 1990s when the subprime market expanded significantly. Bankruptcy filing takes two forms:

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[19] Schorin, Charles, Steve Weinreich and Oliver Hsiang. 1998. Home Equity Loan Handbook, 1998 Edition. Morgan Stanley Dean Witter Fixed Income Research (November).

[20] The median loan amount in 1998 for home purchase subprime mortgages was $84,000 compared to $108,000 for home purchase prime mortgages.

[21] The adjustable-rate share of overall mortgages was 30 percent, based on the last six months of 1999. See National Association of Home Builders, Housing Market Statistics, April 2000.

Chapter 7, in which debtors' assets in excess of their statutory exemptions are distributed to creditors to repay debt, and Chapter 13, in which debtors' disposable income over a number of years is pledged to repay debt. In 1996, households with income below $25,000 represented a little over one-third of all households, but represented half of households entering Chapter 13 and two-thirds of households entering Chapter 7.[22]

The Survey of Consumer Finances reports detailed data on household assets and liabilities for 1998, 1995, and a number of previous years. The SCF data suggest that households with incomes above $10,000 and below $25,000 were drawing down their home equity between 1995 and 1998.[23] About one-quarter of the households in this income stratum held home-secured debt in 1998. The Survey shows that the median value of home secured debt for this group increased from $29,700 to $34,200 over this period. This $4,500 increase is larger than the $2,900 gain in the median value of homes for households in this income group who owned homes. Moreover, other forms of debt reduction and asset accumulation did not appear to accompany the increasing use of home equity, as median debt of all sorts increased for these households, while median net worth declined.

The Survey of Consumer Finances also presents evidence that some low-income households were struggling with a larger debt burden in 1998 than in 1995. In 1998, nearly 20 percent of households with incomes between $10,000 and $25,000 reported debt payments totaling more than 40 percent of their income, compared with 15 percent a decade earlier and 17 percent in 1995. The share of households in this income group who reported being more than 60 days late in payments due on their debt rose slightly from 11.3 percent in 1995 to 12.3 percent in 1998 (the same share as in 1989).

Heavily indebted consumers whose financial situations continue to deteriorate may end up filing for bankruptcy. In 1999, over 1.2 million households, or 1.2 percent of the total, filed for personal bankruptcy. Data on bankruptcy filers suggests that debtors who own homes extract all of their available home equity before filing; and, given their income and financial condition, most likely use subprime markets to do so. In 1996, about 40 percent of debtors entering Chapter 7 owned homes, as did about 60 percent of debtors entering Chapter 13.[24] However, average housing debt exceeded the average collateral value of the homes for these groups: mean housing-secured debt for Chapter 7 filers with debt was $112,000, while collateral averaged $105,000, and the corresponding figures for Chapter 13 filers were $97,000 and $94,000. Thus, home equity was completely gone by the time debtors entered bankruptcy. Since the average values of homes owned by the income group typical of bankrupt debtors increased during the 1995-98 period, it seems likely that debtors who declared bankruptcy had drawn down home equity.

[22] Share of all households taken from Kennickell et al ("Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances", *Federal Reserve Bulletin*, January 2000). Share of bankruptcy filings taken from Barron and Staten ("Personal Bankruptcy: A Report on Petitioners' Ability to Pay", Monograph # 33, Credit Research Center, 1997), who analyzed a 1996 sample of bankruptcy filings.
[23] SCF data cited in this section are drawn from tables 1, 3, 8, 11, and 14 of Kennickell et al (January 2000). We exclude households with income below $10,000 because they are a small part of the sample and may involve unusual circumstances.
[24] This fact and the following ones are taken from Barron and Staten (1997).

While this data at best only suggests a link between growing subprime mortgage lending and growing consumer debt and bankruptcy among homeowners, it is important to consider the consequences that many American families ultimately face after borrowing extensively from home equity. Access to the subprime mortgage market has created new opportunities for many families to own homes and to pay for important expenses, but it also may have fueled significant growth in consumer debt that has left some families in an inferior economic position.

4. Characteristics of Subprime Borrowers

As one would expect, subprime borrowers as a group have lower credit quality than borrowers in the prime market. Consequently, the borrower demographics in the subprime market reflect those populations that may have low or volatile income or thin credit history. HMDA data and other data sources provide information on the characteristics of subprime borrowers. The main findings on the characteristics of subprime borrowers are discussed in this section.

a. Credit Characteristics

One common way by which lenders classify borrowers' credit characteristics is through FICO or other credit scores.[25] A credit score assigns a single quantitative measure, or score, to a potential borrower that represents an estimate of the borrower's future loan performance. This approach allows lenders to examine all of a borrower's credit characteristics at the same time and objectively measure potential default risk.

Lenders differ with respect to mortgage underwriting guidelines, but the typical "A" credit or prime borrower – that is, a borrower whose loan would be purchased by Fannie Mae or Freddie Mac under their guidelines – has a FICO score that exceeds 650, has no late mortgage payments, and no more than one 30 day late payment on consumer credit. Borrowers that do not meet these credit guidelines are often considered subprime borrowers and, as a group, they are characterized by worse credit histories than "A" borrowers. For example, in the third quarter of 1999, the average FICO score of the top prime issuers of 30-year mortgage pools (privately issued non-GSE mortgage-backed securities) was 721 compared to a 605 average FICO score for subprime issuers of fixed-rate pools.[26]

Within the subprime sector, borrowers are graded from the least risky "A-minus" borrower to the most risky "D" grade borrower. These grades are not well defined across the industry, but an "A-minus" borrower may have good credit generally but has had some minor payment delinquencies in the

[25] The acronym FICO comes from the name of the company that developed the leading credit scoring model – Fair Isaac Company of San Rafael, California. FICO scores range from 350 to 850, with higher scores indicating better past credit performance.
[26] See "Third Quarter 1999 FICO Score and Credit Support Levels for Residential Mortgages," www.standardandpoors.com/ratings/structuredfinance/fico.htm.

past year. A "C" or "D" borrower may have a marginal or poor credit history, including multiple payment delinquencies in the past year or past bankruptcies.[27]

Most subprime lenders focus on borrowers with better credit histories. Estimates of credit classifications within the subprime market vary, but tend to show that the "A-minus" segment accounts for a majority of subprime borrowers. The National Home Equity Mortgage Association reports that the "A-minus" segment makes up 60 percent, the "B" segment 30 percent, the "C" segment 9 percent, and the "D" segment 1 percent of the market. *Inside B&C Lending* reports that the "A-minus" segment makes up 73 percent, the "B" segment 13 percent, the "C" segment 9 percent, and the "D" segment 5 percent of the market.[28]

Borrowers with no or non-traditional credit histories and borrowers with atypical employment histories or income patterns also tend to use the subprime market. Several subprime lenders specialize in serving "low-doc" and "no-doc" borrowers who are unable to (or prefer not to) provide full documentation of income or employment history to the lender.

Subprime borrowers are more likely to have higher debt-to-income ratios than prime borrowers. Conversely, subprime borrowers have lower loan-to-value (LTV) ratios, especially at the lower credit grades, as lenders use the borrower's equity in their house to compensate for the borrower's poor credit quality. Subprime borrowers at the higher credit grades are likely to use subprime mortgages to repair blemished credit with the intention of refinancing at prime rates in the future. Subprime borrowers at the lower credit grades may be more interested in cash out than borrowers at the higher credit grades, and are more likely than others to refinance during periods of increasing interest rates.[29]

b. Delinquency and Foreclosure Characteristics

Delinquency and foreclosure data show that subprime mortgages are more risky than prime or FHA mortgages. From January 1998 through September 1999, delinquency rates (total loans past due) in the subprime market averaged 13.5 percent and foreclosure rates averaged 2.6 percent. In contrast, for prime mortgages, over the same period, delinquency rates averaged 2.8 percent and

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[27] The "A-minus" and other risk grades are not always well defined, as a variety of thresholds for late payments and the FICO score have been used to describe subprime borrowers. Under one classification, an "A-minus" borrower has a FICO score between 620 and 650 and may have less than two late mortgage payments. Under another classification, a 580 FICO score has been used to describe the minimum credit score acceptable for "A-minus" credit. Still, the lower grade subprime borrowers are characterized by a history of more delinquencies on their credit obligations. Under one classification, "B" and "C" borrowers can have a minimum FICO score of 540 and may have four late mortgage payments in the past twelve months. See Jess Lederman, Tom Millon, Stacy Ferguson, and Cedric Lewis, "A-minus Breaks Away from Subprime Loan Pack," in Secondary Market Executive, May 2000, pages 1, 24-28.
[28] "Correspondents Reign Supreme in 1999," Inside B&C Lending, 3-10-00. The credit score floors used by *Inside B&C* to determine borrowers credit risk classifications were recently lowered, effectively moving more borrowers into the lower risk categories (toward "A-minus").
[29] See "Amresco Exec: Myths Abound in Subprime Business," Origination News, July 1998, p. 58.

foreclosure rates averaged 0.24 percent, while for FHA mortgages total delinquency rates averaged 8.5 percent and foreclosure rates averaged 0.62 percent.[30]

There is also substantial variation in risk across the different grades of subprime borrowers. For the third quarter of 1999, MIC reports that the serious delinquency rate (90-day delinquency plus foreclosure started) varied as follows: 3 percent for A-minus loans, 7 percent for B loans, 10 percent for C loans, and 21 percent for D loans.[31]

c. Borrower Demographics

Income and Race. Low-income and black borrowers account for a larger share of subprime refinance borrowers than of the mortgage market generally. According to 1998 HMDA data, low-income borrowers accounted for 41 percent of subprime refinance mortgages but only for 20 percent of conventional prime refinance mortgages.[32] Black borrowers accounted for 19 percent of all subprime refinance loans but only 5 percent of overall refinance mortgages. In contrast, white borrowers accounted for 70 percent of subprime refinance mortgages and 84 percent of all refinance mortgages.[33]

Combining the income and race of the borrower showed that more than half of low-income black borrowers refinance in the subprime mortgage market. In 1998, subprime lenders provided approximately 50 percent of all refinance loans going to low-income black borrowers. Low-income black borrowers accounted for 8 percent of subprime refinance mortgages, compared to only one percent of overall refinance mortgages.

Marital Status. According to 1998 HMDA data, 44.5 percent of all subprime borrowers were single applicants, versus 33.1 percent of prime borrowers. The same pattern holds for home purchase lending, where 50.2 percent of subprime lending was to singles and 38.1 percent of prime

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[30] Prime and FHA data are from the Mortgage Bankers Association of America (as reported by Inside Mortgage Finance, Mortgage Market Statistical Annual for 2000, Volume I, p. 210). Subprime data are from the Mortgage Information Corporation (as reported by Inside Mortgage Finance, Mortgage Market Statistical Annual for 2000, Volume I, p. 215). Combining the MIC and MBA data also allow for comparisons between FHA and the "A-minus" portion of the subprime market. In September 1999, the serious delinquency rate (90-day delinquencies and foreclosures started) for "A-minus" subprime loans was 3.29 percent, which was higher than the 2.12 serious delinquency rate for FHA loans.

[31] Mortgage Information Corporation, "The Market Pulse," Winter 2000.

[32] See Randall M. Scheessele, 1998 HMDA Highlights, Housing Finance Working Paper No. 9, Office of Policy Development and Research, HUD, October 1999. Loans where income was not considered by the lender for origination of the loan were excluded. A disproportionate percentage of FHA mortgages have missing income so only the comparison between conventional prime and subprime refinance mortgages is reported.

[33] Hispanic borrowers accounted for 6 percent of subprime refinance mortgages and 4 percent of refinance mortgages overall. The statistics reported here are calculated based upon the assumption that missing race data is distributed the same as loans where race was reported by the applicant. The lender is not required to report the race of the applicant if the borrower does not provide the information in a mail or telephone application. Subprime applicants are more likely not to have reported race data in a mail or telephone application than mortgage applicants overall.

borrowing was to singles. Finally, refinance lending again shows the increased use of subprime lending for singles, rather than co-applicants. Although singles made up 28.2 percent of the prime borrowers, they made up 43 percent of subprime refinance borrowers.[34]

Gender and Race. According to 1998 HMDA data, female borrowers accounted for 29 percent of subprime refinance mortgages compared to 19 percent of all refinance mortgages.[35] Other studies report different figures for the female share of subprime loans. For example, Weicher reports that single females accounted for 19 percent of subprime refinance mortgages and Freddie Mac reports that females accounted for 45 percent of all subprime mortgages but only for 37 percent of prime mortgages.[36]

Black females accounted for a much larger share of borrowers refinancing in the subprime market than of the total borrower population. According to 1998 HMDA data, black females accounted for 8 percent of subprime refinance mortgages but only 2 percent of overall refinance mortgages. White females, on the other hand, accounted for similar shares of the subprime and overall markets – 17 percent of subprime refinance mortgages and 15 percent of overall refinance mortgages.[37]

Age. Subprime borrowers are more likely to be older than prime borrowers. Borrowers in the 45-54 age group accounted for 31 percent of subprime mortgages but only 22 percent of prime mortgages; borrowers in the 55 years and up age group accounted for 35 percent of subprime mortgages but only 21 percent of prime mortgages. Comparable statistics for borrowers in the 18-44 year age group were 34 percent for subprime mortgages compared to 57 percent for prime mortgages.[38] Using different age categories, the National Home Equity Mortgage Association reports

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[34] Source: "The Subprime Lending Industry and Allegations of Predatory Practices", SMR Group, April 2000, p. 62-66.
[35] The statistics reported here are based upon the gender of the primary borrower reported under HMDA. The statistics are also calculated based upon the assumption that missing gender data is distributed the same as loans where gender was reported by the applicant. The lender is not required to report the gender of the applicant if the borrower does not provide the information in a mail or telephone application. Subprime applicants are more likely to have missing gender data than mortgage applicants overall.
[36] See Howard Lax, Michael Manti, Paul Raca, and Peter Zorn, "Subprime Lending: An Investigation of Economic Efficiency" (unpublished paper), February 25, 2000; and Weicher, John C., The Home Equity Lending Industry: Refinancing Mortgages for Borrowers with Impaired Credit, 1997 Hudson Institute, Indianapolis, Indiana.
[37] Black males accounted for 10 percent of subprime refinance mortgages but 3 percent of overall refinance mortgages compared to 52 percent of subprime refinance mortgages and 69 percent of overall refinance mortgages for white males. Again, the statistics reported here are calculated based upon the assumption that missing gender and race data is distributed the same as loans where gender and race were reported by the applicant. Subprime applicants are more likely to have missing gender and race data than mortgage applicants overall.
[38] See Howard Lax, Michael Manti, Paul Raca, and Peter Zorn, "Subprime Lending: An Investigation of Economic Efficiency" (unpublished paper), February 25, 2000. Freddie Mac designed and commissioned a survey that was implemented by the Gallup Organization from a sample of borrowers who obtained mortgages between January 1996 and June 1997; the borrower sample was obtained from DataQuick, a firm that collects mortgage transaction data from county records. The Freddie Mac sample included first lien purchase and refinance mortgages and second mortgages. The differences in subprime percentages by age partially reflects the fact that younger borrowers are more likely to be obtaining home purchase loans while a greater percentage of older borrowers are refinancing mortgages. Also, subprime refinance loans accounted for a higher share of overall refinance loans during the January 1996 - June 1997 time period studied by Freddie Mac than in 1998, a year of low interest rates and high refinancing in the prime market. That is, the Freddie Mac survey may have been more likely to pick up borrowers who

the age characteristics of subprime borrowers as follows: under 35 years of age - 15 percent of the subprime market; borrowers between the ages of 35 and 49 - 50 percent; borrowers between the ages of 50 and 65 – 25 percent; and borrowers over 65 years of age – 10 percent.

Education. Subprime borrowers are less well-educated than prime borrowers. College graduates accounted for only 38 percent of subprime mortgages but 60 percent of prime mortgages. High school graduates and borrowers with some college account for 59 percent of subprime mortgages but only 39 percent of prime mortgages.[39]

C. Overview of the Subprime Lending Pipeline: From Borrowers to Investors

The subprime mortgage market is much more complicated than the simple interaction between a borrower and a lender. The market may be thought of as a pipeline that connects the ultimate source of funds (i.e., the investors) with the individual borrower. This pipeline may involve more than half a dozen types of participants. Understanding how this pipeline works is crucial to understanding the possible sources of predatory practices and the possible solutions to halting such practices.

At one end of the pipeline is the borrower being granted credit. There are a wide range of intermediaries involved in delivering the mortgage loan to the borrower. These intermediaries include participants in the subprime market that are likely to deal directly with the consumer such as home improvement contractors, mortgage brokers, finance companies, mortgage bankers, and insured depository institutions. It also includes companies that fund subprime lenders' warehouse lines of credit and securitize subprime loans such as commercial and investment banks. Credit life insurance companies participate in the subprime market by providing credit property, life, and disability insurance. Recently, mortgage insurance companies and government sponsored enterprises, have entered in the subprime mortgage market.

At the other end of the pipeline are the ultimate providers of funds. These providers are as varied as the components of the pipeline itself. Insured deposits and other depository liabilities are one source of funds. Capital market borrowing by depositories and finance companies is another source. And capital market investors may buy the subprime mortgages themselves, typically by purchasing asset-backed securities that constitute an ownership interest in an underlying pool of subprime mortgages. Thus, the ultimate source of funds includes depositors, pension funds, mutual funds, and other investors (both institutions and individuals).

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primarily refinanced to cash out than the typical borrower in 1998 who primarily refinanced to take advantage of more favorable mortgage terms. Weicher reports similar statistics for data obtained from members of the Home Equity Lenders Leadership Organization (HELLO). See Weicher, John C., The Home Equity Lending Industry: Refinancing Mortgages for Borrowers with Impaired Credit, 1997 Hudson Institute, Indianapolis, Indiana.

[39] See Howard Lax, Michael Manti, Paul Raca, and Peter Zorn, "Subprime Lending: An Investigation of Economic Efficiency" (unpublished paper), February 25, 2000.

Any one transaction may involve one or more of these components of the pipeline. For example, a person undertaking a home improvement project may work directly with the contractor to initiate the credit process. The contractor may then interact with a broker, a finance company, a mortgage banker, or a depository institution to obtain the actual credit. A credit life insurance company may provide credit insurance on the loan, and an investment bank may assist in pooling the loan with similar loans and selling an asset-backed security to investors.

It is in this pipeline that we seek to identify predatory lending practices. Since not all firms in the pipeline actually undertake the credit risk of making the loan, they may be less concerned about the loan's ultimate repayment and more concerned with the fee income they may earn from the transaction.

1. Borrower Entry into the Lending Pipeline

Typically, a borrower's entry into the subprime lending pipeline involves interacting with an institution or an individual that either specializes in subprime loans or deals with subprime loans as part of overall business operations.

One method of entry into the subprime lending pipeline is through a borrower dealing directly with an institution that is the source of funds (either directly or indirectly by issuing securities to capital market investors). Some of these institutions include: finance companies, mortgage bankers, subprime affiliates of a prime lender, or insured depositories. In this case the borrower would likely discuss loan options with a loan officer that is employed by one of these institutions. Under this structure, the lender is accountable for its loan officers and has a responsibility to monitor their activities.

Another method of entry into the subprime lending pipeline is through a borrower dealing with intermediaries that bring borrowers together with funding sources. These intermediaries are not necessarily controlled by the funding sources, and include home improvement contractors and mortgage brokers. This structure is less regulated and may leave room for greater abuses in the subprime mortgage marketplace. Some lenders have claimed that they are not accountable for the resulting abuses because they have no control or responsibility over the practices that these intermediaries may employ.[40] These intermediaries are subject to varying degrees of federal and state regulation as described below.

The marketing practices of the various intermediaries also may be linked to abusive lending practices. Consumer advocates and borrowers have indicated some of these intermediaries, particularly

[40] For example, finance companies purchase loans from mortgage brokers, but claim that they cannot be held responsible for the practices of mortgage brokers. Recently, in settling a complaint brought by the Justice Department and HUD under the Fair Housing Act and RESPA, Delta Funding Corporation, a subprime lender, agreed that it was responsible for ensuring that mortgage brokers' compensation was reasonably related to the goods, facilities and services provided and that it would lower its yield spread premium or refuse to purchase a mortgage from a mortgage broker unless the compensation was reasonable.

in the subprime market, use aggressive or deceptive marketing techniques.[41] These advocates point out that because of aggressive sales techniques, borrowers who otherwise might not have sought home secured credit are introduced into the subprime mortgage market. Moreover, evidence from enforcement actions indicates that some less scrupulous intermediaries often target their efforts in predominantly minority neighborhoods.

Based on the work of the Task Force, two groups of intermediaries – home improvement contractors and mortgage brokers – appear to be significant sources of abusive lending practices.

Home improvement contractors in both the prime and subprime markets sell home improvements to consumers and frequently arrange the financing through mortgage brokers, finance companies, mortgage banks or other lenders. Borrowers and consumer advocates report that certain home improvement contractors who arrange subprime loans are extremely aggressive in face to face marketing. They target their efforts to consumers whose homes are most in need of repair and whose occupants are least able to shop because of age or infirmity. While a home improvement contractor may provide useful services to homeowners, some seek to convince homeowners to purchase repairs that are unnecessary or overpriced. Some arrange loans with abusive terms and perform shoddy and/or incomplete work once the loan is closed and their fees have been paid. In the worst cases, homeowners may increase their home-secured debt largely as a result of loan fees that may equal or exceed the costs of actual repairs. Home improvement contractors may be regulated under state and local law but are not ordinarily subject to Federal regulation.

Mortgage brokers arrange mortgage financing for borrowers with other mortgage loan providers (including finance companies, mortgage bankers, thrift institutions, credit unions, and banks). Few mortgage brokers act as agents or fiduciaries of borrowers, but mortgage brokers' services include counseling borrowers on suitable loan products, assisting with the borrower's application, obtaining credit and employment reports, and performing other necessary origination services. A mortgage broker ordinarily forwards a borrower's loan file to a lender for underwriting. Mortgage brokers may close loans in their own names using their own funds or warehouse lines of credit or they may close them in the name of a mortgage lender or other type of investor. [42]

The mortgage industry in recent years has seen a steady increase in the use of mortgage brokers. According to the National Association of Mortgage Brokers, mortgage brokers arrange financing for well over half of all home mortgages today.[43] The National Home Equity Mortgage

[41] Some home improvement contractors and mortgage brokers market their services door to door, use signs and handbills, and/or mail and phone solicitations to target borrowers. Other intermediaries use direct mail or television and advertisements to attract customers.

[42] Generally, mortgage brokers are not highly capitalized entities and do not ordinarily provide funding for the loan. While some brokers utilize warehouse lines of credit to fund loans, most brokers' loans are "table funded." In table funding, a loan is processed and closed in the name of the broker. At or about the time of settlement, there is an advance of monies and a transfer of the loan to an investor, ordinarily a finance company, mortgage banker or depository institution.

[43] www.namb.org/CONSUMR2/facts.htm.

Association also reports that about 50 percent of subprime loans are originated through mortgage brokers.

Brokers are paid for their services directly by the borrower, frequently as a percentage of the total loan amount and through other direct fees including, for example, application fees. Brokers are also frequently paid "indirectly" by the lender/investor based on the yield of the mortgage loan through a "yield spread premium." A yield spread premium is a payment a mortgage broker receives from a lender based on the difference between the interest rate and points of the loan the broker entered into with the borrower, and the par rate offered by the lender to the mortgage broker for that particular loan (e.g., a loan of 8% and no points where the par rate is 7.50% will command a greater premium for the broker than a par rate of 7.75% and no points).[44] Consumer advocates assert that this method of broker compensation provides an incentive for brokers to and higher rates. Brokers respond that indirect compensation allows brokers to charge lower direct fees to borrowers, permitting "no-cost" or "low-cost" loans.

In most states, mortgage brokers are subject to state regulation, but the degree of regulation may be modest as compared to other types of institutions involved in home financing. HUD has limited regulatory authority for settlement service providers under RESPA, including mortgage brokers.

The presence of a variety of intermediaries may create complexities in the subprime market, particularly for less informed borrowers. Because some of the intermediaries involved in the origination of a subprime mortgage loan do not actually take on the credit risk of making the loan, some may be less concerned about the loan's ultimate repayment, and more concerned with the fee income they earn from the transaction. The compensation arrangements of mortgage brokers and others may not be sufficiently transparent to borrowers, notwithstanding existing disclosure requirements under RESPA and TILA. Often substantial compensation to an intermediary is financed into the loan amount, reducing the transparency of these costs to the borrower and making the loan more costly in the long run. While most borrowers can compare interest rates, the fees and other charges levied by intermediaries may be less conspicuous and, particularly in a non-competitive setting, not readily comparable.

2. Sources of Funds

a. Pre-1990s: Finance Companies

Prior to the 1990s, the lending pipeline in subprime industry was more streamlined than it is today as the industry was dominated by traditional finance companies that originated loans and held them in their own portfolios. Historically, large finance companies financed subprime mortgages with secured and unsecured debt.[45] These companies relied on a variety of financing methods including equity capital, commercial paper, bonds, and commercial bank lines of credit. Finance companies also used both short and long-term debt, the exact mix depending on the terms of the loans they originated. Throughout the 1980s, commercial paper and long-term indebtedness were the principal liabilities of

[44] The term "par rate" refers to the rate offered to the broker (through the lender's price sheets) at which the lender will fund 100% of the loan with no premium or discounts to the broker.
[45] "B&C Mortgage Issuers Turn to High Yield Bonds," Origination News, December 1997, page 57.

finance companies, accounting for 37 percent and 35 percent, respectively, of total liabilities and capital.[46]

b. The 1990s: Securitization Becomes Important

By the 1990s, securitization – the process of pooling together a group of loans and issuing a security representing an ownership interest in the loans – had already become a major source of funding in the prime mortgage market. As investors became comfortable with these investment products, private firms began securitizing other residential and consumer loans. For example, the market for conventional loans above the conforming loan limit (so-called jumbo loans) was increasingly relying on securitization by the end of the 1980s. During the 1990s, multifamily loans, automobile, manufactured home, subprime mortgage loans, and community development loans have been securitized and sold to investors.[47]

During the 1990s, established finance companies continued to rely on a variety of debt instruments to fund loans but they also began to issue asset-backed securities with finance loans as the collateral. Automobile and other forms of consumer credit initially accounted for the majority of loans securitized by finance companies although home equity loans accounted for the majority of loans securitized by the mid-1990s. The securitization of subprime mortgages was a major reason for the rapid growth of finance companies and new entrants into the industry during the mid-1990s.

Inside Mortgage Finance has published data on the securitization of subprime loans since 1994. As shown in Table 3.4, securitization of subprime loans increased from $11 billion in 1994 to $83 billion in 1998 before dropping to $60 billion in 1999. As a share of total subprime mortgage originations, the securitization rate increased from 32 percent in 1994 to as high as 55 percent in 1998, before dropping to 37 percent in 1999. This drop most likely reflects the industry shakeout in 1998 (discussed below).

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[46] Finance lenders that obtain the lowest cost of funds typically have a level of equity capital that is commensurate with the default risks of its loan portfolio. In 1988, the equity capital-to-asset ratio that the capital market required for finance lenders was at least 9 percent. See James A. Rosenthal and Juan M. Ocampo. Securitization of Credit: Inside the New Technology of Finance, John Wiley & Sons, Inc., 1988, page 6.

[47] Rosenthal and Ocampo, op. cit., discuss the benefits of securitization. Basically, securitization allows risk to be divided up and sold to investors with differing preferences for return and risk.

Table 3.4: Subprime Securitization: 1994 – 1999

Year	Estimated Subprime Mortgage Originations	Subprime MBS/ABS Securitization	Subprime MBS/ABS Securitization Rate
1994	$35	$11.05	32%
1995	$65	$18.47	29%
1996	$97	$38.16	40%
1997	$125	$66.19	53%
1998	$150	$82.58	55%
1999	$160	$59.88	37%

Source: Inside Mortgage Finance, Mortgage Market Statistical Annual for 2000, Vol. 2, p. 1-2

While securitization has provided a growing source of funds for subprime lending through the 1990s, portfolio lenders remain an important source of funding in today's subprime market.

3. Securitization Increases Wall Street's Participation in the Lending Pipeline

The process of securitization involves increased participation by Wall Street firms in the lending pipeline. For mortgage-backed securities created from subprime loans to have wide appeal to investors, they typically have some form of credit enhancement. Credit enhancement improves the credit quality of the security thereby broadening the pool of interested investors and lowering the yield required on the security, thus expanding the pool of investors that are interested in funding subprime mortgages. The market for providing credit enhancements is innovative and highly competitive, and many types of assets have been securitized.

Two common forms of credit enhancement for subprime mortgages are bond insurance and structural enhancements. Bond insurance is provided by financial guaranty companies (typically monoline insurance companies). Under this form of credit enhancement, the securitization would include a surety bond from a monoline insurance company so that the deal would achieve a AAA rating. With this type of transaction, the insurer, not the investor, holds the loans' credit risk.

The second common type of credit enhancement is structural enhancements, the most common of which is the senior-subordinate structure. Under a senior-subordinate structure, the underlying cash flows of a securitization are distributed first to the senior classes of the securitization. Thus, the subordinate pieces of the securitization serve as a form of credit enhancement in that they absorb losses before the senior pieces. Typically the level of subordination is set to allow the senior portion of the securitization to obtain an AAA rating.

The major rating agencies play an integral role in determining the amount of credit enhancement necessary for subprime securitizations. The rating agencies set the parameters for transforming subprime collateral into a AAA-rated security. One of their main functions is to determine the appropriate level of credit enhancement for subprime securities based on the characteristics of the collateral and the track record of the issuer and servicer. Because issuers provide them with loan-level data, the rating agencies are also one of the best sources of information on the risk characteristics of subprime loans.

Recently, these two types of credit enhancement have been used in roughly the same proportions. Moody's estimates that 53 percent of the subprime mortgage-backed securities issued from 1997 to 1999 carried bond insurance, while the rest involved senior-subordinate structures.[48]

Wall Street investment firms have always been the top subprime mortgage security underwriters. The primary function of security underwriters is to purchase securities from issuers and sell the securities to investors. The top eight Wall Street underwriters of subprime securities accounted for three-fourths of all subprime issues during 1999. Two affiliates of prime mortgage lenders were ranked in the top ten underwriters of subprime securities in 1999.

4. Changing Industry Fortunes in the Latter 1990s

Securitization expanded opportunities for both established lenders and new entrants into the subprime market. Wall Street investment firms and commercial banks provided new and established lenders with access to warehouse lines of credit and lenders used this short-term funding to originate and temporarily hold mortgages for later securitization. Lenders would either issue securities directly or act as correspondents for other subprime lenders that issued securities backed by subprime loans. Wall Street investment firms underwrote the securities and sold them to investors. As lenders grew they attracted long-term capital at lower costs through equity and debt markets by becoming publicly traded companies.

The subprime mortgage market became highly competitive in the mid-1990s fueled by refinancings and profitable spreads. Increased competition also led to more flexible underwriting standards – ultimately resulting in higher delinquency rates, default rates, and prepayment rates.

However, the success enjoyed by many subprime companies in the mid-1990s has been reversed in recent years as the subprime market experienced significant turbulence. Indeed, significant risks have arisen on three fronts: credit risk, liquidity risk, and reputation risk. First, many subprime lenders were slow to adopt best practice underwriting techniques for their loans, resulting in higher than expected defaults. Second, the volatile financial markets of 1998 put liquidity pressure on many already troubled subprime lenders. That is, their borrowing costs increased significantly and investor interest in the subordinated tranches of their loan securitizations evaporated. Lastly, media exposes and lawsuits

[48] Moody's Investors Services, Predatory Lending and Home Equity Securitizations, April 28, 2000, p. 2.

arising from alleged abuses by some subprime lenders spawned concern about "reputation risk" across the industry.

Both depository institutions and consumer finance companies have run into difficulties with subprime lending. While asset quality has affected both types of intermediaries, consumer finance companies that specialize in the subprime sector have also experienced trouble securing financing (debt and equity).

One key problem many finance companies faced was deterioration in the quality of their balance sheets as a result of income not materializing as expected. The primary source of income for many subprime lenders that securitize loans is the cash flow that comes from excess servicing. (Excess servicing arises from the interest rate on the mortgage being greater than the interest return that must be paid to the security holder and the fee for servicing the mortgage.) Using "gain-on-sale" accounting, lenders book the expected present value of excess servicing as current income -- although this value depends importantly on assumptions about default rates, loss rates, and prepayment rates.

Beginning in late 1997 and continuing through 1998, lenders that had under-estimated prepayment speeds and loan defaults were forced to restate the value of their servicing rights, resulting in a decline in their capital base. This, in turn, eroded investor confidence and the value of subprime lenders' outstanding debt and asset-backed securities declined. Congruently, the Asian financial crisis led to a general reduction of capital market liquidity and thus new sources of funds for subprime lenders either became more expensive or dried up entirely. In fact, during 1998, hedge funds and investment banks were said to have lost their appetite for subordinated portions of subprime securitizations, thus halting a large portion of secondary market activity in these loans.

Several subprime mortgage firms filed for bankruptcy protection during 1998. Other troubled specialty subprime lenders were acquired by more diversified mortgage lenders or by bank holding companies.

Trouble with subprime lending was not limited to consumer finance companies. According to the Federal Deposit Insurance Corporation (FDIC), the three most costly depository institution failures of 1999 (with loss rates over 50 percent) all involved subprime lending to some degree. These institutions were Best Bank (CO), Pacific Thrift & Loan (CA), and First National Bank of Keystone (WV). Furthermore, active subprime lenders (i.e., those with more than 25 percent of their equity capital in subprime loans) are over-represented on the FDIC's "problem bank" list. In fact, subprime lenders, by this definition, constitute one percent of FDIC-insured institutions, but make up some 21 percent of problem institutions. In response to growing concerns about the risks of subprime lending to *lenders*, the OCC, OTS, FDIC, and the Board issued joint guidelines on the nature and risks of subprime lending in March 1999.

5. New Entrants in the Subprime Market

The financial turbulence of the latter part of the 1990s altered the structure of the subprime market. One of the main features has been consolidation. Morgan Stanley reported in 1998 that "the subprime sector has been characterized over the past two years by increasing competition and, more recently, by the consolidation seen in the financial services industry generally."[49] In 1996, the top 25 lenders originated 50 percent of subprime loans. This percentage climbed to 62 percent in 1997 and to 70 percent in 1998 and 1999.[50] Financial turbulence in the subprime market also attracted new entrants, including prime lenders, private mortgage insurers, and the GSEs.

Prime Lenders. Prime mortgage lenders have accounted for a small share of the subprime market in the past but have become important participants in the wake of the industry shakeout in 1998.[51]

Banks and thrifts, which typically specialize in prime lending, are also increasing their profiles in the subprime market. Between 1993 and 1998, the number of subprime mortgages loans originated by banks and thrifts increased by 551 percent. The number of subprime loans originated by affiliates of banks and thrifts increased nearly 70-fold, from a very small base in 1993. Taken together, banks, thrifts and their affiliates accounted for approximately one quarter of all subprime mortgage originations in 1998.[52]

Prime lenders have played a smaller role in the subprime market until recently because originating and servicing subprime mortgages is much different than originating and servicing prime mortgages. For many prime lenders, their initial entry into subprime has been in the least risky (A-minus) tier of the market. Their marketing has been based on better pricing and a stable source of capital.[53]

Prime mortgage lenders have entered the subprime market by starting their own subprime mortgage divisions and through acquisitions of established subprime lenders. In addition to these types of direct involvement in subprime lending, prime lenders also:

- Issue and purchase subprime securities. These companies may play an increasingly important role in the securitization of subprime product because of their access to credit markets and their expertise in securitizing mortgages.[54]

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[49] Morgan Stanley Dean Witter, Home Equity Loan Handbook 1998 edition, p. 5.

[50] Inside Mortgage Finance, Mortgage Market Statistical Annual Vol. 1, 1999, p. 117-123.

[51] See "Continuing Shake-Out in Subprime Market Expected To Create Opportunities for A Market Lenders in '98." Inside Mortgage Finance. January 15, 1999. Page 9. "New Year Spells New Opportunity, New Hope for Subprime Recovery." January 11, 1999. Inside B&C Lending. Pages 1,2.

[52] Litan et al., *op cit*.

[53] This discussion of the entry of prime lenders into the subprime market draws from Jess Lederman, Tom Millon, Stacey Ferguson, and Cedric Lewis, "A- Breaks Away from Subprime Loan Pack", in Secondary Marketing Executive, May 2000, pages 1, 24-28.

[54] There are other advantages to a bank or thrift charter. For example, Associates and Commercial Credit applied for thrift charters in late 1997 and early 1998. Both companies stated that the federal preemption of individual state regulations accorded federal savings associations was one reason for their application.

- Service subprime mortgage portfolios.

- Perform back office functions related to securitization (e.g., acting as a trustee for subprime securitizations).

- Provide warehouse lines of credit to subprime lenders.

Wall Street. In addition to Wall Street investment firms' traditional role as underwriters, beginning in late 1997 (in the wake of the shakeout in the subprime market) several firms also became important issuers of subprime securities. Wall Street investment firms obtain subprime loans through whole loan purchases from lenders that have been unable to profitably issue securities. Wall Street investment firms have also formed alliances with subprime lenders.

Private Mortgage Insurers. Private mortgage insurers first entered the subprime market in 1997, insuring "A-minus" loans as a way to expand their market.[55] However, the market for their subprime product really began to develop in late 1998 when prime lenders began moving into the "A-minus" market. Traditional subprime lenders, who focused on B and C loans, had never felt the need for mortgage insurance. Prime lenders saw an opportunity to expand into the "A-minus" market after a liquidity crisis in late 1998 led to the demise of many traditional B&C lenders. The growing use of automated underwriting at about the same time enabled prime lenders to assess risk more accurately, but they still wanted the comfort of mortgage insurance. In particular, portfolio lenders who face risk-based regulatory capital requirements have an incentive to use mortgage insurance. The availability of mortgage insurance also enabled existing "A-minus" lenders to stretch their product guidelines by increasing LTVs and maximum loan amounts, and by allowing lower credit scores.

The GSEs. Although the GSEs are not currently significant participants in the subprime market; Fannie Mae and Freddie Mac have shown increasing interest in the subprime market throughout the latter half of the 1990s. Both GSEs have begun purchasing "A-minus" and "Alt-A" mortgages..[56] The GSEs' interest in the subprime market has coincided with a maturation of their traditional market (the conforming conventional mortgage market), and their development of mortgage scoring systems, which they believe allows them to accurately model credit risk.

D. Subprime Lending and Low-Income and Minority Neighborhoods

[55] This discussion of the role of private mortgage insurers in the subprime market draws from Jess Lederman, Tom Millon, Stacey Ferguson, and Cedric Lewis, "A- Breaks Away from Subprime Loan Pack", in Secondary Marketing Executive, May 2000, pages 1, 24-28.
[56] Alternative – A (or Alt –A) mortgages are made to prime borrowers who desire low down payments or do not want to provide full documentation for loans.

This section reviews two important aspects of the growth in subprime lending. The first is the heavy reliance of low-income and minority neighborhoods on subprime lenders for their refinance loans. The second is the rapid increase in foreclosures of subprime loans in these same neighborhoods.

1. Subprime Concentration in Low-Income and Minority Neighborhoods

Analysis of HMDA data show that subprime lending is disproportionately concentrated in low-income and minority neighborhoods. Reasons for the disproportionate amount of subprime lending in certain neighborhoods likely results from the following factors: differences in credit characteristics of borrowers; differences in the types of loans (e.g., small balance loans); and less competition from mainstream lenders. Low-income and minority neighborhoods may be especially vulnerable to abusive lending practices because subprime lending tends to be concentrated in these neighborhoods. Not all subprime lending is predatory, but predatory practices are most frequently found in connection with subprime lending.

HUD's detailed study of the almost 1 million subprime mortgages reported to HMDA in 1998 focused primarily on home refinancing loans, which account for 80 percent of all subprime loans. HUD's study found that there has been a tremendous growth in subprime lending since 1993, and that this growth is concentrated in low-income and minority neighborhoods. In particular, borrowers in black neighborhoods rely heavily on subprime lending when refinancing their mortgages. This disparity between the share of borrowers in black and white neighborhoods refinancing in the subprime market holds even after controlling for neighborhood income (but not controlling for individual borrowers credit characteristics).

Low-Income Neighborhoods. Subprime loans are three times more likely in low-income neighborhoods than in high-income neighborhoods. Nationwide, 11 percent of refinance mortgages in 1998 were subprime, but in low-income neighborhoods, the percentage was more than double at 26 percent. In upper-income neighborhoods, only 7 percent of borrowers refinanced in the subprime market in 1998. In 1993, only 3 percent of subprime mortgages in low-income neighborhoods and 1 percent in moderate- and upper-income neighborhoods were subprime. In the poorest communities, where families make only 50 percent of the median income, fully 44 percent of borrowers refinanced in the subprime market in 1998.

Looking at individual borrower income rather than neighborhood income, the findings are similar. Low-income borrowers were almost 3 times as likely as upper-income borrowers to rely upon subprime refinancing (21 percent of low-income borrowers versus 8 percent of upper-income borrowers.)

Black Neighborhoods. The HMDA data indicate that borrowers in black neighborhoods are five times as likely to refinance in the subprime market than borrowers in white neighborhoods. In predominantly black neighborhoods, subprime lending accounted for 51 percent of refinance loans in 1998 – compared with only 9 percent in predominately white areas. Comparable 1993 figures were 8 percent in black neighborhoods and 1 percent in white neighborhoods.

Most notably, these disparities still exist if homeowners in black and white neighborhoods are compared while controlling for the income of the neighborhood.[57] Among borrowers living in upper-income white neighborhoods, only 6 percent turned to subprime lenders for refinancing in 1998. In contrast, 39 percent of borrowers living in upper-income black neighborhoods refinanced in the subprime market (i.e., borrowers in black neighborhoods were six times as likely to refinance with a subprime loan).[58] In fact, borrowers in *upper-income* black neighborhoods were twice as likely as homeowners in *low-income* white neighborhoods to refinance with a subprime loan. In 1998, 18 percent of borrowers living in low-income white neighborhoods relied upon a subprime loan, compared with 39 percent of borrowers living in upper-income black neighborhoods.

Individual Metropolitan Areas. HUD's analysis at the metropolitan area level reveals the same trends in subprime lending. A detailed analysis of the five metropolitan areas where forums were held by the Predatory Task Force showed the same income and racial patterns in the use of subprime lending at the metropolitan level as at the national level in 1998.

- In Atlanta, subprime refinancing during 1998 accounted for at least 25 percent of all refinancing in 101 of the 475 census tracts. In 94 of these 101 census tracts, the population was at least 30 percent black.
- Subprime mortgages accounted for at least 25 percent of all refinance mortgages in 253 of the 1,641 census tracts in the Los Angeles metropolitan area. Census tracts where either blacks or Hispanics (or both) comprised more than 30 percent of the population accounted for 241 of the 253 census tracts with high subprime activity.
- In New York, subprime refinancing represented one in four loans in more than half of all census tracts, and black neighborhoods alone accounted for almost 50 percent of all subprime lending in the city.
- In Chicago, subprime refinancing account for at least 25 percent of all refinancing in 438 of the 1,767 census tracts. In 367 of these 438 census tracts, blacks accounted for at least 30 percent of the population.
- In Baltimore, almost one-third (or 156) of the census tracts had at least 25 percent subprime refinancing, with the greatest subprime refinancing activity occurring in the black neighborhoods (118 of the 156 tracts).

Banking regulators have recognized the need for more mainstream lenders in neighborhoods currently being served by subprime lenders, and have urged banks and thrifts to seek profitable lending opportunities in these communities. Ellen Seidman, Director of the Office of Thrift Supervision, recently echoed the sentiments of other banking regulators when she stated that, "Many of those served by the sub-prime market are creditworthy borrowers who are simply stuck with sub-prime loans or sub-prime

[57] This analysis did not control for differences in the credit characteristics of neighborhoods.

[58] This pattern is also present in neighborhoods of other income levels. Borrowers in low-income black neighborhoods are almost three times as likely as borrowers in low-income white communities to have subprime refinancing, and borrowers in moderate-income black neighborhoods are four times as likely to have subprime refinancing.

lenders because they live in neighborhoods that have too few credit or banking opportunities."[59] Similarly, Comptroller of the Currency, John D. Hawke, Jr. recently stated that, "We must target not just the predators themselves, but conditions that allow them flourish. That means encouraging responsible competition in the same markets in which the predators operate."[60]

2. The Effects of Foreclosure on Low-Income and Minority Neighborhoods

The growth in subprime lending over the last few years has been documented in the above sections. By providing loans to borrowers who do not meet the credit standards for borrowers in the prime market, subprime lending can and does serve a role in the nation's economy. These borrowers typically have blemishes in their credit record, insufficient credit history or non-traditional credit sources. Thus, it is not surprising that, generally, , subprime loan borrowers present more credit risk as a class, and have higher rates of serious delinquency and default than mainstream conventional borrowers (see national data on delinquencies and foreclosures reported in Chapter IV.B.3 above).

This section reports findings about subprime foreclosures from studies of three individual metropolitan areas. These studies have found that in the areas studied, the growth in mortgage foreclosures paralleled the growth in subprime lending. They also found that subprime borrowers are quicker to default on their loans than are prime borrowers and default, leads to foreclosure by the lender. Like originations, foreclosures on subprime loans are concentrated in low-income and minority neighborhoods.

Chicago. The National Training and Information Center (NTIC) related subprime lending to foreclosure trends in its examination of mortgage markets in Chicago for the period 1993 to 1998.[61] The NTIC study found that:

- Between 1991 and 1997 the subprime share of the mortgage origination market rose from 3 percent to 24 percent. However, between 1993 and 1998, the subprime share of foreclosures increased from 1.3 percent to 35.7 percent.
- Foreclosures on loans originated after 1994 had higher average interest rates than foreclosures on loans originated before 1994. Between 1993 and 1998, the greatest growth in foreclosures was on loans with interest rates 4-8 percentage points above the 30-year Treasury rate.
- Fast foreclosures in the Chicago area grew rapidly in the subprime market. The vast majority of foreclosures on home loans less than two years old were foreclosed by subprime lenders.

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[59] "Puzzling Through: Approaching Alternative Credit Responsibility." Remarks by Ellen Seidman. Director of the Office of Thrift Supervision. Interagency Conference on CRA. San Francisco, April 17, 2000.

[60] Remarks by John D. Hawke, Jr. Comptroller of the Currency. National Community Reinvestment Coalition Annual Convention. Washington, DC. March 21, 2000.

[61] NTIC, Preying on Neighborhoods: Subprime Mortgage Lenders and Chicagoland Foreclosures, September 1999. The NTIC study focused on completed foreclosures between 1993 and 1998 in the Chicago area, including the City of Chicago, suburban Cook County, and DuPage and Will counties. NTIC obtained foreclosure data from the Foreclosure Report of Chicago, a private, for-profit company that collects foreclosure court filings. Unlike the studies of foreclosures by Abt Associates and HUD (discussed below) which focused on foreclosures initiated, the NTIC study focused on "foreclosures completed" where the property was sold at an auction.

Atlanta. Building on the NTIC study, Abt Associates recently conducted an analysis of mortgage foreclosures in the Atlanta metropolitan area.[62] Abt examined mortgages that were entering the foreclosure process between 1996 and 1999, and compared foreclosures of loans by subprime and non-subprime lenders.[63] The Abt study found that:

- Among lenders that report to HMDA, the overall share of foreclosures attributable to subprime lending increased from 5 percent in 1996 to 16 percent in 1999.[64] The subprime share of originations was 10 percent in 1996, 12 percent in 1997 and 9 percent in 1998.
- Over the 1996-99 period, loans with high interest-rate spreads (more than four percentage points over 30-year Treasury) represented 44 percent of the subprime loans entering foreclosure.[65]
- The median age of loans entering foreclosure was only two years for subprime loans, compared to 4 years for prime loans.
- Considering only foreclosures by HMDA reporters, subprime lenders accounted for 36 percent of all foreclosures in predominantly minority neighborhoods during 1999, compared to their origination shares of 28 percent in 1997, 31 percent in 1997, and 26 percent in 1998.

Baltimore. HUD examined all petitions to initiate foreclosure actions in Baltimore for the three month period of January to March 2000 and compared these results with available HMDA data on mortgage originations.[66] The HUD study found that:

- The subprime share of foreclosures in Baltimore is much larger than the subprime share of mortgage originations.[67] While subprime loans account for 45 percent of the foreclosure petitions, the subprime share of mortgage originations in Baltimore City was 21 percent in 1998.[68]

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[62] Abt Associates Inc., Analyzing Trends in Subprime Originations and Foreclosures: A Case Study of the Atlanta Metro Area, February 2000. The Abt study covered 12 of the 16 counties in the Atlanta metropolitan area.
[63] Abt obtained monthly data from the *Atlanta Foreclosure Report* (AFR) on advertisements for foreclosure sales; as Abt notes, the data may include some properties that avoid foreclosure. Thus, the term "foreclosure" in the Abt report should be interpreted as a loan entering the foreclosure process. See pages 12-16 of the Abt report for a discussion of the AFR data. Abt identified subprime lenders using HUD's list of lenders that primarily originate subprime loans.
[64] HMDA reporters accounted for about 70 percent of Abt's sample. Including all lenders in the Abt sample, the subprime share of loans entering foreclosure increased from 3 percent in 1996 to 11 percent in 1999.
[65] However, Abt finds that foreclosures with high interest rate spreads have increased for all types of lenders. It is also important to note that Abt had data on interest rate spreads for only a quarter of the listed foreclosures.
[66] See the HUD report Unequal Burden in Baltimore: Income and Racial Disparities in Subprime Lending, May 2000. HUD obtained the data on foreclosure petitions in conjunction with the staff of the St. Ambrose Housing Aid Center. The data was obtained from the files of the Circuit Court for Baltimore City. The data on foreclosures included the petition and origination dates, the interest rate, product type (FHA, VA, conventional), the name of the lender, and the address of the property. HUD used its subprime list of HMDA lenders to identify subprime lenders in Baltimore City. HUD also identified lenders that specialize in subprime lending but either do not report to HMDA or were not identified earlier by HUD.
[67] HUD's analysis was based on 1,251 petitions. The original file consisted of 1,889 cases. HUD excluded 14 foreclosure petitions from 1999, 51 that had missing petition dates, and 274 that had dates after March 31, 2000 -- leaving 1,550 foreclosure petitions. From these HUD excluded: 112 foreclosure petitions that had origination dates before 1990, 46 petitions in which the lender was missing, 65 petitions in which the lender was reported as the seller

- Subprime loans account for 50 percent of foreclosure petitions in low-income Baltimore City neighborhoods, compared with 33 percent of the mortgage originations.
- Subprime loans account for 57 percent of foreclosures in predominantly black neighborhoods, compared with 42 percent of mortgage originations in predominantly black Baltimore City neighborhoods.
- Subprime loans result in foreclosure during a shorter period of time after origination than prime and FHA loans. The mean lag between the origination date and the date that the foreclosure petition was filed is 1.8 years for subprime loans compared to 3.2 years for FHA and prime loans. Subprime loans originated in 1999 account for a substantial minority (28 percent) of all subprime foreclosure petitions.

As the above data show, as subprime lending has increased in many communities, so have foreclosure rates. In some cases, the shares of foreclosures in the subprime market exceeded the subprime share of originations. While a higher share of foreclosures in the subprime market should be expected given the higher risk characteristics of these loans, foreclosures can have a devastating impact on families, contribute to the deterioration of many communities, and be costly for lenders. For individual families, foreclosure results in the loss of the home, a family's most valuable asset. For communities, foreclosed homes frequently remain vacant for prolonged period of time, during which they may be poorly maintained. Foreclosed homes are often a primary source of neighborhood instability in terms of depressed property values and increased crime.

E. Concluding Observations

The characteristics of subprime lending – the higher rates and fees associated with such lending, and the population served by subprime lenders – suggest the positive and negative aspects of the subprime market. On the one hand, subprime lending is an important element of our financial system because it delivers credit to those that may otherwise be unable to obtain credit. On the other hand, it appears more susceptible to abusive lending practices than is the prime market. A subprime borrower may have few financial options available or less information on loan terms and conditions and less opportunity to shop for the best terms and conditions available.

For some borrowers, the subprime market is an opportunity to overcome past credit difficulties and obtain new credit. This opportunity carries with it the necessities of managing one's finances carefully, learning the options, terms and conditions available and considering one's capacity to repay

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of the property or a realty company, and 76 petitions that either did not have geocode information or were not located in Baltimore City. FHA loans accounted for 17 percent of the petitions excluded from the analysis.

[68] The subprime share reported for 1998 may be the most useful share when comparing the subprime share of foreclosures with the subprime share of originations since 61 percent of subprime foreclosures in Baltimore City were for subprime loans originated since 1998. The subprime share of the market is derived from purchase and refinance loans that are reported to HMDA since the foreclosure data includes purchase and refinance loans. As noted earlier, the subprime origination shares reported in this section for home purchase and refinance loans in Baltimore City differ from the subprime share of purchase and refinance loans in the Baltimore metropolitan area.

the loan. As in any credit market, subprime borrowers should exercise caution and judgment in selecting a lender, and should shop multiple lenders if possible to obtain the best deal available. Of course, lenders have a corresponding responsibility to ensure that their practices do not subvert a borrower's ability to exercise these judgements.

This chapter also illustrates two important obstacles in developing remedies for abusive practices in the subprime mortgage market: the lack of clear definitions and the constant change taking place in the mortgage market. For example, automated underwriting may lead to more finely-tuned risk-based pricing in both the prime and subprime market. Consequently, there may no longer be a single class of prime borrowers but multiple classes defined by a complex mix of borrower credit scores and other factors. As technology permits lenders to define risk along a continuum, rather than at a few discrete points, pricing and loan terms may become more tailored to the circumstances surrounding each individual loan. Market competition by larger numbers of reputable lenders will be key to assuring these developments work to benefit consumers. Enhancing competition is also an essential element of effort to drive predatory lending practices from the mortgage market.

Chapter V.   Current Legal Context

The following section summarizes the status of existing laws designed to protect consumers from abusive practices in mortgage lending.

A. Home Ownership and Equity Protection Act (HOEPA)

The Home Ownership and Equity Protection Act (HOEPA), enacted as part of the Riegle Community Development and Regulatory Improvement Act of 1994, amended TILA to provide consumers enhanced protections for certain high-cost home loans. The origin of HOEPA was a concern about "reverse redlining", the targeting of residents of disadvantaged areas for credit on unfair terms. HOEPA does not prohibit loans with high interest rates or fees or cap rates or fees. Instead, it subjects certain loans, the rates or fees for which exceed specified rates or fees (HOEPA loans) to enhanced disclosures, restrictions on certain contract terms, and private and administrative consumer remedies for violations of the act.

<u>HOEPA loans</u>. HOEPA covers closed-end loans made to refinance existing mortgages and closed-end home equity loans that charge either (i) an annual percentage rate (APR) of more than 10 percentage points above the yield on Treasury securities of comparable maturities (although the FRB may adjust this trigger down to eight percent or up to 12 percent), or (ii) points and fees (including compensation to mortgage brokers, but excluding certain *bona fide* third party fees) that exceed the greater of 8 percent of the loan amount or $400 (adjusted for inflation – for calendar year 2000, $451). HOEPA excludes from its coverage purchase money mortgages (i.e., loans to purchase or construct a residence), open-end credit, and reverse mortgages. HOEPA's restrictions apply to any creditor that originates two or more HOEPA loans, or one or more such loans through a mortgage broker, in any 12-month period.

<u>Disclosures</u>. HOEPA loans require certain disclosures in addition to those required by TILA. These disclosures, moreover, must be in conspicuous type size and given to the consumer at least three days before the closing. The lender must disclose that the consumer is not required to complete the agreement even though an application has been signed, and that the transaction creates a mortgage on the consumer's home that could result in the consumer's losing the home and any equity in the home if the loan is not paid. The lender must also disclose the APR and amount of the regular monthly payment (including any balloon payment), and, in the case of a variable rate loan, that the monthly payment may increase and the maximum monthly payment that is possible under the maximum interest rate allowed by the loan agreement.

<u>Restricted terms</u>. HOEPA also constrains the use of certain provisions in HOEPA loans. A HOEPA loan may be subject to a prepayment penalty only if (i) at the time the loan is consummated, the consumer's total monthly debt payments are not greater than 50 percent of the consumer's monthly gross income and there is appropriate verification of the consumer's income and expenses; (ii) the prepayment is not made with funds borrowed through a refinancing from the same creditor or an affiliate; (iii) the penalty does not apply more than five years after the mortgage was consummated; and

(iv) the penalty is not prohibited by any other law. A HOEPA loan may not: have, after default, a rate of interest higher than the rate before default; in most circumstances, require a balloon payment on a loan with a term less than five years; contain terms creating negative amortization; or require prepayment at closing of more than two periodic payments. A lender may not engage in a pattern or practice of extending HOEPA loans based on the home without regard to the consumer's ability to repay from other sources (e.g., income) – a provision that has been interpreted by the Federal Reserve Board ("the Board") to forbid a pattern or practice of lending to consumers unable to repay from sources other than home equity. In addition, where a home improvement contract is involved, the creditor may not pay the contractor directly but must use a check payable jointly to the consumer and the contractor or, at the consumer's election, make payment through an escrow agent pursuant to certain requirements.

Rulemaking Authority. HOEPA gives the Board broad regulatory authority with regard to HOEPA loans. It grants the Board authority to expand or contract HOEPA's coverage by adjusting the APR trigger (now at 10 percentage points above comparable Treasury securities) between eight percent and 12 percentage points and including in the points-and-fees trigger. additional charges not specified in the statute In addition, the act requires the Board to prohibit acts or practices in connection with mortgage loans that it finds to be unfair, deceptive, or designed to evade HOEPA's provisions, and acts or practices in connection with refinancing of mortgage loans that it finds to be associated with abusive lending practices or not otherwise in the interest of the borrower. This authority to regulate unfair, deceptive, and abusive practices extends to all consumer mortgage loans, not just those covered by HOEPA.

Liability and Enforcement. In case of a violation of HOEPA, a borrower has available the same remedies available under TILA (see part B., below) and, in addition to those remedies, a borrower may also recover an amount equal to the sum of all finance charges and fees paid by the consumer, unless the creditor can show that the failure to comply is not material. (This amount may also be recovered for consumers by the Federal Trade Commission.) HOEPA preserves a borrower's claims and defenses against a purchaser or assignee of a HOEPA loan that violates HOEPA, unless the purchaser or assignee can demonstrate that a reasonable person could not have determined the mortgage was subject to HOEPA. The administrative and judicial remedies available to federal agencies against lenders that violate TILA are also available against lenders that violate HOEPA. In addition, state attorneys general are authorized to enforce violations of HOEPA in federal or state court.

B. Truth in Lending Act (TILA)

The Truth in Lending Act (TILA) was enacted to provide consumers with meaningful information about credit transactions. TILA requires creditors to disclose to consumers for closed-end credit loans, inter alia, (1) the finance charge, (2) the Annual Percentage Rate (APR), (3) the amount financed, and (4) the total of all payments. The finance charge is the cost of credit disclosed to the consumer as a total dollar amount, including the interest for the loan and other costs of the loan such as origination fees, discount points, and private mortgage insurance (PMI). The APR for closed-end credit is the finance charge expressed as an annualized percentage rate. Before TILA was enacted, creditors could advertise the same interest rate but calculate it by different means. The APR is designed to provide a benchmark figure for consumers to consider the real costs of credit for a loan and to facilitate comparison shopping for credit. Assuming the existence of additional costs of a loan beyond the interest charged, the APR will be greater than the interest rate on the loan.

TILA, which applies, *inter alia*, to all transactions that involve a mortgage on a consumer's personal residence, requires uniform disclosure of credit terms, including an annual percentage rate (APR). The act grants consumers a right to rescind certain mortgages within three days of the later of (1) closing, (2) the provision of accurate material disclosures, or (3) the giving of notice of the right to rescind. Regulatory agencies can obtain certain administrative and (in the case of the Federal Trade Commission) judicial remedies for TILA violations. An individual plaintiff may recover actual damages; statutory damages in the amount of twice the finance charge, although this remedy cannot be greater than $2000 or less than $200; and costs and reasonable attorneys fees.

C. Real Estate Settlement Procedures Act (RESPA)

RESPA requires the disclosure of settlement costs to consumers for federally-related mortgage loans at the time or soon after a borrower applies for a loan and again at the time of real estate settlement. Section 8 of RESPA prohibits payments by settlement service providers for the referral of settlement service business and unearned fees and splits of fees for such services. In enacting RESPA, Congress intended to curb abuses that lead to increased settlement costs. RESPA also limits amounts held in borrowers' escrow accounts and requires notices to borrowers of affiliated businesses and transfers of mortgage servicing.

RESPA currently requires creditors (or mortgage brokers) within three days of loan application to provide all applicants for "federally related mortgage loans" with an estimate (the "Good Faith Estimate" or GFE) of the amount or the range of charges for specific settlement services in mortgage transactions. These charges include creditor-imposed fees, such as loan origination fees; charges by third parties, such as appraisal or title insurance fees; and amounts the consumer is required to put into an escrow account for items such as property taxes or insurance.

The GFE allows consumers to understand how the total amount of closing costs will be allocated. It also provides an opportunity for consumers to shop for some of the services (for example, the services of a settlement agent or title insurer). At or before settlement, consumers receive a second RESPA disclosure -- the uniform settlement statement (the HUD-1) -- that enumerates the final costs associated with both the loan and, if applicable, the purchase transaction.

HUD has interpreted RESPA to require that the charges disclosed on the GFE must bear a reasonable relationship to the actual charges. The figures disclosed on the GFE, however, need not be firm or guaranteed. Moreover, RESPA does not impose liability on a creditor for an inaccurate or incomplete estimate, or for failing to provide one.

Section 8(a) of RESPA prohibits kickbacks and referral fees. Section 8(b) prohibits unearned fees. These provisions have provided a legal basis for addressing certain abusive and predatory practices under the RESPA statute. (Section 8(c) permits bona fide compensation for goods and facilities actually provided and services performed.)

The statute provides criminal penalties for violation of Section 8, private rights of action for damages and limited injunctive relief. However, the statutes of limitations are short. The disclosure provisions of the statute concerning settlement costs do not include sanctions for violations.

Chapter VI. Recommendations for Reform

Testimony from consumer advocates, the industry and borrowers at the HUD-Treasury Task Force forums demonstrated that an unfortunate combination of circumstances often drives consumers into abusive loans. The testimony and our research suggest that predatory lending stems from problems in four major areas:

1. Inadequate consumer literacy and disclosure – Many victims of abusive lending practices are not informed of the basics of mortgage credit, how to shop among lenders, and how best to finance household debt. While lack of knowledge is one important part of this problem, complicated and uneven disclosures of loan costs and terms can further confuse even the most knowledgeable borrowers in the market.

2. Harmful sales practices – Unscrupulous actors in the lending market, including lenders, brokers, contractors and appraisers, engage in abusive sales practices that harm consumers, but that may not be prohibited under current law. Examples of these practices may include loan "flipping," lending to borrowers without regard to their ability to repay, and incomplete reporting of borrower payment history to the credit bureaus.

3. Abusive or deceptive terms and conditions – Certain terms and conditions of some loans sold in the subprime marketplace are so burdensome to borrowers as to be injurious in all cases. Other terms and conditions may become abusive when they are combined with other practices or high costs.

4. Imperfect market structure – Borrowers who fall victim to predatory lenders often live in neighborhoods where competition among lenders is inadequate. Other borrowers in the subprime market might be able to qualify for prime loans, but are unaware of or lack access to the mainstream financial sector. Furthermore, our knowledge of the prime and subprime lending markets is currently inhibited by a lack of data on these markets.

HUD and Treasury believe that problems in these four areas call for the following types of actions through legislation, regulation and other initiatives:

1. Increasing the transparency of mortgage transactions, while mounting new efforts to educate borrowers, can compensate for the information asymmetries that may disadvantage less informed borrowers.

2. Strengthening enforcement of existing law and prohibiting certain practices that injure consumers can help to curb the deceptive, fraudulent and abusive practices that lead borrowers into taking these loans.

3. Identifying and restricting certain terms and conditions that are associated with many of the more abusive transactions in this market can reduce opportunities for predatory lenders to exploit some borrowers' lack of knowledge.

4. Expanding borrowers' access to the prime market, increasing information about the mortgage market and enforcing private market discipline to curb abusive practices can help to correct for the market failures that allow predatory lending to persist.

The following section discusses a variety of specific problems in each of the four problem areas described above. For each of these problems, this section:

- Offers background on the practice/term/product, including data and other evidence that informed HUD's and Treasury's recommendations in that area;
- Discusses the policy problem, why it should be addressed and challenges for reform; and
- Provides HUD's and Treasury's recommendations for addressing the problem.

A. Consumer Literacy and Disclosure

1. Need for Greater Financial Literacy

Background

The testimony at the Task Force forums suggests that consumer education is a necessary strategy for reducing predatory lending. Many victims of predatory lending lack information on the basics of finance or how to shop for loans and evaluate the often complex terms and conditions associated with most lending. Consumers are often not aware of the abusive terms and conditions of predatory loans. The terms and conditions of these loans suggest that if borrowers better understood these transactions, they would not enter into them. Thus, efforts to extend consumer education and improve the financial literacy of consumers are important strategies for reducing predatory lending.

Since the abuses identified by the Task Force tend to occur in the subprime market, one effective way to stem these abuses might involve helping more borrowers to retain or to obtain good credit ratings so that they could find loans in the prime market. Additionally, because up to three-quarters subprime loans used for debt consolidation or "cash-out" refinancing, it is appropriate to consider how borrowers could avoid needing these loans in the first place. Both of these approaches involve educating consumers more broadly about credit, and empowering them to have better credit options and to make better choices in the market.

What is the Problem?

There is mounting evidence that consumers could benefit from increased information about credit markets, managing credit and the benefits of maintaining good credit:

- Studies indicate many subprime borrowers tend to be unfamiliar with financial concepts and not well-informed about the mortgage origination process. In one survey, 12 percent of subprime borrowers said they were not familiar with basic financial terms such as the interest rate and the principal of the loan.[69] One-third of subprime borrowers said they were not familiar with the types of mortgage products available.

- Evidence from the 1998 Survey of Consumer Finances indicates that family debt burdens are rising, especially in the home-secured consumer debt market. The proportion of families with home-secured debt rose more quickly between 1995 and 1998 than the homeownership rate. Additionally, the median home-secured debt held by families with such debt rose more quickly during this period than home prices. Rising debt burdens may put families at greater risk of default or bankruptcy.

- The same survey showed declines in the median value of financial assets for lower-income families and non-homeowners between 1995 and 1998. Borrowers with lower levels of savings can be charged higher prices or be shut off from credit in the prime market if their down payments leave them with too high a loan-to-value ratio. Saving to build assets should be a key component of any family's long-term financial plan.

Educating and empowering consumers in the credit market can reduce the demand for loans with potentially abusive terms, and should be a component of any strategy to curb predatory lending practices.

Policy Recommendations

a) **Create a consumer credit task force at the National Partners for Financial Empowerment** – Treasury recently announced the formation of the National Partners for Financial Empowerment (NPFE), a consortium of government agencies, financial services providers, and consumer and community organizations dedicated to improving financial literacy efforts in the US. Treasury and HUD, both members of the NPFE, will work with their partners to develop a special focus on enhanced curricula around consumer and mortgage credit, including anti-predatory lending education.

b) **Support local consumer education initiatives regarding mortgage lending** – Programs to assist community and faith based organizations that provide training to consumers in credit management deserve increased attention from the federal government. In addition to helping borrowers to maintain better credit over the long term, new consumer awareness initiatives may help credit-impaired borrowers to avoid abusive lending practices in the short term. For instance, the city of Boston is promoting a "Don't Borrow Trouble" message in TV and print media. A similar national campaign could also deliver the message to less creditworthy borrowers that consolidating credit card debt by borrowing against their home equity puts their homes at risk in the event of default.

[69] Howard Lax, Michael Manti, Paul Raca, and Peter Zorn, "Subprime Lending: An Investigation of Economic Efficiency" (unpublished paper), February 25, 2000.

2. Need for Housing Counseling

Background

Understanding the terms of a home loan – and taking the time to seek the best available loan – are basic steps that borrowers must take to avoid being victimized by unscrupulous market players. Because home loans represent the largest transactions that most families will ever undertake, and because they put at risk families' ownership of their homes, informed consumer behavior in the home mortgage market takes on even greater importance.

For even the most knowledgeable borrowers, the process of obtaining a home loan can be an intimidating one, filled with confusing terminology and complex tradeoffs between loan features. The task may be even more challenging for borrowers in the subprime market. People shopping for a loan in the subprime marketare more likely to have experienced problems understanding credit in the past, or they may have little to no experience with credit at all. Additionally, as detailed in Chapter IV, borrowers in the subprime market have less formal education on average than borrowers in the prime market.

The gap in borrower financial literacy and the need for increased counseling are supported by evidence that there may be a substantial number of borrowers in the subprime mortgage market that may qualify them for a prime mortgage loan. While some of these borrowers may face inadequate lender competition in their communities, others may not know that they could qualify for lower-cost credit.

What is the Problem?

Testimony at the regional forums from borrowers who received abusive loans revealed that, in almost every case, the borrower did not understand all the terms of the loan. This was often due in part to the misleading and aggressive tactics of the individuals who sold them the loans, who in many cases discouraged the borrowers from reading the relevant forms. Evidence indicates that in some low-income and predominantly minority neighborhoods, unscrupulous contractors and mortgage brokers go from door-to-door to find borrowers who need credit, selling them loans at exorbitant and/or unaffordable rates. At the same time, borrowers' lack of knowledge also highlighted a need for greater access to education about how to shop for a loan, and guidance as to what loan terms and conditions may/may not be to their advantage. Such education could help borrowers to identify and avoid predatory lending practices, and to find credit on better terms.

One option for educating consumers is to make pre-transaction counseling available. Consumers who obtain pre-transaction counseling may be less likely to enter into mortgage loans that they cannot afford. Current federal law requires pre-loan counseling for reverse mortgages provided under HUD's Home Equity Conversion Mortgage (HECM) program, due in part to the complex nature of these mortgages and the financial implications of the transaction.[70] In other situations, such as default on an FHA loan,

[70] 12 U.S.C. § 1715z-20(f).

lenders are required to provide borrowers with information about the availability of approved counselors, but borrowers are not required to seek counseling.

Pre-transaction counseling might be especially beneficial for high-cost loan borrowers. It would educate credit-impaired borrowers about home mortgage credit. It would also provide counselors an opportunity to review the terms of applicants' potential loans, and advise borrowers whether they have the financial capacity to enter into the loans (and whether the loans contain potentially abusive terms). Knowing that a borrower would seek counseling might deter less scrupulous creditors from attempting to entice the borrower into a loan that might not be to his/her benefit.

Challenges for Reform

The primary challenge to delivering pre-transaction counseling to high-cost loan borrowers is the additional cost of such services. If the government assumes the cost of funding counseling, through expanded HUD grants, that funding should be targeted toward the borrowers who need those services most. It may be reasonable to target counseling at those borrowers converting lower cost FHA or other subsidized loans to subprime loans, those entering into non-FHA reverse mortgages or balloon loans and those whose particular debt to income ratio demonstrates the possibility that income may be insufficient to meet a loan's demands. In addition, further inquiry should identify other ways to finance the costs of valuable counseling. While not all undereducated borrowers have high-cost loans, as a starting place, it is reasonable to target counseling resources at the most credit-impaired individuals borrowing against their home equity.

An expanded role for pre-transaction borrower counseling would require adequate resources dedicated to the effort. The existing base of affordable counseling available to borrowers is small. Through its Housing Counseling Assistance program, HUD will be able to provide counseling to 250,000 families in 2000 with the $15 million in funding dedicated to this program. Those benefiting from this counseling are by and large FHA homebuyers.

As explained later in this section, HUD and Treasury are recommending that HOEPA triggers be lowered to give protections to more borrowers of high-cost mortgages. Assuming that up to 20 percent of the subprime mortgage market could be covered under the lowered triggers, as many as 500,000 mortgage loans per year might qualify as high-cost.[71] While not all of these borrowers may need counseling, providing free counseling services to even a fraction of these borrowers would require that new resources be dedicated to the effort – for certifying counseling providers, and for hiring, training and retaining qualified counselors.

A corollary challenge is certifying the federal or state level that the entities providing the counseling are qualified to do so, and are following guidelines for providing the best possible homebuyer counseling.

Policy Recommendations

[71] Based on 1999 estimate of $160 billion in subprime mortgage originations and average loan size of $60,000 (source: Inside B&C Lending), and estimate that lowered APR trigger could cover 20 percent of subprime mortgage loans. See Section VI.C.1.

a) **Congress should require creditors to recommend certified home counseling to high-cost loan applicants–** Individuals who may become borrowers of the highest-cost loans may be most in need of pre-closing home counseling. Their credit may be more damaged, the implications of their taking the loan may be more significant, and they may be more at risk of having been exposed to abusive lending practices. Treasury and HUD believe that creditors should be required to give all HOEPA loan applicants a list of approved home counselors pre-closing, and to recommend that the borrower seek their services. Counselors must be certified by HUD, or its designees, USDA, Neighborhood Reinvestment Corporation or the appropriate state housing/financial regulators.

b) **Congress should fund the provision of additional HUD-certified home mortgage counseling** – The President's FY 2001 budget includes $24 million, a $9 million increase over funding for FY 2000, for the Housing Counseling Assistance program. This program provides comprehensive housing counseling services to homeowners, including pre-purchase and default counseling. In order to reach more borrowers who may be vulnerable to predatory mortgage lending practices, Congress should fully fund the President's FY2001 budget request in this area. Home counseling can play an important role in helping more borrowers to overcome the lack of information and bargaining power they may face in the higher-cost loan market.

c) **HUD will study ways to improve the counseling process.** HUD will study ways to maximize the effectiveness and use of counseling as a means for discouraging borrowers from taking on predatory loans.

3. Improving Disclosures and Remedies

a. RESPA/TILA Reform

1) Improving Disclosures

Background

As discussed above, RESPA and TILA seek to ensure, respectively, that consumers obtain timely and standardized information about the cost of real estate settlement services and the cost of credit. RESPA requires that within three days after applying for a mortgage loan, an applicant receive a HUD Special Information Booklet containing information to help him/her understand the nature and costs of settlement services and a Good Faith Estimate (GFE) of settlement costs specific to the borrower's loan application. (At this time the consumer also receives a RESPA initial transfer of servicing disclosure describing whether or not the loan's servicing may be transferred. The consumer also receives the TILA cost disclosure containing the APR and related information (home purchase only).

At settlement, or one day prior to settlement upon request, consumers receive another RESPA disclosure – the uniform settlement statement (the HUD-1) – that itemizes the final costs associated with both the loan and, if applicable, the purchase transaction. (If an escrow account has been established in connection with the loan, under RESPA, the consumer receives an initial escrow account statement at closing or within 45 days after settlement.)

At or before consummation,[72] the consumer must receive a TILA disclosure. In the case of a refinancing or home equity loan, the consumer must receive the TILA disclosure for the first time at or just before closing. For certain home equity loans and refinancings, the consumer must also receive a notice of the right to rescind under TILA.

TILA requires disclosure, *inter alia*, of the Annual Percentage Rate (APR) and the finance charge on mortgage loans. Consumers must receive such a disclosure at least once before becoming obligated on a closed end loan. The finance charge is the cost of credit, disclosed to the consumer as a total dollar amount which includes, *inter alia*, the interest for the loan and other costs of the loan such as the origination fees, discount points and private mortgage insurance (PMI).

The APR for closed end credit is the finance charge, expressed and disclosed as an annualized percentage rate that equates mathematically the stream of payments made over the life of the loan to its present value (the amount financed). The APR is intended to provide a benchmark figure to enable the consumer to consider the real costs of credit and to compare loans before entering into a financial transaction.

What is the Problem?

Consumers are confronted with numerous disclosures during the real estate settlement process from the time of application to settlement. The Federal disclosures under RESPA and TILA comprise only 3-5 forms out of what can involve up to 50 documents, most required by the lender or possibly state law disclosures. The HUD/Fed Report recommended that the RESPA/TILA disclosure scheme be improved so that the information on these disclosures is simpler, more reliable and more timely to facilitate shopping by consumers, competition and lower settlement costs.

HUD has interpreted RESPA to require that the GFE cost disclosures bear a reasonable relationship to the actual charges at settlement. However, RESPA does not impose liability for an inaccurate or incomplete GFE, or even for failing to provide one. Thus, there are few incentives for creditors to incur costs to ensure compliance or increase accuracy. In some transactions, unexpected closing charges result from unanticipated events or circumstances. In other cases, however, actual charges are higher either because the estimates were prepared with insufficient regard for their accuracy, or were purposely understated. Many borrowers with high-cost loans that have been characterized as abusive have complained that final disclosures of settlement charges differed substantially from the charges originally described and disclosed on the GFE.

[72] TILA uses the term "consummation" (closing), while RESPA uses the word "settlement" for this report the terms are used interchangeably. Consummation (or closing) and settlement ordinarily occur simultaneously.

Reliability of Settlement Cost Disclosures

In order to make settlement cost disclosures more reliable and more useful to consumers, the HUD/Fed report recommended that creditors and others be given a choice between guaranteeing settlement costs and providing estimated closing costs that are accurate within a prescribed tolerance as follows:

Guaranteed Settlement Costs

One means of ensuring that consumers receive an accurate disclosure of loan closing costs is for creditors to guarantee them. The guaranteed-cost option has been advocated by various segments of the mortgage industry, including many of the nation's largest creditors. According to these creditors, consumers do not shop for individual settlement services. These creditors say that consumers are more interested in the overall price of settlement and that consumers would shop if all they needed to compare was a single guaranteed price for required settlement services. To arrive at a price, these creditors envision entering into volume-based contracts with affiliated and other settlement service providers for such services as appraisals, and "packaging" all the services needed for the loan. They believe that by doing so they will be able to secure discounts that could ultimately be passed on to consumers. Packaging services will keep costs down more effectively than RESPA's anti-kickback provisions, they say, because it will better enable consumers to comparison shop and will encourage creditors and others to package competitively and to pass along discounts. To facilitate guaranteed costs, fees paid and arrangements entered into by creditors and other settlement service providers could be exempt from Section 8 of RESPA so long as certain conditions were met. Those not meeting the conditions would remain subject to Section 8.

Guaranteed costs would capture all charges for creditor-performed services, such as application, underwriting, and origination. They would also include third-party fees for such items as surveys, appraisals, credit reports, and mortgage broker services. Official fees associated with filing or recording a mortgage or release which can be determined easily would be included. To ease compliance for creditors, charges included in the guaranteed costs could generally track TILA's definition of finance charges.

As with the finance charge, disclosed under TILA, not all fees would be captured in the guaranteed costs. For example, the cost of hazard insurance would not be included because the cost depends upon consumers' choices unrelated to the credit transaction (such as the purchase of additional personal property or liability coverage). Charges assessed in a comparable cash transaction, such as taxes, also would be excluded from the guaranteed amount (although they would continue to be disclosed as "other costs"). (Alternatively, HUD suggested in the Report that some costs excluded from TILA's finance charge such as for recording a deed could be included in the guaranteed amounts.) Some costs like per diem interest, which fit within the definition of finance charge, could be excluded from guaranteed costs because they are dependent on the borrowers' choice of settlement. These amounts as well as optional costs would, however, be separately disclosed.

RESPA Section 8 Relief

Under the guaranteed cost approach, HUD and the Board recommended that an exemption from RESPA Section 8 be offered to creditors who provide a package of settlement services at a guaranteed price. To carry out this purpose, HUD specifically recommended that an exemption from Section 8 should be made available to creditors and others that meet appropriate conditions including:

- Offering consumers a comprehensive package of the settlement services needed to close a loan;
- Providing consumers with a simple prescribed disclosure that gives the guaranteed maximum price for the package of services through closing; and
- Disclosing the rate and points offered to the consumer for the loan with the guarantee that rates and points would not increase subject to prescribed conditions (e.g., market changes in rates).

GFE Tolerance

A second way to provide consumers with more reliable information is to impose an accuracy standard on the GFE and establish remedies for noncompliance. The tolerance could be based on a percentage of the total estimated closing costs. If the actual costs exceed the sum of the estimated costs and the amount of the tolerance, the creditor would be held liable. Alternatively, the tolerance could be limited to certain categories of costs, for example, costs not within the creditor's control; charges imposed directly by the creditor would have to be accurate.

In either case, an increase in costs resulting from a consumer's choice would not count against the creditor in determining whether the total closing costs exceeded the tolerance. Neither would increased costs associated with specified changes to the transaction, such as an increase in the loan amount. But increased charges resulting from a creditor's decision (for example, to require a pest inspection after reviewing the appraisal) could not exceed the tolerance.

Adopting an accuracy standard for GFE disclosures would require little or no change to the current GFE form. The GFE would retain the item-by-item listing of those charges that consumers are expected to incur in connection with closing. Because the closing costs would not be guaranteed, there would be no relief from Section 8 liability.

Timing of Settlement Cost Disclosures

The generic disclosure, the special information booklet, is given at the time of loan application only for home purchase transactions. It may be more valuable to the consumer if it is given or offered earlier such as when the consumer first contacts a creditor, realtor or other settlement service provider. Additional booklets for other types of transactions would also be useful. A more significant problem is the timing of the specific cost disclosures. Currently, consumers receive the GFE within 3 days after application after they have paid an application fee and are committed to a loan provider.

HUD stated in the HUD/Fed Report that consumers need firm information early in the loan process so that they can compare the products of one settlement service provider with another. If consumers receive firm information but it comes too late in the loan process, they will not have the opportunity to shop. Moreover, if the information is available but the consumer must pay a significant fee to obtain it, consumers may be disinclined to seek comparable information from multiple sources.

To determine the interest rate and points of the loan, the creditor generally must evaluate the consumer's creditworthiness. To determine the other costs to close the loan, the creditor must ascertain what services are needed and their price. Advances in technology make these determinations easier.

For the guaranteed cost approach, HUD encourages approaches where consumers arrange for credit information to be made available to creditors to enable them to make a guaranteed offer of interest rate, points, and closing costs early in the shopping process. While earlier disclosures are needed, in some cases (because of the consumer's credit or employment circumstances) there will be an inevitable "trade-off" between providing an early disclosure and providing a disclosure that is firm and complete enough to allow the consumer to shop and to protect against any later increase in cost. For such cases, timing requirements should be flexible enough to allow time to provide guaranteed information.

In the report HUD said consumers should be provided initial disclosures under the estimated cost approach as early as possible, as early as technology will permit.

Timing for subsequent settlement cost disclosures also could be improved. Currently, the consumer may have only one day before closing to review the settlement statement and discuss with the creditor any changes to the terms of the transaction. Material changes to the settlement charges may also not be readily apparent to the consumer. Additionally, consumers may not know that they have the right to the settlement information, since it need not be provided except at the consumer's request.

The APR

The APR was designed to provide consumers a uniform benchmark figure for credit costs, enabling them to compare the costs of different loans using one variable. While a single figure is easy to use, as presently designed, the APR excludes certain costs and does not therefore fully reflect the cost of credit. Congress has excluded, for example, title insurance, appraisal and document preparation fees. The Board has excluded application fees. Even if the APR included all costs, it would have limitations. For example, the APR is not designed to assist consumers in determining whether they should pay points up-front or bear the credit costs over the life of the loan, and it does not provide information on the financial impact of the amount of the monthly payment or down payment. In measuring the cost of any particular loan, the APR does not account for an early payoff.

Challenges for Reform

A better disclosure scheme could be useful to prime borrowers and many subprime borrowers as well. Improved cost disclosures of the type envisioned by HUD and the Board, including an improved APR, would simply and more reliably explain the costs of the loan. However, better disclosures alone will not be sufficient to curb abusive and predatory lending. Disclosure of costs does not, by itself, prevent unfair terms and other abuses. In fact, in many of the situations the Task Force studied, lenders and other participants in the loan origination process sought to ensure that the required written disclosures were provided to borrowers and maintained in the loan files. Nevertheless, the borrowers testified that they often did not understand, and were unpleasantly surprised by, the costs or terms of their loans. The fact is that written disclosure requirements, without other protections, can have the unintended effect of insulating predatory lenders where fraud or deception may have occurred. Moreover, merely simplifying disclosures to those consumers unlikely or unable to shop for a loan (i.e., those borrowers who are older, infirm, less informed, or who, in fact, have fewer credit options available to them) cannot be expected to protect them from abuse.

Borrowers, particularly those in the subprime and high-cost mortgage market, could benefit from earlier, simpler, and more reliable disclosures. While such disclosures will not, in themselves, prevent abusive lending practices, in combination with the other recommendations in this report, improved disclosures could increase consumer awareness and enable borrowers to protect themselves with regard to one of the most important financial transactions they are likely to undertake. Improvements to and greater understanding of the APR could make it a more useful tool for consumers.

Policy Recommendations

a) **Simplify and improve the RESPA disclosure scheme as recommended by HUD and the Board provided that sufficient substantive protections against abusive lending practices are adopted** – HUD and Treasury support the recommendations in the HUD/Fed Report for statutory reforms to the Real Estate Settlement Procedures Act and the Truth in Lending Act to make information provided to consumers more reliable, more timely and more helpful in comparison shopping for all services required to finance a home. These recommendations must be considered as part of a broader package to provide additional consumer protections against abusive lending practices. More specific recommendations with respect to RESPA disclosures follow.

b) **Require Creditors to Guarantee the Closing Costs or Provide Firmer Good Faith Estimates**. The HUD/Fed Report recommended that creditors and others be given a choice between guaranteeing closing costs and providing estimated closing costs that are accurate within a prescribed tolerance Treasury and HUD recommend that in the context of a comprehensive package of reforms addressing abusive lending, the Report's recommendations that an exemption from Section 8 be granted to any entities offering a package of settlement services at a guaranteed price should be implemented. Consistent with HUD's recommendation, the exemption should be available to entities that offer consumers a comprehensive package of the settlement services needed to close a loan; provide consumers with a simple prescribed disclosure that gives the maximum price for the package through closing; and disclose the rate and points offered to the consumer for the loan, together with a guarantee that the rates and points will not increase, subject to prescribed conditions. If consumers are required to pay a significant up-front fee to the creditor in order to obtain firm information, it serves as a deterrent to shopping.

c) **Improve Timing for Generic Disclosures -** The Settlement Booklet could as easily be provided at application or given or offered earlier, such as when the consumer first contacts a creditor, realtor, or other settlement service provider. Either change would simplify the disclosure scheme for creditors and would improve it by providing educational material to consumers earlier.

d) **Improve Timing of Initial Disclosures Under the Guaranteed Cost Approach and the Estimated Cost Approach**. HUD and the Board recommended that consumers be given initial disclosures as early in the shopping process as possible. Under a guaranteed cost approach, HUD stated that the initial guaranteed information about interest rate, points, and other closing costs should be given to consumers early enough so that they can shop and make informed choices--ideally at first contact with a creditor. To effectuate this, the agencies support approaches where creditors and others would have sufficient credit information to make a guaranteed offer early in the shopping process. Consumers should be provided initial disclosures under the estimated cost approach as early as possible. In the interest of promoting shopping, initial disclosures should be provided before the consumer pays any significant fees.

e) **Improve timing of subsequent disclosures at closing –** Several changes could help consumers avoid unexpected costs at closing including:

   i) **Providing the HUD-1 settlement statement earlier –** The time for providing the settlement statement could be moved from one day to three days before closing (this would track the current timeframe for providing the HOEPA disclosures). This would allow consumers to have information in time to review it before closing and make any necessary arrangements, or engage in discussions and negotiations with the creditor, if the terms of the transaction are different from what had been disclosed previously.

   ii) **Provide the HUD-1 settlement statement automatically –** The settlement statement could be provided automatically, rather than on request a day before closing, and the right to the information should be expanded to include any necessary re-disclosure of material terms such as the APR. This would eliminate any concern about consumers not knowing whether they have a right to the information.

   iii) **Require re-disclosure of charges on the HUD-1 that have changed materially –** The quality of closing cost information could be improved by encouraging that disclosures be accurate for all charges. In any instance where there is a material change from the disclosures provided three days before closing, re-disclosure at closing would be mandatory. It could be provided that a loan not be closed until the borrower has had three full days to consider the final loan disclosures.

f) **Enact essential reforms to the mortgage scheme if major reform is not enacted along the lines proposed –** Whether or not Congress chooses to enact major RESPA reform along the lines outlined in this section, an essential reform package should be enacted. This package should: (1) require dissemination of educational booklets to consumers for various types of loan transactions including refinancings and subordinate liens early in the home-buying and mortgage process; (2) combine and simplify the RESPA and TILA disclosure forms to be provided to consumers; (3)

coordinate the timing of RESPA and TILA disclosures to the greatest extent feasible; (4) require more accurate estimates of settlement costs using tolerances or similar mechanisms; (5) establish new remedies to protect consumers against nondisclosure or misdisclosure; and (6) new remedies for violations of RESPA.

g) **Require that originators disclose the borrower's credit score and index to the borrower, if requested, along with an explanation, where applicable, of the role that credit score plays in pricing the loan. Originators should be required to disclose the availability of this option to borrowers.** Mortgage originators should be required under RESPA to disclose this information to a borrower, if requested, along with an explanation that credit score is one of several factors used to price the borrower's loan, and that his/her credit score may vary depending upon the particular scoring system used by the lender.

h) **Retain and Improve the APR Disclosure Under TILA and Educate Consumers Further About its Significance** - The HUD/Fed Report recommended that that the APR be retained and improved by: (1) amending the law to require that the full costs of credit be included in the APR, (2) adding the interest rate on the note as a new disclosure, and (3) educating consumers regarding the significance of the APR. This "all in approach" would improve the APR's usefulness and at the same time lessen the compliance burden for industry. The disclosure of the note rate on the loan would facilitate consumer education and additional education could advise consumers of the APR's significance and relevant considerations for using the APR in light of an individual borrower's own circumstances.

i) **Undertake efforts to improve the entire mortgage disclosure scheme.** While simplification and streamlining of RESPA and TILA disclosures may improve the transparency of the mortgage process for borrowers, as described earlier in this section, these disclosures represent a fraction of the paperwork involved in closing a loan. HUD and Treasury will facilitate efforts by state governments and attorneys generals, the mortgage lending industry, and consumer groups to improve and simplify the information the consumer receives at or before closing.

h) Carry Out Efforts Under RESPA to Curb Lending Abuses. Absent statutory changes revising RESPA and the enactment of substantive protections against abusive lending, HUD will act to implement its existing authority under RESPA to improve the RESPA disclosure scheme to the extent feasible and will take such other enforcement and regulatory actions as are warranted to curb lending abuses.

2) Improving Remedies Under RESPA/TILA/HOEPA

Background
The remedies available under HOEPA, RESPA and TILA are described in Chapter V. above.

What is the problem?
There is concern that, as currently structured, the remedies available under RESPA, TILA and HOEPA

may be inadequate in a number of ways:

- *Insufficient Penalties and Damages Available* – The penalties that may be levied on parties who violate RESPA, TILA, or HOEPA, and the damages available under TILA and RESPA to borrowers harmed by these parties, may not be sufficient to deter unscrupulous lenders and brokers from engaging in practices that are illegal under these laws.

- *Inadequate Enforcement* – There may not be an adequate level of resources – at the federal or state level – dedicated to enforcing these laws, or to scrutinizing those market participants who may pose the greatest threat of violating them.

- *Inconsistencies and Differences Among and Within Statutes* – There are inconsistencies in the treatment of certain violations within RESPA: there are penalties for some egregious violations and not others. Additionally, there are differences between RESPA and TILA with respect to which parties and transactions are covered.

Policy Recommendations

a) **Congress should expand penalties for violations of TILA, HOEPA and RESPA, and increase damages available to borrowers harmed by such violations** – Changes to penalty and damage provisions in these statutes would enhance their deterrent effects, and allow borrowers to recover damages sufficient to compensate for their monetary losses:

   i) Increase the cap on statutory damages under TILA.

   ii) Authorize the FTC, with respect to HOEPA, and HUD, with respect to RESPA, to collect civil money penalties for violations of these statutes. Under both statutes, authorize civil penalties of at least $2,500 per violation.

   iii) Authorize a consumer who may have been harmed by a violation of RESPA to seek three times the amounts charged for any settlement service for which a violation is found. Also permit private causes of action for damages, specific performance, reasonable attorneys fees and costs, and any other relief as the court would deem just and equitable (e.g., enforcement of creditor responsibilities when tolerance level in GFE or combined GFE/TILA document is exceeded).

   iv) Add to RESPA penalties for servicers' negligent or intentional failure to make timely disbursements from escrow accounts, or to return escrow funds within a specified period of time after payoff.

   v.) Update the amount of the criminal misdemeanor penalty under Section 8 of RESPA so that it is consistent with similar consumer protection laws.

b) **Congress should provide for and encourage additional enforcement actions against creditors in violation of TILA, HOEPA and RESPA –** While federal agencies should devote increased attention to bringing actions against unscrupulous market participants, additional agencies at the state level should be given authority to enforce these statutes. The regulators should also use their examination authorities to detect and discourage predatory lending practices.

   i) Expand enforcement and injunctive authority of state agencies. Authorize state attorney generals, who have the power to enforce HOEPA, to enforce RESPA and TILA. Empower state banking commissioners and similar state agencies to enforce all three statutes.

   ii) Encourage the FTC to conduct investigations and examinations of lenders not otherwise subject to routine federal examination that originate high concentrations of high-cost loans, as determined by FTC.

   iii) Encourage Fed to conduct routine risk-based examinations of non-bank subprime lenders that are subsidiaries of bank holding companies to ensure safe and sound lending practices [see **VI.F** for further details].

   iv) Encourage state banking regulators to expand routine examinations of lenders not otherwise subject to routine federal or state examination that originate a significant number of high-cost mortgages.

c) **Congress should provide for greater consistency among statutes –** The statutes could be modified to provide more equal treatment of equal violations, and to cover similar parties and transactions:

   i) Harmonize coverage between RESPA and TILA/HOEPA regarding transactions/parties covered. Statutes should cover: transactions secured by one-to-four family residence; party to whom note is made payable. Mortgage brokers taking loan applications should be required to provide disclosures if the brokers, meet the same numerical tests (interms of numbers of loans) as other parties covered by TILA and RESPA.

   ii) Make statute of limitations period uniform, for all sections of RESPA – 3 years for private actions; 6 years for agencies – and treat each transaction as a separate violation.

B. Harmful Sales Practices

1. Targeting Minority, Female, Elderly and Low-Income Borrowers

Background

Predatory lenders often engage in "reverse redlining" – specifically targeting and aggressively soliciting homeowners in predominantly lower-income and minority communities who may lack sufficient access to mainstream sources of credit.

Predatory lenders often target people that are "house rich but cash poor," usually the elderly. Elderly homeowners are likely to have built up significant equity in their homes, the values of which may have appreciated substantially over time. Some elderly homeowners living on fixed incomes need cash for medical and other expenses, but lack an adequate understanding of the complexities of financial transactions, the usual cost of home repairs, or their own credit-worthiness. Some elderly are widows who may have little or no experience with finances prior to the death of a spouse. In addition, some elderly borrowers suffer from medical problems, diminished faculties, and isolation that impair their ability to understand loan terms and/or make them especially vulnerable to aggressive sales tactics. Frequently unable to perform household repairs, some elderly appear to be specifically targeted by predatory lenders engaged in home improvement scams. Because of these particular vulnerabilities, predatory lenders may charge these homeowners rates that do not correspond to their levels of risk, or convince them to take out loans that are larger than necessary or inappropriate for their needs.

What is the Problem?

In some low-income and minority communities, especially where competition is limited, predatory lenders may make loans with interest rates and fees significantly higher than the prevailing market rates, unrelated to the credit risk posed by the borrower. Some consumer advocates allege that these predatory lenders are engaged in "steering" – the practice of directing consumers to high rate/high cost loans based simply on their race or economic status and their lack of information, rather than based on their credit histories or credit risks.

Some targeted predatory lending may violate the fair lending laws, which prohibit discrimination on the basis of, *inter alia,* race, gender, national origin, and, in the case of the Equal Credit Opportunity Act, age. Testimony at the forums strongly indicates that many predatory lenders may have engaged in reverse redlining, or targeting abusive practices to protected groups. There is also some evidence that predatory lenders may charge different fees based on race or gender. One highly publicized case, Delta, involved allegations that African-American women were being charged more than other white borrowers with similar credit histories. The Department of Justice, HUD, and the FTC, in March 2000, entered a consent decree with Delta Funding Corporation, under the Fair Housing Act and the Equal Credit Opportunity Act, for charging higher fees to African American females than charged to similar white males. The consent decree also addressed claims that Delta had violated RESPA for allowing unreasonable broker fees on loans, and the HOEPA, for engaging in asset-based lending. United States v. Delta Funding Corporation, CV00-1872, (E.D. N.Y. March 20, 2000)

One obstacle to identifying practices of this kind is that most non-depository institutions are not subject to regular examinations for compliance with consumer or civil rights laws. However, these lenders are subject to the Fair Housing Act and other Federal civil-rights and consumer-protection statutes, that – with respect to these types of lenders – are enforced at the federal level by the Federal Trade

Commission, the Department of Justice, and HUD.

Finally, the concentration of predatory loans in low-income and minority neighborhoods also means that the effects of predatory lending, such as increased foreclosures, and vacant properties that diminish neighborhood safety and property values, are concentrated in these neighborhoods.

Challenges for Reform

Products should be priced based upon the potential borrower's individual credit and income characteristics, rather than upon the borrower's race, ethnicity, national origin, gender, age or residence in a minority neighborhood. Discriminatory pricing is already illegal under federal fair lending laws; however, these anti-discrimination cases can be complex and expensive, and as a result, are not frequently brought by individual borrowers or fair housing advocacy and civil rights groups with limited resources. Additional data and information is essential to assist the enforcement agencies in monitoring compliance with fair lending laws.

Policy Recommendations

a) **Congress should increase funding for enforcement of federal fair lending laws –** HUD's office of Fair Housing and Equal Opportunity has an established network of agencies, which it funds to conduct private fair housing enforcement and education under its Fair Housing Initiatives Program (FHIP). FHIP-funded agencies have contributed successfully to highlighting the significant problem of predatory lending in minority communities. Funds for these organizations who perform this work are extremely limited, however. In FY 1999, over 50 organizations had to share a pool of approximately $15 million. A set-aside of FHIP funds specifically to address predatory lending would help address the civil rights implications of minority neighborhoods targeted for these abusive lending practices.

b) **The Federal Reserve Board should consider using its authority under HMDA to require additional data disclosure –** Additional data would promote increased scrutiny of the kinds of loans being made, the kinds of borrowers receiving them, and any concentration of the loans in minority neighborhoods. See Section VI.D.1. The reporting of additional HMDA data elements as recommended in Section VI.D.1 would enhance the ability of HUD and other public and private fair housing groups to monitor mortgage lending to minorities and in low-income communities.

2. Loan "flipping"

Background

Loan flipping generally refers to repeated refinancing of a mortgage loan within a short period of time with little or no benefit to the borrower. Loan flipping typically occurs when borrower is unable to meet scheduled payments, or repeatedly consolidates other unsecured debts into a new, home-secured loan at the urging of a lender. Lenders who flip loans tend to charge high origination fees with each successive refinancing, and may charge these fees based on the entire amount of the new loan, not on just the incremental amount (if any) added to the loan principal through the refinancing. In addition, each refinancing may trigger prepayment penalties, which could be financed as part of the total loan amount, adding to the borrower's debt burden.

One lender may be responsible for flipping a loan multiple times, or one or more mortgage brokers may engage in flipping a borrower's loan among different lenders. There is no existing federal-law prohibition on loan flipping per se. HOEPA attempts to curb the flipping of high-cost loans by restricting the terms that may make such loans unaffordable in the first place (such as prepayment penalties, short-term balloon payments and negative amortization), and that can also add to refinancing costs.

What is the Problem?

When a loan is flipped, a borrower refinances on terms that are not economically beneficial to him or her, due to the financing of points, fees and prepayment penalties that accompany such loans. A borrower may receive modest additional funds or a slight reduction in the interest rate, but the points and fees that accompany such transactions in the end make the total transaction more costly to the consumer. For example, reducing a borrower's monthly payment by a small amount, say $30 may cost the borrower thousands of dollars in up-front costs and interest over the life of the loan. The high fees derived from flipping attract unscrupulous originators who deceive borrowers about the true cost of the loan. Borrowers who have been victimized by predatory lending in the past often find themselves victimized yet again by flipping, when they are flipped into a new loan in an attempt to avoid default. Each time the loan is flipped, more equity is lost in the home. Several witnesses at the regional forums (including Ms. H. in Baltimore – see Section II for description) had refinanced more frequently than once every two years.

Moreover, some creditors may extend credit knowing that the consumer cannot afford the scheduled monthly payments or a large balloon payment due at the end of the relatively short loan term. This practice guarantees that the loan will have to be refinanced within a short time and thereby initiates a cycle of successive refinancings that either erode the borrower's equity, or in the worst cases, simply delay inevitable default while increasing the borrower's debt.

Challenges for Reform

Proposals to address loan flipping should promote borrower options and continued access to credit through loan refinancing. For instance, blanket prohibitions on financing points and fees on a loan refinance may discourage refinancing that is beneficial to the borrower.

Policy Recommendations

a) **Congress should require a borrower to derive a tangible net benefit from short-term refinancing into a HOEPA loan –** The crux of the problem with loan flipping is that the borrower derives no economic benefit from the refinanced loan. Therefore, lenders should be prohibited from refinancing any mortgage into a HOEPA loan within 18 months of the mortgage closing unless there is a tangible net benefit to the borrower. The Board should be given the authority to define an appropriate safe harbor where a net tangible benefit is assumed. In defining the safe harbor, the

Board should consider items such as a minimum necessary decrease in APR, or limits on points and fees charged for loans where the APR does not reflect such a decrease.

b) **Congress should specify that for refinances of any loan into a HOEPA loan within 18 months, creditors are permitted to charge points and fees only on the amount of the new advance, if any –** Evidence from the regional forums demonstrated that some borrowers were charged exorbitant fees upon refinancing into a high-cost mortgage, even if the creditor was adding only a small amount of principal to the existing mortgage. Creditors should be permitted to charge points and fees only on the amount of the new advance; this will prevent creditors who charge expensive origination fees from evading HOEPA by calculating points and fees as a percentage of the entire principal.

c) **Congress should restrict modification or deferral fees on HOEPA loans –** Unscrupulous brokers and lenders might seek to evade flipping restrictions by modifying the terms, instead of refinancing a borrower's loan and charging high fees to do so. If the modified loan is a HOEPA loan, creditors should be prohibited from levying modification or deferral fees, unless the APR on the loan decreases by 1.5 percentage points.

d) **The Federal Reserve Board should consider using its authority to define loan flipping as an unfair, deceptive or abusive practice –** HOEPA expressly grants the Board broad authority to issue rules to regulate unfair, abusive, or deceptive acts or practices. The Board is *required* by HOEPA to: (1) "prohibit acts or practices in connection with mortgage loans that the Board finds to be unfair, deceptive, or designed to evade" HOEPA's provisions; and (2) "prohibit acts or practices in connection with…refinancing of mortgage loans that [it] finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower." 15 U.S.C. § 1639(l)(2).

   The Board could adopt a rule forbidding refinancings within a specified time period that are not of tangible net benefit to the borrower. The Board should require that the determination of tangible net benefit take into account specified circumstances of the loan, such as the terms of the new and the refinanced loans, the cost of the new loan, and the ability of the consumer to repay the new loan. A safe harbor under the tangible net benefit test might be constructed by considering the factors outlined in recommendation (a).[73]

[73] The HOEPA Conference Report acknowledged the testimony Congress had heard "concerning the use of refinancing as a tool to take advantage of unsophisticated borrowers. Loans were 'flipped' repeatedly, spiraling up the loan balance and generating fee income through the prepayment penalties on the original loan and fees on the new loan." Conf. Report, No. 103-652, 103d Cong., 2d sess. (Aug. 2, 1994), p. 162. Importantly, the report declared that "[s]uch practices may be appropriate matters for regulation under this subsection." *Id*.

3. Lending to Borrowers without the Ability to Repay: Asset-Based Lending

Background

A creditor's decision on whether to originate a mortgage loan should be guided by his/her assessment of the borrower's ability to repay the loan from liquid sources (e.g., income and non-housing assets). Other factors, such as the overall size of the loan, the borrower's credit history and the value of the collateral play into the decision as well. There is widespread concern, however, that some unscrupulous creditors are making loans to borrowers who clearly cannot afford to repay them.

The motivation for lending to a borrower who cannot afford to repay the loan may vary. For some unscrupulous brokers, the incentive to originate such a loan may be the potential for fees, which are levied in direct proportion to the loan's size. In some predatory lending cases, brokers may misrepresent a borrower's income on the loan documents and the lender may have inadequate controls to detect the problem. For unscrupulous lenders, the attraction may be the equity the borrower has in his/her home. Predatory lenders may dislodge long-standing residents and provide an opportunity for resale at a high profit.

HOEPA prohibits creditors from engaging in a "pattern or practice" of making high-cost mortgages to consumers based on the consumer's collateral without regard to the borrower's ability to repay (based upon the consumer's current and expected income, current obligations and employment status). This type of lending is often referred to as "asset-based lending." Although a borrower may be only seeking to forestall losing his or her home as the result of not being able to meet the monthly payments, his/her burden of proof under HOEPA is to establish that such asset-based lending constitutes a pattern or practice of the originator.

What is the Problem?

In the regional forums, HUD and Treasury heard testimony from numerous borrowers with loans that they clearly could not afford at the time of origination. In many cases, these loans were made to older borrowers living on fixed incomes, replacing low-cost, low-principal loans these borrowers had previously held. The increases in these borrowers' monthly payments caused by the new loans were clearly too much for these borrowers to afford on their fixed incomes. In some cases, the monthly payments equaled or exceeded the borrower's monthly income. Some of these loans were originated due to a combination of deceptive mortgage broker tactics (such as falsifying borrower income on the application) and lender underwriting systems that are not adequate to detect these tactics.

Lending with no reasonable expectation of repayment other than recourse to the underlying collateral is not a practice engaged in by safe and sound lenders.[74] Similarly, responsible mortgage brokers do not broker loans to borrowers where the borrower can't repay. Asset-based lending can have significant social implications, particularly in home-secured transactions. Borrowers not only risk losing their homes to foreclosure, but also their accumulated equity in their homes, a major source of wealth for many Americans. In addition, foreclosure has the potential to destabilize neighborhoods by generating vacant properties.

One potential barrier to fully addressing the problem of lending to borrowers without regard to their ability to repay is the interpretation of HOEPA's "pattern or practice" requirement. The one court to address the meaning of this requirement in the HOEPA context in a published opinion has ruled that to prove such a pattern or practice requires "an empirical analysis of a representative sample of all of the lender's loans."[75] It can be difficult for an individual to obtain the evidence necessary to satisfy this standard, which may chill individual attempts to obtain relief. Elimination of the pattern or practice standard would allow consumers to obtain redress solely on the factual circumstances of their own loan.

Challenges for Reform

If the pattern or practice standard were eliminated, lenders would be required to assess each HOEPA loan applicant's ability to repay the loan. It would be important to preserve the lender's flexibility to formulate its own underwriting standards and to accommodate borrowers in unique situations. Imposing standards that are too vague or too stringent could directly limit access to credit for many subprime borrowers.

Policy Recommendations

a) **Congress should repeal the "pattern or practice" requirement under HOEPA and create a safe harbor –** The "pattern or practice" requirement sets an unreasonably high bar for an individual hoping to demonstrate that the lender made a loan that she could not afford. The requirement should be repealed, but a safe harbor created. The safe harbor should be structured to give a lender appropriate flexibility to consider a borrower's alternative sources of income in its underwriting process:

    i) Establish a conclusive presumption that a loan in which the borrower's total monthly debt payments-to-monthly income ratio is less than 50 percent is NOT asset-based, unless his/her household residual income did not meet or exceed the guidelines established for purposes of housing loans guaranteed by the U.S. Veterans Administration, or the borrower was already in

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[74] See Statement of John D. Hawke, Jr., Comptroller of the Currency, before the Committee on Banking and Financial Services, US House of Representatives, May 24, 2000.

[75] Newton v. United Companies Financial Corp., 24 F.Supp 2d. 444, 457 (E.D. Pa. 1998). This appears to be a stricter interpretation than courts usually have given the statutory "pattern or practice" standard in civil rights cases. See, e.g., United States v. Balistrieri, 981 F.2d 916, 929-30 (7th Cir. 1992).

serious delinquency or default on an existing loan.[76] The Board should be given the authority to adjust the 50 percent threshold within a five (5) percentage point tolerance.

ii) Additionally, the Board should define the criteria that creditors must consider and processes creditors must follow in originating high-cost mortgages. At a minimum, the Fed should require that lenders consider and document in the loan file borrower income, employment, other (non-home) financial assets, credit history and credit score. A finding that a creditor failed to consider these criteria and follow these processes would constitute a violation of HOEPA. The Board should also be required to alter or eliminate the safe harbor if the Board finds that creditors are making loans without regard to the borrower's ability to repay.

b) **The Federal Reserve Board should consider using its authority to place new restrictions on asset-based lending –** HOEPA grants the Board broad authority to "issue such regulations as may be necessary to carry out" HOEPA. P.L. 103-325 § 155, 108 Stat. 2190, 2197 (Sept. 23, 1994). Under this authority, the Board could address asset-based lending by amending its regulation implementing the provision of HOEPA that prohibits lenders from "engag[ing] in a pattern or practice of extending credit to consumers under [HOEPA-covered mortgages] based on the consumers' collateral without regard to the consumers' repayment ability, including the consumers' current and expected income, current obligations, and employment." 15 U.S.C. § 1639(h). At present, the regulation forbids a pattern or practice of extending credit based on collateral if the consumer "will be unable to repay." 12 C.F.R. § 226.32(e)(1).

The Board could clarify that a "pattern or practice" does not have to be proved by a statistically significant, random sample, and that the phrase should be given the same meaning that the same phrase in the Fair Housing Act (FHA), 42 U.S.C. § 3614, has been given. The courts have ruled that the FHA pattern-or-practice requirement can be satisfied by proof of several instances of a prohibited conduct in a relatively short period of time.[77]

The Board could also propose a rule interpreting the pattern or practice requirement as creating two, alternative bases for demonstrating a violation of the statute. Such a rule could clarify that a practice may be proved by evidence of a lender policy of asset-based lending even if there were not sufficient evidence to prove a pattern.

[76] See 38 C.F.R. 36.4337(e).

[77] The only court to have interpreted the "pattern or practice" requirement of HOEPA in a published decision has given it a stricter interpretation than the courts have given the same requirement of the Fair Housing Act. As it is used in HOEPA, the phrase has been interpreted by a district court to require proof of "a representative sample of [the lender's] loans analyzed empirically." Newton v. United Companies Financial Corp., 24 F. Supp. 2d 444, 457 (E.D. Pa. 1998) (holding proof inadequate despite evidence of asset-based lending by defendant to several plaintiffs). Although the Fair Housing Act's pattern-or-practice requirement cannot be satisfied by isolated instances, it *can* be satisfied by proof of several examples of such conduct, at least if they occur within a relatively short period. See, e.g., United States v. Balistrieri, 981 F.2d 916, 929-30 (7th Cir. 1992) (holding evidence of discriminatory treatment of five black testers over a little more than a month sufficient).

4. Mortgage Broker, Home Improvement Contractor and Appraiser Misconduct

Background

Federal laws such as RESPA and TILA govern the disclosures regarding fees that mortgage brokers must make to borrowers. Most regulation of mortgage broker, home improvement contractor and appraiser practices, however, traditionally occurs at the state level. Table 6.1 below shows the characteristics of state regulation of mortgage brokers and home improvement contractors.

Table 6.1. State Regulation of Mortgage Brokers and Contractors

Participant	Type of Regulation	# of states
Mortgage broker	Licensing/registration	39
	Fee/proof of net worth	29
	Competence test	6
Home improvement contractor	Licensing/registration	30
	Proof of net worth	14
	Competence test	21

Sources: 75 Wash U.L.Q. 1737; *Home Improvement Contractors: A Model State Law*, AARP Public Policy Institute, 1999.

What is the Problem?

Nearly all of the borrowers who gave testimony at the regional forums were taken advantage of not only by a lender but also by an unscrupulous mortgage broker and/or a home improvement contractor who solicited them directly, often in their homes:

- *Aggressive Tactics* – Based upon reports from consumer advocates, a very large number of third parties that participate in the origination of predatory loans employed aggressive marketing and solicitation tactics. In some instances, aggressive sales tactics may rise to the level of fraud or illegal deception, such as misleading or incomplete disclosures of loan terms, "bait and switch" tactics, and improper solicitation of fraudulent gift letters and co-signers who cannot realistically be considered as part of the borrower's ability to repay the loan. In other cases, aggressive practices range from traditional "fast-talking," such as misleading the potential borrower that time to consummate the loan is limited, to providing "expedited services" such as home delivery of loan documents or transportation to a lender's office that are in fact, simply designed to close the deal before a borrower has time to reconsider. These practices interfere with, and in some cases, deprive borrowers of the opportunity to understand the terms of a proposed loan.

- *Neighborhood Targeting* – There were many anecdotes of unscrupulous contractors canvassing inner-city neighborhoods, where housing stock is older and often in need of repair, offering to refinance unsuspecting borrowers' mortgages to fund home improvement projects. Borrowers testified that the work done by these contractors was shoddy, incomplete, and sometimes commenced before the loan was closed (giving unscrupulous lenders the opportunity to modify the loan terms to the borrower's disadvantage once work had begun). Lenders themselves may also engage in such targeting. Some low-income and minority neighborhoods in Baltimore are blanketed with posters for subprime loans, such as those that ask: "Got an FHA/VA Loan - Need Cash?" These advertisements have the potential to mislead consumers into believing that there is some affiliation between the lender and these federal agencies, when in fact there is not.

- *Excessive and Concealed Fees* – Unscrupulous brokers may receive unreasonably high compensation as a result of inflated up-front fees paid by borrowers and indirect fees paid by lenders. According to the testimony of many borrowers at the regional forums, these fees may constitute more than 10 percent of the loan amount. Brokers and lenders may also structure fees so that they are less transparent to the borrower, through the use of mechanisms such as yield-spread premiums, which may disguise the true cost of credit.[78]

- *Outright Fraud* – In inner-city Baltimore and other cities, some appraisers, lenders, investors and real estate brokers have colluded in abusive lending in the purchase money mortgage context. One practice, commonly known as "asset flipping" frequently entails the purchase of dilapidated properties by a development company and/or contractor, which performs cosmetic repairs and then places the properties on sale at a dramatically increased price justified by a fraudulent appraisal. Parties to these scams are aware of the fraud, but allow the borrower to take on far more debt than the property is actually worth. In the FHA context, predatory brokers and lenders that collaborate in this type of fraud have incentives to structure loans that the consumers cannot afford. For these mortgages, the lender can collect on the FHA insurance after foreclosure, and then begin the flipping process all over again with a new buyer, another set of origination fees, and potentially, another FHA payout.

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[78] Yield-spread premiums compensate a mortgage broker for putting a borrower into a home loan with a higher interest rate than the par rate established for the purchase of the loan by the lender. As explained above, a yield spread premium is a payment a mortgage broker receives from a lender based on the interest rate and points of the loan the broker entered into with the borrower as compared to the par rate offered by the lender to the mortgage broker for that particular loan (e.g., a loan of 8% and no points where the par rate is 7.50% will command a greater premium for the broker than a par rate of 7.75% and no points).The broker receives payment for the value of the extra increment of interest, while the lender receives the higher rate of interest over the life of the loan. While yield spread premiums must be disclosed under RESPA, the form of the disclosure may not adequately communicate the nature of the fee to the borrower (on the GFE and HUD-1, the yield spread premium is often abbreviated "YSP").

RESPA Statement of Policy 1999-1 sets forth HUD's position on the legality of lender payments to mortgage brokers in connection with federally related mortgage loans under RESPA. HUD stated that such payments are not illegal *per se*. In determining whether a payment from a lender to a mortgage broker is permissible under Section 8 of RESPA, the first question is whether goods or facilities were actually furnished or services were actually performed for the compensation paid. The fact that goods or facilities have been actually furnished or that services have been performed does not itself make the payment legal. The second question is whether the payments are reasonably related to the value of the goods or facilities that were actually furnished or services that were actually performed. In applying this test HUD stated that it believes that total compensation should be scrutinized to ensure that it is reasonably related to goods, facilities or services performed to determine whether it is legal under RESPA. Total compensation to a broker includes direct origination and other fees paid by the borrower, including those that are derived from the interest rate paid by the borrower, or a combination of some or all.

State oversight of brokers, appraisers and contractors is uneven, and in some cases non-existent. Even if state enforcement in these areas were heightened, interstate problems might remain. Legal aid attorneys at the regional forums testified about unscrupulous, thinly capitalized brokers, contractors and lenders who abused consumers, declared bankruptcy, moved to new states and began operating there under different names.

Challenges for Reform

Imposing additional regulations on brokers, contractors and appraisers will impose costs on all of these parties, not just those who engage in abusive practices. New regulations should seek to protect vulnerable consumers, while not imposing undue compliance burdens on honest market participants.

The FHA and other federal programs may provide a mechanism for regulating some brokers, contractors and appraisers as a condition of participation in these federal programs; however, such strategies would not reach parties that do not participate in the these programs. The reforms that HUD has proposed to address fraud by brokers and appraisers in the FHA context, particularly in connection with property flipping, are outlined in Section IX.A.2.

In all other respects, the regulation of brokers, contractors and appraisers is primarily a matter for state law. Any policies developed at the federal level must recognize the traditional authority of states to regulate the registration, licensing, and practices of these market participants. At a minimum, efforts to increase financial literacy, discussed in Chapter VI.A. will make borrowers more resistant to aggressive, and misleading sales tactics. In addition, the reforms discussed below would help to protect prospective borrowers against being pressured or misled into loans with oppressive terms.

Policy Recommendations

Federal Actions

a) **The Federal Reserve Board should consider using its authority to prohibit blatantly abusive practices by lenders and third parties** – Under HOEPA, the Board is *required* to define unfair and deceptive practices. The Board should use it authority to prohibit practices including: (1) forging signatures or obtaining signatures on blank documents; (2) falsifying loan applicants' income or the appraised value of the property; (3) overcharging consumers with illegitimate fees; (4) selling credit life or disability insurance to consumers who do not qualify for the insurance, or writing policies for amounts that exceed the consumer's indebtedness; (5) fraudulently conveying title in the property to third parties to facilitate the diversion of loan proceeds; (6) employing bait and switch tactics; (7) general fraud and misrepresentation; and (8) evasion of HOEPA.

b) **The FTC should increase federal investigations of fraudulent trade practices** – Under its unfair and deceptive trade practices authority, the FTC may bring suit against these market participants for many of the practices outlined above. However, to bring actions against the growing number of unscrupulous actors in the marketplace, the FTC requires additional staff resources. Congress should fund the FTC at the level requested in the President's FY 2000 budget to ensure that adequate resources may begin to be devoted to these enforcement activities. In the future, the federal government should pay increased attention to the role that the FTC can play in deterring abusive lending practices.

c) **Congress should require brokers to document the appropriateness of the loan for the borrower and disclose this information –** Just as lenders have an obligation to assess the borrower's ability to repay the mortgage loan (see Chapter VI.2.d), mortgage brokers should assume similar responsibilities in their origination processes. For HOEPA loans, a mortgage broker should be required to document in a plain English disclosure: (1) the information he/she considered in approving the loan, including the borrower's income, credit score, debt, and, as appropriate, other financial assets; and (2) all fees received or to be received by the broker in connection with the mortgage transaction. The broker and the borrower should be required to review and sign this document three (3) days prior to closing. This requirement is similar to a requirement imposed on securities brokers before they effect transactions in high-risk "penny stocks" for certain customers. 17 C.F.R. § 240.15g-9(b).

d) **Congress should expand the definition of "creditor" under HOEPA –** Expanding the types of parties who can be penalized for HOEPA violations could serve to stem abusive practices in the subprime market. In particular, defining a "creditor" to include any individual who controls the lending practices of a company would broaden the universe to include thinly capitalized entities that dissolve or declare bankruptcy to avoid liability under HOEPA. The President recommended this expanded definition in his May 1999 consumer protection plan.

e) **Congress should establish lender liability for illegal broker/contractor acts –** Lenders should be made liable for broker or home improvement contractor malfeasance if such party acts as the lender's agent, has an ongoing financial relationship with the lender, or if the lender knew, or should have known, of broker or contractor malfeasance.

f) **Congress should require a licensed or certified appraiser to appraise properties that are to secure a HOEPA loan –** Under the Financial Institutions Reform, Recovery and Enforcement Act of 1989, properties with a value above $250,000 must be appraised by a licensed or certified appraiser. Since many of the abuses occurring in Baltimore and other urban markets involve high-cost loans and fraudulent appraisals, it would be beneficial to introduce qualified appraisers into this arena. The requirement for a licensed or certified appraisal should be extended to a property that is intended to secure a HOEPA loan.

g) **The FFIEC should encourage development of education and qualifications for Urban Appraisers –** Because of the heterogeneous nature of housing stock – and neighborhoods generally – in the inner city, special expertise may be needed in order to issue a high-quality appraisal of a property located there. The Federal Financial Institutions Examination Council (FFIEC) maintains an Appraisal Subcommittee to provide monitoring and funding (on a line item basis) to the Appraisal Foundation. The Foundation is authorized by Congress to establish and maintain the minimum standards for appraisers and appraisal practice. The FFIEC could fund an Urban Appraiser effort that would develop minimum requirements (experience and education) for appraising inner-city properties, create standardized tests that include fair lending and subsidized housing material, and market literature on appraiser selection to consumers.

State/Local Actions

a) **The federal government should foster development of model state laws for registration, licensing and regulation of mortgage brokers, home improvement contractors and appraisers** – While the details of model state laws for each of these market participants would vary, each could include provisions regarding: licensing and registration, bonding and insurance, prohibited acts and contract provisions, recovery fund, enforcement agency, penalties (criminal and civil), hearings and private rights of action.[79] The federal government should foster development of these laws.

b) **The federal government should encourage and work with state/local task forces to combat predatory lending –** Enforcement efforts at the state and local levels can help to prevent many abusive practices in this marketplace, especially among smaller-sized market participants like brokers and contractors. The federal government should encourage the activities of these local task forces, and the federal agencies should provide advice and technical assistance where appropriate.

c) **States should increase prosecution and enforcement of state consumer protection laws governing fraudulent and aggressive sales practices –** Through the regional Task Force forums, HUD and Treasury learned that the exact nature of abusive lending practices often varies from community to community. State regulators and enforcement agencies should give increased focus to the growing problem of fraudulent, unfair and deceptive practices in the mortgage lending market, as they may be best equipped to understand the roots of the problems that exist within their own borders.

d) **States should cooperate in the creation of national computerized registries of mortgage brokers and home improvement contractors** – Such databases would include information on individual brokers and contractors respectively, as well as complaints and actions taken against the registered parties. Maintaining this information in a centralized location may reduce opportunities for an unscrupulous actor to "close up shop" in one state where it has been engaging in abusive practices and to start business in another state under a different name. Such action could build on the National Association of Mortgage Brokers-led effort to establish a national registry of its mortgage broker members.

[79] For example, in a 1999 report, the AARP developed a model state statute for home improvement contractors.

5. Lenders' Incomplete Reporting to Credit Bureaus

Background

Currently, the consumer reporting system used by lenders operates on a voluntary basis. Mortgage lenders enter into agreements with credit bureaus to report borrower payment information and to access borrower credit history.

What is the Problem?

There is evidence that, in an effort to keep good customers, some subprime mortgage lenders have adopted a policy of not reporting to consumer reporting agencies their borrowers' credit lines, high balances or loan payment behavior. When this information is not reported to the national credit bureaus, borrowers may not be able to establish or repair their credit history. Consequently, borrowers who deserve more favorable, more competitively priced loans will not be in a position to learn about or qualify for such loans from other market participants. The business reason for not reporting this information to the credit bureaus is clear – less scrupulous lenders wish to keep customers captive and not reveal business opportunities to their market competitors.

In addition, non-reporting could have broader safety and soundness implications for the banking industry. Lenders that rely on credit bureau reports have incomplete information on credit applicants and incomplete prescreened lists which could skew lending decisions and possibly compromise the integrity of risk management processes.

Policy Recommendations

a) **Congress should amend the Fair Credit Reporting Act (FCRA) to require lenders who regularly report to a credit bureau to report full-file payment information for borrowers** – FCRA should be amended to require lenders to provide borrowers' full payment histories for all mortgage products. The only reason for lenders not to report on-time payment information is to trap borrowers in more expensive products than they would otherwise qualify for, clearly an abusive practice.

C. Abusive or Deceptive Terms and Conditions

1. Limited set of borrowers benefit from HOEPA's protections

Background

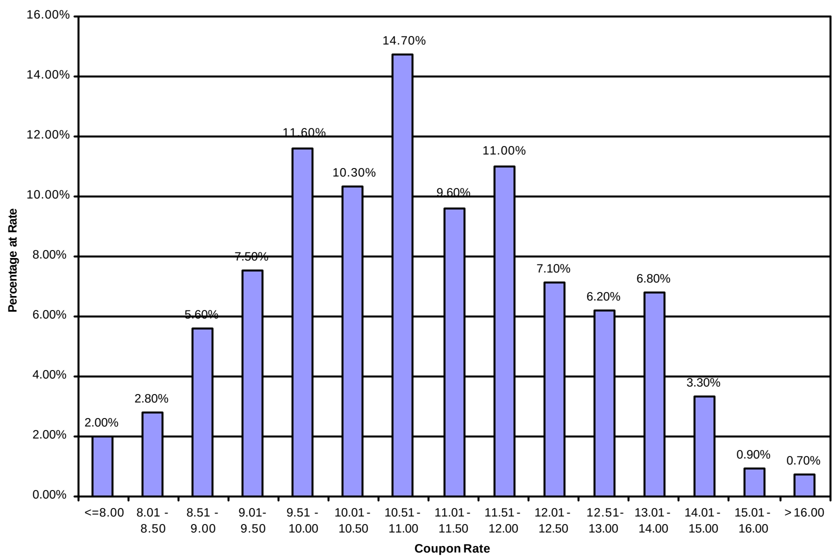
As discussed in Chapter V, HOEPA defines a set of "high-cost" mortgage loans, for which certain terms and conditions are restricted and heightened disclosures are required. HOEPA applies to home mortgage refinance and closed-end home equity loans, but not to purchase money mortgages or home equity lines of credit.

What is the Problem?

HOEPA's disclosures and restricted loan terms and conditions are intended to increase the amount of information available to consumers about a set of high-cost loans, and to protect them from potentially abusive terms such as short-term balloon payments and negative amortization. However, evidence suggests that due to the high thresholds that a loan must exceed in order for HOEPA to apply, very few consumers in the subprime market benefit from the law's provisions. Anecdotal evidence, including testimony at the Task Force forums, also suggests that abuses often occur in loans just below the HOEPA triggers.

The available data on interest rates charged in the subprime market indicate that a very small percentage of loans currently exceed the HOEPA APR threshold. Figure 6.1 shows coupon rates for subprime mortgage loans originated from July through September 1999. With the yield on 30-year Treasury securities averaging 6 percent during this period, only the 0.7 percent of subprime loans with an interest rate greater than 16 percent would have met the HOEPA APR threshold. Data on points and fees charged on mortgage loans in the subprime market are not available.

Figure 6.1. Very Few Subprime Loans Exceed HOEPA's Interest Rate Threshold



Source: MIC LPS, data from 1999Q3

The HOEPA fee threshold excludes certain "reasonable" fees paid to third parties, and mortgage broker fees that are not paid directly by the consumer. There is concern that this exception in some cases may create room for abuses, such as substantial "indirect" compensation to mortgage brokers through yield-spread premiums.[80]

[80] In a commentary accompanying its proposed rule implementing HOEPA, the Fed stated, "The Board believes that Congress intended a very broad application of the term 'compensation,' including, for example, amounts paid to brokers by creditors (in addition to amounts paid by consumers)." 59 FR 61832, 61834 (December 2, 1994). The Board's Staff Commentary, however, has been interpreted to exclude yield spread premiums from the points-and-fees trigger. See Commentary ¶ 32(b)(1)(ii).

Challenges for Reform

The primary challenge in opening up additional loans to HOEPA's restrictions is ensuring that an adequate amount of credit still flows to borrowers who cannot qualify for lower-cost loans. By increasing required disclosures and restricting certain terms, HOEPA may increase some creditors' costs, and many might choose to exit entirely the business of originating these loans if the triggers were lowered. Bringing more loans under HOEPA, however, would require lenders who remain in the market to provide more transparent credit to their most credit-impaired borrowers.

Policy Recommendations

a) **Congress should lower the HOEPA APR thresholds to 6 percentage points above Treasury securities for first liens and 8 percentage points above Treasury securities for second liens –** So that more loans would be subject to HOEPA's disclosures and restrictions on abusive practices, the APR trigger should be lowered. The impact of lowering the interest rate trigger by one or more percentage points can be estimated from Figure 6.1.

   The evidence from Figure 6.1 suggests that lowering the interest rate threshold to 6 percentage points above comparable Treasury securities for first liens, and 8 percentage points above comparable Treasury securities for second liens, could capture the most credit-impaired borrowers in the subprime mortgage market. Most of the testimony on abusive lending practices at the HUD-Treasury Task Force's regional forums pointed to problems in the home refinance (first lien) market, indicating that lower triggers in that market may be appropriate. Lowering the APR trigger to these levels would provide HOEPA's protections to about one in five subprime borrowers based on interest rate. Evidence indicates that this may closely track the portion of C-risk and D-risk borrowers in the subprime market.[81]

b) Congress should expand the definition of high-cost loan under HOEPA to include high-cost purchase money mortgages, reverse mortgages, and home equity lines of credit – Although the subprime market traditionally focused on home equity loans, an increasing share of subprime loans are being originated for home purchase. Expanding HOEPA to apply to purchase money mortgages and home equity lines of credit would grant equivalent consumer protections for homebuyers and homeowners accessing the equity in their homes, and place subprime lenders that specialize in home purchase and subprime lenders that specialize in home refinance/home equity on a more equal footing. Reverse mortgages are also exempt from HOEPA rules for high-priced loans, but are subject to an alternative disclosure scheme. As the population ages, the demand for reverse mortgages will likely increase, and high-cost reverse mortgages may require additional protections. HUD and Treasury thus recommend that the definition of "high cost" mortgages be expanded to apply to purchase money mortgages, to open and reverse mortgages (recognizing that modifications will have to be made for reverse mortgages, e.g., restrictions against negative amortization should not apply for these mortgages).

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[81] Mortgage Information Corporation, *The Market Pulse*, Web edition, Winter 2000.

c) **Congress should expand the definition of points and fees included in the HOEPA fee threshold –** Including points paid if any to reduce the interest rate and any additional fees paid to third parties in the HOEPA fee threshold would increase transparency to consumers while reducing the potential for creditors to levy exorbitant indirect compensation charges on high-cost loans. Fees considered towards the threshold should include: (1) fees and amounts imposed by third party closing agents (except payments for escrow and primary mortgage insurance); (2) prepayment penalties that are levied on a refinancing; and (3) all compensation received by a mortgage broker in connection with the mortgage transaction, whether or not the mortgage broker originates the loan in his/her own name in a table funded transaction. If single premium credit insurance (and similar products) is not prohibited altogether (see VI.3.b), its costs should also be counted toward the HOEPA fee threshold.

d) **Congress should lower the HOEPA fee threshold to the greater of 7 percent of the loan amount or $1,000 –** Combined with revising the HOEPA fee trigger to include almost all costs of credit, lowering the fee trigger by a modest amount would expand HOEPA's protections to more borrowers in the subprime market. At 7 percent, the trigger should be sufficient to allow originators to recover all costs for originating smaller sized loans as well.

e) **Congress should consider the fully-indexed spread for purposes of the HOEPA APR trigger –** The HOEPA APR trigger is based on the rate of the loan at closing. However, a substantial portion of mortgages in the subprime market – 23 percent in the third quarter of 1999 – are adjustable rate. If the loan carries a low fixed rate for the first two years, but will shift to an adjustable rate plus a significant spread thereafter that exceeds the HOEPA interest rate threshold, it is important that the consumer receive the same disclosures and protections against potentially abusive terms that he/she would receive under HOEPA. To accommodate these loans under HOEPA, the APR considered for purposes of the threshold for adjustable-rate mortgages should take into account the fully-indexed spread – the spread above comparable Treasury securities once the initial or "teaser" rate has expired. Similarly, some predatory loans may involve low interest rates followed by loan terms that set the amount owed as a function of the value of the home. Congress should also set the HOEPA triggers to take account of such loans.

f) **The Federal Reserve Board should consider using its authority under HOEPA to lower the APR trigger -** HOEPA expressly grants the Board authority to expand HOEPA's coverage by lowering the APR trigger and broadening the class of costs counted toward the fees trigger. The Board is authorized to lower the APR trigger (which is now 10 percentage points over comparable Treasury securities) to as low as 8 percentage points over such securities, 15 U.S.C. § 1602(aa)(2). According to recent data, an estimated five (5) percent of subprime mortgage loans have interest rates that would exceed such a threshold and, therefore, come under HOEPA were the Board to make such a change.

g) **The Federal Reserve Board should consider using its authority under HOEPA to include additional fees in the HOEPA points-and-fees trigger –** HOEPA expressly grants the Board authority to include in the points-and-fees trigger, in addition to charges enumerated in the statute, "such other charges as the Board determines to be appropriate," 15 U.S.C. § 1602(aa)(4)(D). There are two types of charges that the Board should specifically consider counting toward the HOEPA points-and-fees trigger:

i) ***Single Premium Credit Insurance and Similar Products –*** As explained in the following section, single premium insurance products are thought to injure consumers because they unnecessarily increase consumers' total borrowing costs, and disguise the true cost of the insurance on a monthly basis. Evidence also suggests that some lenders may "pack" insurance into the mortgage loan without the borrower's knowledge.[82] If the sale of this type of product is not prohibited altogether, either through legislation or regulation, the Board should strongly consider including it for purposes of calculating the HOEPA points-and-fees trigger. Congress intended that, pursuant to the Board's authority to add "other charges as [it] determines to be appropriate," the Board could include in the points-and-fees trigger the cost of single premium credit insurance. According to the Conference Report, "The Board has authority to include additional charges in calculating the triggers, *such as credit insurance premiums*, if evidence establishes that such charges are being used to circumvent or evade the provisions of this legislation." Conf. Report, No. 103-652, 103d Cong., 2d sess. (Aug. 2, 1994), at p. 159 (emphasis added).[83] The evidence that creditors may be "packing" insurance into mortgage loans and earning significant commissions, presented at the HUD-Treasury regional forums, suggests that these products may indeed be used to evade HOEPA.[84]

   The Board may also choose to consider including other types of financed, lump-sum products, including debt cancellation or suspension agreements, in the points-and-fees trigger.[85] These alternative products may be even more expensive than credit insurance, the price of which is regulated in some states.[86] Anecdotal evidence indicates that, as with single premium credit insurance, creditors may use these products to generate significant fee income while making loans below the HOEPA triggers. Should the Board choose to include in the HOEPA points-and-fees trigger the costs of single premium credit insurance, but not the costs of other lump-sum products, creditors may shift their sales activity toward these other products, with the result that HOEPA will not protect more consumers.

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[82] According to an industry-funded study that considered consumer loans, which typically involve much less paperwork than mortgage loans, almost 40 percent of borrowers either did not know that they had received credit insurance or were not told that it was optional. *Credit Insurance: Rhetoric and Reality*, Credit Research Center, Krannert Graduate School of Management, Purdue University, 1994.

[83] A Senate committee report described charges for credit insurance as "charges that have been used to exploit unwitting consumers but are not part of the finance charge under Truth in Lending." Sen. Rep. 103-169, Committee on Banking, Housing, and Urban Affairs, 103d Cong., 1st sess. (Oct. 28, 1993), at p. 24.

[84] Consumers Union reports that creditor commissions for credit life and credit disability insurance average over 30 percent.

[85] In addition to credit insurance, according to FTC staff, products sold in a lump sum with subprime mortgage loans include accidental death and dismemberment insurance, accident and health insurance, and involuntary unemployment insurance.

[86] For example, rates for credit life and credit disability in Kentucky are capped by statute. See K.R.S. § 304.19-080.

ii) ***Yield Spread Premiums*** – A yield spread premium is a payment a mortgage broker receives from a lender based on the difference between the interest rate and points of the loan the broker entered into with the borrower, and the par rate offered by the lender. Including yield spread premiums in the points-and-fees trigger would prevent lenders from evading HOEPA by charging a rate higher than they otherwise would, but still lower than the APR trigger. The Federal Reserve Staff Commentary has been interpreted to exclude yield spread premiums from the points-and-fees trigger. See 12 CFR 226, Supplement I Commentary ¶ 32(b)(1)(ii). The Commentary could be revised to make clear that yield spread premiums paid by lenders to brokers are included in the trigger. Such a rule is: a reasonable interpretation of Congress' requirement, echoed by the regulation, that "*all* compensation paid to mortgage brokers" be included in the trigger, 15 U.S.C. § 1602(aa)(4)(B) (emphasis added), 12 C.F.R. § 226.32(b)(1)(ii) (same phrasing as statute); a reasonable implementation of Congress' direction to include "such other charges as the Board determines to be appropriate," 15 U.S.C. § 1602(aa)(4)(D); and a proper means to regulate "mortgage loans designed to evade the provisions of [HOEPA]," § 1639(l)(2)(A). Section 1602(aa)(4)(B) does not distinguish between compensation paid to brokers by borrowers and compensation paid to brokers by lenders.[87] Moreover, it may be appropriate to include yield spread premiums in the points-and-fees trigger because they are an integral part of the loan transaction: they reflect a premium paid by the borrower in the interest rate.[88]

2. Credit Insurance and Other Insurance Products Paid in a Single Premium from Loan Proceeds

Background

There are four common types of credit insurance: credit life, credit disability, involuntary unemployment, and credit property. Credit life insurance pays off the remaining mortgage balance upon the death of the borrower during the period of coverage and credit disability pays the borrower's monthly mortgage payments in the event of an accident or health problem that incapacitates the borrower. Insurance coverage is typically for the first five to seven years of the mortgage.[89]

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[87] The Board, itself, has stated that it "believes the Congress intended a broad application of the term 'compensation,' including, for example, *amounts paid to brokers by creditors* in addition to amounts paid by consumers." 60 Fed. Reg. 15,463, 15,466 (March 24, 1995) (emphasis added).

[88] For this reason, a yield spread premium is "payable by the consumer" within the meaning of 15 U.S.C. § 1602(aa)(1)(B). Although it is not payable directly by the consumer, it is payable indirectly by him/her through the interest rate on the loan. HUD pointed out in its RESPA Policy Statement on lender payments to mortgage brokers that all compensation to the broker is ultimately paid by the consumer, either in the form of fees or points, directly or by addition to principal, or derived from the interest rate of the loan paid by the borrower. In addition, the yield spread premium paid in a table-funded transaction is "payable at or before closing," as § 1602(aa)(1)(B) also requires. Under RESPA, lender-paid fees to mortgage brokers as well as borrower-paid fees to brokers are required to be disclosed on the GFE and the HUD-1 and are otherwise subject to RESPA, including Section 8. See 24 C.F.R. part 3500, Appendix B, Fact Pattern 13.

[89] Coverage is sometimes as long as ten years. Coverage beyond ten years falls outside the coverage limit set by state laws that govern credit-related insurance.

Credit insurance is often described as "single-premium" or "lump-sum" credit insurance because premiums for the entire coverage are typically collected up-front at closing and financed in the loan. When financed, single-premium credit insurance effectively reduces the borrower's monthly payment as compared to what the borrower would pay for the insurance on an installment basis, because the cost of a five to seven year policy is financed over the 15 or 30 year life of the mortgage.

Credit insurance is a very profitable product for insurers. The Consumer Federation of America reported in 1999 that the credit insurance industry had a loss ratio (the ratio of claims to premiums) equal to 40 percent for credit life and credit disability insurance in the 1995 to 1997 period, compared to the 60 percent recommended by the National Association of Insurance Commissioners (NAIC). Consumers Union reported that only three states (New York, Maine, and the District of Columbia) had loss ratios above 60 percent for the same period.[90]

TILA contains no limitations regarding the sale of credit life insurance, except that disclosures of the premium amount must be provided, and need not be included as part of the disclosed finance charge if the insurance is optional and certain other conditions are satisfied.

What is the problem?

There are number of problems related to credit insurance. First, the low loss ratios in the industry imply that these products may be a bad deal for consumers. Credit insurance companies typically sell lenders group insurance products and the lender passes the premiums on to the consumer. Credit insurance companies must compete to attract lenders not borrowers and since lender compensation is generally based on commissions or a percentage of profits, the lender has little incentive to seek out insurance companies with the lowest premiums.

Second, single-premium credit insurance is typically added to the loan amount, increasing the total finance charges paid by the consumer. Lump-sum insurance products, when financed into the cost of the loan, provide no actuarial benefit to the consumer.

Third, consumers have reported experiencing a number of abuses associated with credit insurance. Some of these abuses are the result of high pressure sales tactics that would not be effective if credit insurance was sold after the loan is closed. For example, lenders may mislead consumers into believing that credit insurance is a requirement for approval of the loan. An industry-funded report found that 18 percent of those surveyed did not remember being told that credit insurance was optional.[91] In some instances, borrowers have been unaware that they have purchased credit insurance. Even if borrowers understand that they are purchasing the product and do so voluntarily, the lender may mislead the consumer into thinking that coverage is for the entire life of the mortgage when the policy is only in effect for the first five to seven years of the loan.

[90] *Credit Insurance: The $2 Billion a Year Rip-Off*. Consumers Union and the Center for Economic Justice, March 1999.

[91] Credit Research Center study, 1994, Purdue University.

Other anecdotal evidence suggests that consumers may be experiencing difficulty in canceling credit insurance. Consumers have also complained that it is difficult to obtain a rebate on the unearned premium when the insurance is canceled or the mortgage is prepaid.

Policy Recommendations

a) **Prohibit the sale of single-premium insurance products with mortgage loans** – The sale of single premium insurance products should be prohibited for all mortgage loans, not just HOEPA-covered loans. These products should be payable only on a monthly basis, not on an up-front, lump-sum basis, and lenders should disclose to borrowers any right they have to cancel such insurance. Legislation should grant the Board the authority to define a group of single-premium products (such as credit life, debt cancellation, and debt suspension) which creditors would be prohibited from selling with these loans.

b) **Restrict the sale of non-mortgage products to post-closing** – Consumers are sometimes led to believe, or at least allowed to believe, that purchasing an insurance product is required in order to close a home mortgage loan. In his May 1999 consumer protection plan, President Clinton called for prohibiting the solicitation of credit life insurance until the lender has approved the loan application and communicated approval to the borrower. We recommend the same approach for the group of products the Board defines here.

c) **The Federal Reserve Board should consider prohibiting/restricting the sale of single-premium insurance products in mortgage transactions** – As explained in VI.B.2.d. (on "loan flipping"), HOEPA expressly grants the Board broad authority to issue rules to regulate unfair, abusive, and deceptive acts or practices – and, in the case of refinancings, acts or practices "not in the interest of the borrower." Moreover, as explained above, lump-sum products are arguably inherently "unfair" because they provide the borrower no net economic benefit; for the same reason, they are almost always not in the interest of the borrower. In addition, the sale of lump-sum products at closing is arguably inherently deceptive, because so many borrowers conclude that they must purchase the products in order to close the loan, or fail at all to notice the products among the lengthy settlement documents. Therefore, the Board could require lenders to "de-link" the sale of lump-sum products from the loan application and closing processes and prohibit lenders from selling such products at or before closing. Such a rule would effectively prohibit the financing of lump-sum products with mortgage proceeds in a mortgage transaction. The Board could also require lenders to disclose to consumers any right they may have to cancel the insurance.

3. Negative Amortization

Background

In a negatively amortizing mortgage, a consumer's regularly scheduled payments do not cover the full amount of interest due, causing the outstanding principal balance to increase. Generally, no data exist on the prevalence of negative amortization in the subprime market. Secondary market participants report that the loan pools they securitize generally do not contain negatively amortizing loans. Negative amortization is not permitted in the context of HOEPA loans. Expanding HOEPA coverage would extend its prohibition against negative amortization to more loans.

What is the Problem?

Since the borrower actually loses equity in her home under a negative amortization payment schedule, there seems to be little economic rationale under most circumstances for choosing such a feature.[92] The existence of such a schedule (except in the case of a reverse mortgage) may indicate a lack of understanding on the part of the borrower or misleading lender practices. There is anecdotal evidence in both the subprime and prime markets that some borrowers have unwittingly wound up in home mortgages with negative amortization features.

Reverse mortgages in HUD's Home Equity Conversion Mortgage program employ a special type of negative amortization that allows older homeowners to increase their standard of living by converting their home equity to an income stream. Notably, the complexity of these loans caused Congress to require that borrowers receive special counseling before entering into such a mortgage. No counseling requirements exist for borrowers who receive a non-FHA reverse mortgage with an increasing balance feature.

Policy Recommendations

a) **Congress should retain the existing prohibition of negative amortization on expanded definition of HOEPA loans** – Negative amortization can reduce a HOEPA loan borrower's principal rapidly due to the high interest rates often charged on such loans. HOEPA borrowers may also be less likely to understand fully the significant implications of reducing their equity in their homes. Retaining this prohibition using the broader definition of HOEPA loan recommended in VI.C.1 would reduce the opportunities for abuse of borrowers in the high-cost loan market.

b) **Congress should expand disclosures on negative amortization for all loans** – Under TILA, creditors are required to make added disclosures to any borrower whose open-end consumer credit plan (secured by a home) may result in negative amortization. Those disclosures must state that negative amortization increases the principal balance and reduces the consumer's equity in the dwelling. These disclosures should be made available to all mortgage borrowers, not just those with an open-end home equity loan.

4. Prepayment Penalties

Background

[92] Negative amortization may, however, make sense in some cases outside of high-cost loans. For instance, the cost-of-funds index ARMresults in short-term negative amortization for borrowers when interest rates are rising because of the scheduled delay between the change in the interest rate on the loan and the interest paid by the borrower as part of the monthly payment.

A prepayment penalty is assessed against a borrower who repays his/her loan before the end of the loan term. Prepayment can occur as the result of the mortgage borrower moving, refinancing the loan, or paying on an accelerated basis. For lenders, a prepayment penalty is designed to reduce the risk of prepayment and compensate the lender for any cost resulting from prepayment. Penalties are typically assessed only for prepayment within a specified period of years after the loan is closed.

Industry analysts note that prepayment penalties are typically applicable for the first two, three or five years of the loan, depending in part on the applicable state law. While there is no industry standard for prepayment penalties, industry sources told us that prepayment penalties typically decline as the loan seasons. The prepayment penalty could be expressed as a percentage of the prepaid loan amount (e.g. 5 percent in year one, 4 percent in year two…) or as a fixed amount of remaining interest payments (e.g. six months of interest on the prepaid balance). For high-cost loans, HOEPA prohibits prepayment penalties for prepayment more than five years from closing and for borrowers with a debt-to-income ratio of over 50 percent.

Some subprime lenders offer borrowers a choice between a loan carrying a prepayment penalty and a loan carrying other, higher costs. For instance, one large subprime lender lowered the interest rate on a loan by 75 basis points in April 2000 for those borrowers who accepted a prepayment penalty.[93] In cases where borrowers are offered and aware of such a choice, the market is allowing individuals to assess their own risk of prepayment, and to select the product that works best for them. In this way, the cost of prepayment can be borne by those borrowers who are more likely to prepay.

It is unclear, however, whether most borrowers in the subprime market are either aware of or given the opportunity to make this sort of trade-off. Mortgage-backed securities analysts estimate that about 70 percent of loans in the subprime mortgage market carry a prepayment penalty.[94] Data from the third quarter of 1999 indicate that 76 percent of subprime mortgage originations that quarter carried a prepayment penalty (see Figure 6.2). Interestingly, the prevalence of prepayment penalties appears to decline as loan interest rate increases. Only 17 percent of the loans that exceeded the HOEPA interest rate threshold in the third quarter of 1999 (i.e., 17 percent of the 0.7 percent of subprime loans that exceeded the APR threshold based on interest rate) carried a prepayment penalty. This suggests that higher interest rates may in part reflect lenders "pricing in" the prepayment risk, or that the debt-to-income ratio for these borrowers may exceed 50 percent (thus effectively prohibiting prepayment penalties on these borrowers' loans).

In contrast to the subprime market, prepayment penalties are not prevalent in the prime market – analysts estimate that only between 1 and 2 percent of conforming loans carry such a penalty.[95] As described in Chapter IV, borrowers in the subprime market are more likely, on average, to prepay than borrowers in the prime market, although prepayment in the prime market is more sensitive to interest rate fluctuations than in the subprime market.

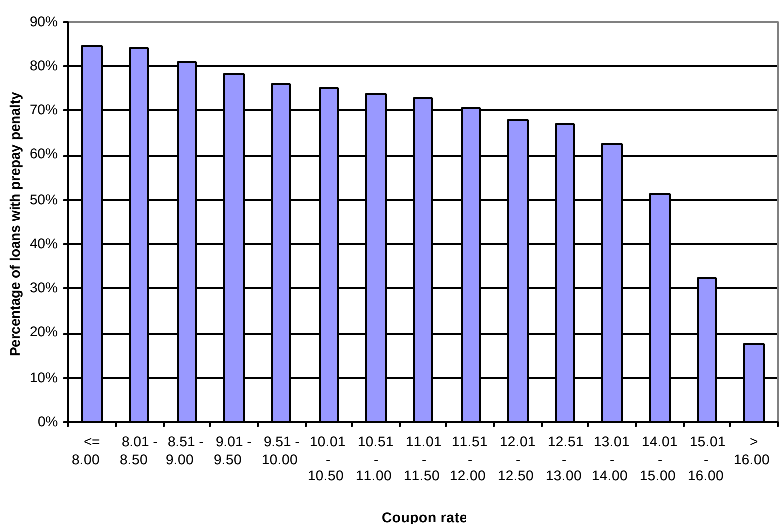
[93] Information from New Century Mortgage Corporation website, www.newcentury.com.
[94] MIC LPS, 1999Q3;
[95] Approximately 0.5 percent of Freddie Mac's purchases, and 2 percent of Fannie Mae's purchases, carry prepay penalties.

What is the Problem?
Seven out of every ten borrowers in the subprime market have a prepayment penalty on their loan. One study has found that subprime loans that carry prepayment penalties are prepaid at about 90 percent of the rate that other subprime loans without prepayment penalties are prepaid, Industry sources indicated to us that this small difference may result from lenders waiving prepayment penalties in order to retain the borrower and state laws that limit the size of prepayment penalties, thereby rendering them not much of a financial deterrent to prepayment.

Nevertheless, in some cases, the existence of a prepayment penalty may inhibit the ability of a borrower to refinance his or her loan at a lower rate. This can be especially problematic in cases where a good payment history may allow the borrower to "graduate" to a lower-cost loan. For this reason, HOEPA restricts prepayment penalties in the high-cost subprime mortgage market, where borrowers may have the greatest need to access lower-cost capital as it becomes available to them.

In cases where the borrower refinances a loan with a prepayment penalty, the cost of that penalty may be financed into the new loan balance, driving up the overall price of the loan to the borrower. The discussion of "loan flipping" in Section VI.B.2.d describes how high fees repeatedly financed into the cost of successive loans may weaken a borrower's equity position in her home.

Figure 6.2. Percentage of Subprime Loans with Prepayment Penalty, by Coupon Rate



Source: MIC LPS, 1999Q3

Challenges for Reform
Further restricting prepayment penalties on HOEPA loans requires the entire pool of HOEPA loan borrowers to bear a greater portion of the costs associated with the risk that some portion of them will

prepay. This requires non-prepayers to pay more for their mortgage than they otherwise would. The cost to the portion of subprime borrowers who carry loans without penalties (30 percent of the entire subprime market) of spreading this risk must be appropriately balanced with the potential benefit of lowered cost and increased refinance flexibility for other high-cost loan borrowers.

Depending upon how existing restrictions are modified, additional measures should be employed to stem any unintended consequences:

- The high incidence of prepayment penalties in the subprime market indicates that secondary market models have been built around the existence of these penalties. Significant restrictions or prohibitions of such penalties in the high-cost loan market could serve to inhibit the flow of credit to these borrowers, at least temporarily, by forcing the secondary market to retool its securitization strategies and climb the subprime "learning curve" again. To the extent possible, new restrictions on prepayment penalties should be tailored to minimize the impact on overall market liquidity.

- Assuming that borrowers are aware that their loans contain prepayment penalties, these penalties could actually reduce the incidence of loan flipping by making refinancing less attractive. An unscrupulous broker looking to refinance a borrower's loan on abusive terms may be less likely to make the effort, or the borrower may be less interested, if the loan carries a prepayment penalty. Further restrictions on prepayment penalties must be accompanied by new measures to curb abusive loan flipping practices.

Policy Recommendations

a) Congress should place further restrictions on prepayment penalties on HOEPA loans – For borrowers with HOEPA loans, further restrictions on prepayment penalties may make it more economical for some families to refinance their loans. The ability to refinance at successively lower interest rates over time may allow more borrowers to graduate from the subprime to the prime market. As detailed in VI.B.2, the financing of prepayment penalties, as well as points and fees, can erode home equity through successive refinancings.

   Under HOEPA, a pre-payment penalty cannot be assessed after five years post-loan closing. Congress should shorten this period and restrict the price of prepayment penalties so that such restrictions would (1) curb predatory lending, and (2) not unduly inhibit the flow of credit to subprime borrowers (i.e., the costs of the inhibition of the flow of credit, if any, are outweighed by the benefits of stemming a practice that is used in a predatory manner).

b) **Congress should require creditors to ensure that HOEPA borrowers derive some benefit from accepting a prepayment penalty on loan –** Not all borrowers in this market may be afforded the choice between lower loan costs with a prepayment penalty and higher loan costs without a penalty. For HOEPA loans, creditors should be required to offer borrowers a trade-off between waiving the prepayment penalty and accepting a higher APR on the loan, or accepting the penalty and receiving a lower APR on the loan.

c) **Congress should create "safe harbors" for prepayers –** HOEPA loan borrowers should have the right to accelerate payments – up to 20 percent of the loan amount annually – without having to pay a prepayment penalty. In addition, prepayment penalties should not be assessed upon move or default, only upon a refinancing. Legislation should create these "safe harbors" from prepayment penalties for borrowers with high-cost loans.

5. Balloon Payments

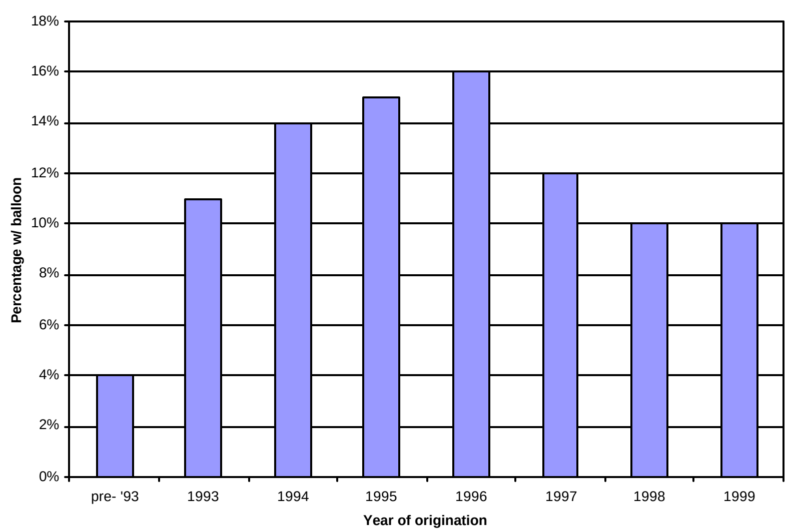
Background

Balloon payments occur at the end of a fixed-rate loan term when regular monthly payments do not fully amortize the loan principal. The regular monthly payments on a HOEPA loan with a term of five years or less must fully amortize the loan principal (thus effectively prohibiting balloon payments within five years of closing).

About 10 percent of subprime loans originated in 1999 had a balloon term, about the same percentage as in 1993, and down from 16 percent in 1996 (Figure 6.3). Only 1 percent of the subprime mortgages originated in the third quarter of 1999 that met the current HOEPA interest rate threshold carried a balloon term.

The evidence also indicates that the use of balloon terms varies significantly from one lender to the next. According to Morgan Stanley's 1998 Home Equity Loan Handbook, one originator issued securities backed by approximately 60,000 fixed-term subprime mortgage loans. About 50 percent of these loans carried a balloon term, far above the market average.

Figure 6.3. Share of Subprime Loans with a Balloon Term, pre-1993 to 1999



Source: MIC LPS, data through 1999Q3

As with prepayment penalties, borrowers who choose to take on a loan with a balloon payment can benefit from lower loan costs, over the short run. Deferring the payment of a portion of the loan principal can make a loan more affordable over the shorter term by reducing the borrower's monthly payments. For elderly borrowers, and borrowers who anticipate that their incomes will increase over time, a balloon payment may be a reasonable option.

What is the Problem?

In the high-cost loan market, borrowers typically must refinance their loans in order to cover balloon payments or they risk default because of inability to make the payment. Even with HOEPA's existing restriction on balloon payments, balloon terms can remain onerous in connection with certain other terms or practices:

- In refinancing a loan to cover a balloon payment, a less scrupulous lender may charge the borrower high points, fees and closing costs. Financing these points and fees may saddle the borrower with higher payments, and present the lender with more opportunities to engage in loan "flipping."

- From the testimony that HUD and Treasury heard at some of the regional forums, it appears that some higher-cost loan borrowers do not know that their loans include a balloon payment, or may not understand that as a practical matter, such a term means that they will need to refinance their loans. A lack of disclosure by the originator or inadequate borrower understanding may thus disadvantage borrowers with balloon loans.

- If the lender reports a borrower's late payments – but not his/her on-time payments – to a credit bureau, the borrower may not be able to qualify for lower-cost credit when the balloon payment is due.

The market should apportion balloon payments to those borrowers who, in assessing the trade-off between lower monthly payments and fully amortizing the mortgage, place a higher value on the former. The fact that only one percent of borrowers with loans whose interest rate exceeded the HOEPA APR threshold in the third quarter of 1999 had a balloon term indicates that abuses of this sort may not be widespread. However, the sorts of practices described above create information disadvantages in which this fraction of subprime borrowers cannot accurately assess the tradeoff. Further restricting balloon payments may allow borrowers to escape a cycle of high-cost refinancings, and reduce borrower exposure to loan "flipping."

Challenges for Reform

As with restricting prepayment penalties, restricting or prohibiting the use of balloon payments in the high-cost loan market would increase the cost of borrowing for people who could reasonably choose this repayment option. These costs must be weighed against the benefits to borrowers whose balloon terms have forced them into a series of refinancings, the long-term price of which can be substantial. Reforms should also take account of the disparate impact that new restrictions on balloons could have on lenders who specialize in originating loans with these terms.

Policy Recommendations

a) **Congress should restrict the timing of balloon payments on HOEPA loans to no less than 15 years –** Balloon payments are most onerous when they are due within a short period of time from closing. High-cost loan borrowers may not have had enough of a chance to repair their credit, and may, as a result, be limited to similarly onerous terms on their refinancings. They also may not have had adequate opportunity to experience increases in income, or to accumulate savings to pay off a portion of the balloon payment. Pushing balloon payments out to year 15 at a minimum would help to alleviate these problems, while allowing the industry to offer a product that may make sense for some HOEPA borrowers.

6. Mandatory Arbitration

Background

A mandatory arbitration clause in a loan agreement requires, as a condition to receiving a loan, that the borrower agree to resolve any dispute arising out of the loan through arbitration, rather than in-court litigation. As a practical matter, currently there are no restrictions on mandatory arbitration clauses, at least so long as they clearly set forth the procedures under which the arbitration will be conducted.[96]

What is the Problem?

Some features of mandatory arbitration clauses in high-cost loans disadvantage the consumer: (1) the arbitration process may limit the borrower's right to factual discovery; and (2) provisions may include requiring the borrower to pay all arbitration costs; not specifying who will pay arbitration costs; or requiring arbitration to be in a location far away from the borrower's residence.

To sign a mandatory arbitration clause at closing, before any dispute has occurred, limits the borrower's flexibility to choose the forum that may provide the best opportunity for resolving the controversy. Many high-cost loan borrowers may not understand at the time of closing the significance of agreeing to arbitration and various associated terms, such as cost allocation and forum location. Consumers may not recognize a mandatory arbitration clause buried in the voluminous loan documents at closing. In addition, private arbitration circumvents the development of clear and uniform standards for compliance with federal fair lending and consumer protection law through the decisions of an independent judiciary.

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[96] The Supreme Court has agreed to grant review in a case in which the lower court declared a mandatory arbitration clause unenforceable because it failed to specify who would pay the arbitration costs. Green Tree Financial v. Randolph, 178 F.3d 1149 (11th Cir. 1999), cert. granted, 68 U.S.L.W. 3629 (U.S. April 3, 2000)(No. 99-1235).

There are other procedural and substantive distinctions between arbitration proceedings and in-court litigation that lend support to further restrictions in this area:

- Individual borrowers with a mandatory arbitration clause in their loans are not able to collectively initiate or join class action lawsuits.
- Mandatory arbitration may make unavailable, or may delay, emergency relief that a court can order, such as a temporary restraining order or preliminary injunction, which may be important in lending disputes.
- An arbitration typically does not result in broad injunctive relief designed to reform a company's unlawful practices to prevent future violations.

Challenges for Reform

In some contexts, arbitration has proven to be an efficient and streamlined process for resolving disputes that minimizes costs and deters frivolous claims. A competitive marketplace might allow borrowers to shop among loans that involve tradeoffs between arbitration clauses and loan costs, but evidence suggests that the subprime market has not yet achieved this level of efficiency. Therefore, some level of restriction may be required.

Policy Recommendations

a) **Prohibit mandatory arbitration for high-cost loans** – The most vulnerable borrowers in the subprime market may be the least likely to understand adequately the implications of agreeing to mandatory arbitration. Since they may also be the most likely borrowers to default or be foreclosed upon, it is especially important that they retain the rights afforded them under federal fair lending and consumer protection laws. In the high-cost loan market, the difference in bargaining power between lenders and borrowers is particularly acute, making pre-dispute mandatory arbitration an unwise option for these consumers.

7. Financing of Points and Fees

Background

HOEPA does not restrict the financing of up-front points or fees into the cost of a loan. In a HOEPA-covered loan that contains a prepayment penalty, the penalty may not apply to prepayments made with amounts obtained by a refinancing from the same creditor or affiliate. 15 U.S.C. § 1639(c)(2)(B).

What is the Problem?

Financing points and fees may disguise the true cost of the loan to the borrower. Restricting the amount of points and fees financed on HOEPA loans would increase transparency to the borrower by forcing more of the lender's costs into the interest rate.

Policy Recommendations

a) **Congress should restrict the financing of points and fees on a HOEPA loan** – By restricting the financing of points and fees to the greater of 3 percent of the loan amount and a de minimus dollar amount for HOEPA loans, the cost of the loan would be more accurately reflected in the interest rate. Borrowers in the high-cost mortgage market would be better able to understand the cost of credit, and to shop for better loan terms.

D. Market Structure

1. Inadequate Data Collection

Background

The Home Mortgage Disclosure Act, and the Board's Regulation C that implements the Act, specify a number of data items that creditors must report to the financial institution regulators with regard to the home mortgage loans they originate.[97] Reporting lenders must provide information on mortgage loans whose purpose is home purchase or home improvement, including refinancings of these loans.[98] At their option, lenders may report on home equity lines of credit.

For loans originated by reporting lenders, information collected under HMDA includes:

- Loan purpose
- Loan amount
- Geography (MSA, state and county and census tract)
- Applicant data (race/ethnicity, sex, income)
- Loan purchaser (if loan was sold – e.g., Fannie Mae, Freddie Mac, bank, thrift, etc.)

What is the Problem?

While HMDA data have been a crucial tool allowing policy makers, regulators and the public to understand mortgage lending patterns, additional data not now required to be reported would more completely describe mortgage markets – the subprime market, in particular. Greater transparency in this market would promote more informed policy making and regulation, and may itself help to improve practices of lenders. There are three general areas in which current HMDA data may be inadequate:

[97] 12 U.S.C. Chapter 29; 12 C.F.R. § 203.

[98] Mortgage lenders required to report annually under HMDA generally include depository institutions and other for-profit non-depository mortgage lenders. Banks, thrifts, and credit unions must report if they (1) have a home or branch office in an MSA on the preceding December 31; (2) have assets of more than $30 million on the preceding December 31; (3) originate at least one home purchase loan (including a refinancing) in the preceding calendar year; and (4) are federally insured or regulated, or make loans that are federally insured, guaranteed, or supplemented, or intended for sale to FNMA or FHLMC. Non-depositories must report if they (1) either have a home or branch office in an MSA on the preceding December 31, or receive applications for, originate, or purchase 5 or more home purchase or home improvement loans on property located in an MSA in the preceding calendar year; (2) have home purchase loan originations (including refinancings) that equal or exceed 10 percent of total loan originations, measured in dollars; and (3) either have assets (when combined with the assets of any parent corporation) exceeding $10 million on the preceding December 31, or originate 100 or more home purchase loans (including refinancings) in the preceding calendar year.

- **Unclear distinction between prime/subprime**. In order to estimate subprime mortgage lending volumes, researchers today identify subprime loans in the HMDA data using a list of lenders, developed by HUD, that are believed to originate primarily subprime loans. Each loan originated by these lenders is assumed to be a subprime loan, and loans not originated by these lenders are assumed to be prime loans.[99] While this methodology for classifying loans is widely used, subprime lenders may originate some mortgage loans to borrowers on terms that would be considered appropriate in the prime market, and banks/thrifts labeled as prime lenders may increasingly be originating loans in the subprime market.

  Similar methodology is also employed to identify manufactured home loans, which are usually originated by lenders who specialize in financing the purchase of prefabricated and mobile homes, and similar inaccuracies may result.

- **Incomplete coverage of lenders in the subprime market**. Under the coverage tests, Regulation C contains a two-part standard to capture lending institutions other than banks, thrifts and credit unions that originate a significant volume of mortgage loans. A for-profit non-depository lender does not have to report under HMDA if: (1) its assets are $10 million or less and it originated fewer than 100 mortgage loans in the prior year; OR (2) less than 10 percent of the dollar volume of its loan originations in the prior year was for home purchase loans (or refinances of such loans).

  There is anecdotal evidence that some of the largest and fastest growing mortgage providers in the country, especially in the subprime market, hold large enough consumer loan portfolios relative to their home purchase and refinancing loans that they fall within the 10percent exemption. Thus, current reporting requirements may omit an important class of lenders originating subprime mortgage loans.

- **Limited data on loan price and other features**. Publicly available data offers little information on loan prices or features. For instance, no public information exists that would allow the regulators to determine the portion of a lender's portfolio that meets the HOEPA triggers. Since abusive practices mostly occur in the high-cost loan market, this lack of information may inhibit the ability of regulators and the public to scrutinize lenders for abusive practices, including potential lending discrimination. Other information on loan terms, such as loan-to-value ratios, would improve the regulators' ability to identify potential fair lending violations.

Congress granted the Board the authority to "prescribe regulations as may be necessary to carry out the purposes" of HMDA, and provided further that such regulations "may contain such classifications, differentiations, or other provisions . . . as in the judgment of the Board are necessary and proper to effectuate the purposes" of HMDA. 12 U.S.C. § 2804(a). In order to carry out the Act's express

[99] See Randall M. Scheessele, *1998 HMDA Highlights*, Housing Finance Working Paper No. 9, Office of Policy Development and Research, US Department of Housing and Urban Development, October 1999.

purpose of helping to determine whether lenders are meeting the housing needs of the communities in which they operate, the Board should require the reporting of additional information under HMDA.[100]

Lenders that are not federally insured and that are not affiliates of federally insured depositories, while required to report under HMDA, may not have adequate incentive to provide complete reports, or to report at all. Enforcement authority under HMDA with respect to reporting by such lenders is vested in HUD. Enforcement authority with respect to banks, thrifts and credit unions rests with the federal financial institution regulators (i.e., Federal Reserve, OCC, OTS, FDIC and NCUA). However, HUD has no authority under HMDA to assess penalties against non-depository lenders that fail to report conventional (non-government-insured) loans. Therefore, many non-federally insured, unaffiliated mortgage companies – including many of the lenders that specialize in originating subprime loans – face no sanctions for incomplete reporting or non-reporting under HMDA.

Challenges for Reform

Collecting additional data items may result in increased costs for both lenders and the collecting agencies (the federal banking regulators and HUD). These costs would need to be weighed against the benefits that increased understanding of the mortgage market could bring to the public and private sectors, and the possibility that potentially predatory practices – which damage both consumers and the reputation of the market – could more easily be identified.

Policy Recommendations

The Board should implement a series of essential revisions to Regulation C to address the problems outlined above.

a) **Repeal the 10 percent rule** – The Board should revise Regulation C to repeal the 10 percent rule and expand the universe of mortgage lenders reporting under HMDA. Increasing the number of reporting lenders that are active in subprime mortgage originations could greatly improve the accuracy of our understanding of the subprime mortgage market.

b) **Collect information on loan price and disclose information on month loan originated** – Prescribing the collection of additional loan level data on loan features under Regulation C would improve understanding of the incidence of subprime and high-cost loans, and of the need for further scrutiny of such loans in the mortgage market. The price of the loan could best be captured by requiring the collection of two additional data items: (1) APR, which is already calculated by the lender for purposes of TILA disclosures; (2) the cost of credit, which would include all charges included under the TILA finance charge (12 U.S.C. 1605(a)), costs of single-premium insurance (if not prohibited), fees and amounts imposed by third-party closing agents and all fees collected by a

[100] "The purpose of this chapter is to provide the citizens and public officials of the United States with sufficient information to enable them to determine whether depository institutions are filling their obligations to serve the housing needs of the communities and neighborhoods in which they are located and to assist public officials in their determination of the distribution of public sector investments in a manner designed to improve the private investment environment." 12 U.S.C. § 2801(b).

mortgage broker in connection with the transaction. This information would allow users to define which loans qualify as “subprime” using information on the price charged to the borrower, and paired with information on the month the loan was originated (currently collected under Reg C but not publicly disclosed), this price information would allow regulators to identify lenders that originate high concentrations of HOEPA loans.

c) **Distinguish manufactured home loans** – As President Clinton recommended in his May 1999 consumer protection plan, the Board should require HMDA reporters to indicate those loans that are used to purchase a prefabricated or mobile home, or to refinance such a loan. This would greatly improve estimates of the size of the manufactured home lending market, and would not impose an undue reporting burden on institutions who originate manufactured home loans.

d) **Require reporting of reasons for denial –** The Board should propose the amendments to Regulation C that Treasury, Justice, HUD, OCC, OTS and the FTC recommended in their joint response to the Board’s 1998 ANPR. These recommendations included requiring creditors to report, for loans that have been denied, the reasons for such denial. Data on reasons for denial would assist supervisory agencies in evaluating whether patterns of loan denials may reflect discrimination, and allow them to focus their efforts where disparities by race are the greatest. Requiring the collection of this data under HMDA would not be unduly burdensome, since the HMDA registers already contain a field for this information, and since creditors must already keep for at least 60 days a record of the reasons for denial to ensure compliance with the Equal Credit Opportunity Act. Institutions regulated by the OCC and the OTS currently report reasons for denial under HMDA for all denied applications.

e) **Collect name of parent institution on transmittal form –** Reporting the name of the parent institution on the HMDA transmittal sheet would impose little burden, and would provide researchers with a much simpler way to identify parent-sub relationships than going through the Federal Reserve’s National Information Center database.

f) **Collect loan-to-value ratio –** This data would assist regulators and other agencies in assessing whether there are variations in LTV between different classes of borrowers or borrowers in certain geographies that may suggest fair lending violations.

Additionally, through a statutory change:

g) **Congress should grant HUD specific authority to assess penalties to enforce HMDA with respect to non-federally-insured, non-bank-affiliated lenders** – Revisions to HMDA could increase the incentives for non-depository, unaffiliated mortgage companies to report under the Act by granting HUD the authority to impose sanctions on these lenders for non-reporting or incomplete reporting.

Additionally, HUD and Treasury recommend that the Board consider how the collection of other data items under Regulation C could improve understanding of the subprime mortgage market, and the high-cost segment of that market in particular:

a) **Debt-to-income ratio (for HOEPA loans)** – This data item would allow regulators to identify those HOEPA loans that may be least affordable for borrowers, and may discourage lenders from originating loans that borrowers may not have the ability to repay.

b) **Indicator for whether loan was originated by a broker** – Knowing which lenders use brokers, and for which loans, would assist the agencies in investigating potentially abusive practices among brokers.

2. The Prime Market

Background

Prime lenders - banks thrifts and credit unions generally - could play a potentially important role in curbing predatory practices:

- As detailed in Chapter IV, banks, thrifts, credit unions and their affiliates are increasingly important players in the subprime mortgage market. Banks and thrifts themselves accounted for approximately 13 percent of all subprime mortgage originations in 1998; together with their affiliates, they accounted for a little more than one out of four subprime originations in 1998.

  This share may be increasing, as a number of the largest subprime lenders are affiliates of prime lenders or have recently been acquired by banks. The relationship between prime lenders and their subprime affiliates may have implications for borrowers in either market.

- A number of prime lenders are beginning to enter the subprime market directly by offering products that cater to borrowers with blemished credit histories. These mortgage products are more expensive than comparable prime products, but often automatically reduce in cost over time as the borrower's credit history improves with on-time payments.

- In addition to originating subprime mortgages either directly or through affiliates, prime lenders play an indirect role in supporting the activities of subprime lenders in a number of ways. They purchase and service subprime loans, issue securities backed by subprime loans, and provide warehouse lines of credit to subprime lenders.

What is the Problem?

There may be two ways in which the prime market, either purposely or inadvertently, allows predatory lending to occur: (1) by not adequately competing for borrowers who may qualify for prime credit but are being served by the subprime market; and (2) by supporting the origination of predatory loans, through affiliates, purchases or other support for unscrupulous lenders.

- *Inadequate Competition* – One pattern that emerged from evidence on predatory lending practices at the regional forums was a lack of competition from prime lenders in the neighborhoods where these practices occur most often. This evidence was buttressed by HUD research that showed large market shares for subprime refinance lending in these neighborhoods. While subprime lending is not synonymous with predatory lending, the subprime market is where predatory lenders are found. The penetration of subprime lending in these areas is owed, in part, to the lower family incomes there. However, the research consistently revealed that, controlling for income, predominantly non-white census tracts showed much higher subprime refinance penetration rates than predominantly white census tracts.[101]

  Income, of course, is only one factor to consider in assessing borrower risk and determining whether he or she may qualify for credit in the prime market. A borrower's credit score is designed to capture a discrete set of elements that contribute to risk, and in addition to the loan terms is the primary metric that lenders use to price a loan. On this note, it is revealing that 28 percent of the borrowers in the MIC Subprime Loan Performance System database in September 1999, the largest data source tracking subprime loans, had credit scores of 640 or above.[102] While some portion of these borrowers may have been unable to access credit in the prime market because of their loan characteristics (e.g., high LTV's, low loan amounts or other credit factors such as income), some portion likely carry credit at a higher price than that for which they would be eligible in the prime market.

  One market deficiency that may contribute to this misdirection of borrowers is that most financial institutions have no processes in place that serve to refer borrowers who qualify for prime credit "upstream" from subprime affiliates to their parent banks and thrifts. The activities of banks' and thrifts' non-bank affiliates are not generally examined by the regulators under the Community Reinvestment Act. However, the purpose for the CRA – encouraging banks and thrifts to meet the credit needs of the communities in which they do business – is broadly consistent with the principle that banks and thrifts should have in place policies to improve borrower access to prime market borrowing opportunities.

  Clearly, borrowers in certain neighborhoods could benefit from increased competition among lenders, including banks, thrifts and other prime lending specialists. In addition, the prime market could do more to help "graduate" borrowers from the subprime to the prime market by offering loan products that over time will connect those borrowers to credit in the financial services mainstream.

[101] HUD's research, performed on a nationwide basis in *Unequal Burden: A Profile of Subprime Lending…*, was based on work completed by the Woodstock Institute in its November 1999 report, *Two Steps Back….* That report found that 18 of the top 20 lenders in predominantly white census tracts in Chicago were prime lenders, while 18 of the top 20 lenders in predominantly black census tracts were subprime lenders. *Two Steps Back* did not control for census tract income or borrower credit history.

[102] As described in Section IV, A-credit borrowers typically have FICO scores exceeding 650.

- *Supporting the activities of predatory lenders* – Banks, thrifts and other prime lenders may not have in place adequate processes to ensure that they do not support predatory lending through their loan purchases, securitizations or lines of credit issued to other lenders. As these institutions increasingly become involved in the subprime mortgage market through their affiliates, opportunities for abusive lending activities to occur at the affiliate level may also increase. By refusing to support unscrupulous lenders and abusive lending activities in any of these ways, the prime market could do much to force these abuses out of the marketplace.

Policy Recommendations

a) **The regulators should award banks and thrifts CRA credit for products that "promote" borrowers from the subprime to the prime markets –** The regulators should publish guidance directing examiners to award CRA credit to banks and thrifts that offer products and procedures, either directly or through their affiliates, that serve to graduate borrowers who make on-time payments from the subprime to the prime mortgage market. The OTS, for example, is exploring ways to give positive CRA lending test consideration for thrifts' responsible subprime lending to low-income borrowers, while discouraging the origination or purchase of loans that have abusive terms. The OCC has issued similar guidance relating to the responsible conduct of subprime lending activities.

b) **The regulators should deny banks and thrifts CRA credit for origination or purchase of loans with predatory terms –** Subprime loans are originated for more credit-impaired borrowers, and thus often serve a low-income population that banks and thrifts may receive credit for serving under the CRA lending test, either through directly originating or purchasing these loans. However, where there is evidence that unlawful predatory practices are associated with the loans originated by the bank or thrift, this should be reflected in the institution's CRA evaluation. This measure should serve as a deterrent to predatory lending. The OTS is developing a predatory lending "overlay" to its compliance procedures to give examiners guidance on identifying the existence of potentially predatory lending practices, and coordinating the various compliance examination procedures – including fair lending, RESPA and TILA – to reach conclusions and recommend corrective action. The OCC has announced that it is prepared to take action against national banks or their subsidiaries who engage in unfair or deceptive lending practices.

c) **The regulators should, in the context of CRA examinations, consider banks' and thrifts' other market activities that may support predatory lending –** The federal financial institution regulators should consider, in the context of their CRA examinations of banks and thrifts, whether those institutions may be supporting predatory lending through activities other than loan origination/purchase.

d) **The Federal Reserve Board should consider conducting examinations of subprime lenders that are subsidiaries of bank holding companies –** Of the 239 lenders who report that they specialize in subprime lending, 15 percent (including a number of the larger ones) are banks or nonbank subsidiaries of bank holding companies.[103] This figure does not include the various lenders who engage in subprime lending, but who do not report that they "specialize" in subprime lending. Thus, a significant amount of subprime lending is being conducted by nonbank affiliates of bank holding companies.

Under the "Fed-lite" provisions of the financial modernization act, the Board may examine a non-bank subsidiary of a bank holding company to inform itself of: 1) "the nature of the operations and financial condition" of the subsidiary, 12 U.S.C. § 1844(c)(2)(A)(i), and 2) "the financial and operational risks within the holding company system that may pose a threat to the safety and soundness" of any affiliated bank and the "systems for monitoring and controlling such risks," 12 U.S.C. § 1844(c)(2)(ii). The Board may also examine such subsidiary "to monitor compliance with ... any ... Federal law that the Board has *specific jurisdiction to enforce against such a ... subsidiary* and those governing transactions and relationships between any depository institution subsidiary and its affiliates," 12 U.S.C. 1844(c)(2)(A)(iii) (emphasis added).[104]

The Board should consider conducting risk-based examinations of non-bank lending subsidiaries of bank holding companies where it has a basis to believe that such subsidiaries are violating HOEPA or otherwise engaging in predatory lending.

e) **The regulators should adopt an interagency policy statement on predatory lending enforcement –** The Interagency Policy Statement on Predatory Lending being considered by the interagency group on predatory lending could 1) deter predatory lending; 2) promote more effective enforcement of existing laws with respect to those lenders; and 3) promote fair and responsible lending under the purview of the federal financial institution regulators.

3. The Secondary Market

Background

Chapter IV explored the evolution of the secondary market for subprime loans. Subprime loans may be purchased in the secondary market either whole (in the whole loan market) or through a mortgage-backed security, which gives the buyer an interest in a pool of loans. About 35 percent of subprime lending by dollar volume in 1999 was securitized. The volume of subprime loans purchased outright in the whole loan market is not known, though it likely represents a substantial remainder of the non-

[103] See Randall M. Scheessele, 1998 HMDA Highlight, Department of Housing and Urban Development, Housing Finance Working Paper Series HF-009 (1999).

[104] The Board may examine a lending affiliate to monitor compliance with HOEPA, if the Board has *specific jurisdiction* to enforce HOEPA against such company. Although the Federal Trade Commission has jurisdiction generally to enforce HOEPA against nondepository lenders, the Board is authorized under Section 8(b)(3) of the Federal Deposit Insurance Act, 12 U.S.C. § 1818(b)(3), to bring certain enforcement actions against any bank holding company or nonbank subsidiary for violation of any law, rule or regulation, in the same manner as it could against a state member bank. Arguably, this authority constitutes "specific jurisdiction" for the Board to enforce HOEPA against a nonbank subsidiary, within the meaning of section 5(c) of the BHCA, although this newly enacted provision has yet to be interpreted.

securitized portion of the market.

GSE Statements on Subprime Purchases

Although the GSEs play a relatively small role in the subprime market today, they are beginning to reach out with new products in this marketplace. Both GSEs recently pledged not to purchase loans with certain identified predatory features. Fannie Mae has established greater limitations on its subprime activities than has Freddie Mac, but Fannie Mae has been less involved in the subprime market to date. Fannie Mae, through its Lender Letter LL03-00 ("Eligibility of Mortgages to Borrowers with Blemished Credit Histories," 4/11/00), has announced guidelines that, among other things, restrict lenders from selling loans to the enterprise that contain the following characteristics: excessive points and fees; single-premium credit life insurance; and, prepayment penalties, unless they provide some benefit to the borrower. Fannie Mae has also announced that it will not purchase loans from lenders who steer borrowers to higher-cost products if those borrowers qualify for lower-cost products. Freddie Mac, through two industry letters (Reports to Credit Repositories, 2/22/00; Single-Premium Credit Insurance Products, 4/21/00), has announced that it will not purchase HOEPA loans nor will it purchase mortgage loans with single-premium credit life insurance. Both GSEs have announced that they will require lenders who sell them loans to file monthly full-file credit reports on every borrower.

What is the Problem?

The secondary market may, knowingly or unknowingly, support the activities of predatory lenders by purchasing or securitizing the loans that these lenders originate. For instance, loans with predatory terms may form part of a pool of subprime loans that a secondary market participant securitizes or insures. Alternatively, a financial institution or one of the GSEs may purchase or fund a loan that has predatory features.

While the secondary market could be viewed as part of the problem of abusive practices in the subprime mortgage market, it may also represent a large part of the solution to that problem. If the secondary market refuses to purchase loans that carry abusive terms, or loans originated by lenders engaging in abusive practices, the primary market might react to the resulting loss of liquidity by ceasing to make these loans.

GSE Purchase Restrictions

Restrictions on the loans the GSEs can purchase are consistent both with their public mission and past practice. Fannie Mae and Freddie Mac are prohibited from purchasing loans above the conforming loan limit (currently $252,700) because such purchases do not serve their statutory missions. One could just as easily conclude that purchases of loans with particularly onerous terms do not serve this mission, and the recent announcements by Fannie Mae and Freddie Mac are consistent with that conclusion.

Pledges alone, however, may not be sufficient to ensure that mortgages with abusive features are not purchased by the GSEs. First, although nine of the Federal Home Loan Banks, which are also government-sponsored enterprises, now participate in a program whereby they purchase or fund loans at origination, none of them has made a corresponding commitment. Only legislative or regulatory restrictions can ensure a level playing field among the GSEs. Second, while Fannie Mae and Freddie Mac have issued broad guidelines describing the types of loans that they intend to make ineligible for purchase, these pledges still lack important details. Regulations can be used to make explicit both the precise nature of the restrictions and the mechanisms by which the GSEs would monitor and enforce these restrictions.

Policy Recommendations

a) **The secondary market should not support illegal practices in mortgage lending** – Under the existing TILA/HOEPA requirements, any civil action for violation of TILA that may be brought against a creditor may be maintained against an assignee of such creditor if the violation is apparent on the face of the disclosure statement. Additionally, HOEPA provides that purchasers or assignees of mortgages covered by HOEPA are subject to the claims and defenses with regard to the mortgage that consumers could assert against creditors, unless ordinary due diligence would not have revealed that the mortgage came within HOEPA's thresholds. Secondary market participants must be mindful of these requirements and should have the appropriate procedures in place to address these provisions and thereby protect against HOEPA violations. Similarly, discrimination in residential real estate related financing transactions is prohibited under Section 805 of the Fair Housing Act and the secondary market is subject to these provisions.

   In addition, Congress should consider legislation to require that:

   (i) Loan sellers disclose to the rating agency/bond insurer/issuer of security the number of HOEPA loans in the mortgage pool, plus other data items for HOEPA loans to be determined by regulation.

   (ii) Issuers of mortgage-backed securities disclose in their offering documents the incidence of HOEPA loans in the mortgage pools.

b) **Congress should clarify HUD's and the Federal Housing Finance Board's authorities to regulate the GSEs to prohibit their purchase of loans with predatory features** – HUD has existing general regulatory authority to ensure that the GSEs carry out their Charter purposes. Under this authority, HUD believes it may restrict the GSEs from funding loans with predatory features. Such loans may undermine the availability of mortgage credit to low- and moderate-income families.

   Because predatory practices are constantly changing, sufficient regulatory power and its exercise are the best means of addressing these practices. Accordingly, Congress should enact legislation to clarify that HUD, as the mission regulator of Fannie Mae and Freddie Mac, has the authority to prohibit the purchase by these entities of loans with predatory features. The Federal Housing Finance Board, as the mission regulator of the Federal Home Loan Banks should, to the extent necessary, be given similar authority with respect to these entities. Congress should also require that the two regulators work to ensure consistency in regulation of the GSEs' activities in this area.

Regulations in this area should address the restrictions already voluntarily undertaken by Fannie Mae and Freddie Mac:

- Prohibiting purchases of mortgages with excessive fees. Fannie Mae recently pledged not to purchase any loan if the total points and fees charged to a borrower exceed 5 percent of the loan amount, or to purchase high cost mortgages.

- Prohibiting purchase of mortgages with prepayment penalties, except where: the mortgage provides some demonstrated benefits to the borrower (e.g., such as rate or fee reduction for accepting the prepayment premium); the borrower is offered the choice of another mortgage that does not contain payment of such a premium; the terms of the mortgage provision containing the prepayment penalty are adequately disclosed to the borrower; and the prepayment penalty is not charged when the mortgage debit is accelerated as the result of the borrower's default in making his or her mortgage payments.

- Prohibiting purchases of mortgages made in conjunction with prepaid single-premium credit life insurance.

- Prohibiting purchases of any further mortgages from a seller/servicer that fails to document on a monthly basis that it is submitting payment information to a credit bureau.

E. Other Issues

1. Foreclosure Prevention[105]

Background

The procedures that a creditor must follow for foreclosure are generally governed by state law, local practice and the terms of the contract documents. This includes the amount or type of notice that consumers are entitled to receive about an impending foreclosure. Some states require creditors to provide an actual notice to the consumer of the foreclosure, but in other states notice by publication is deemed sufficient. In some states a judicial process is followed; the creditor must file a lawsuit and obtain a judgment in order to obtain permission to sell the property. Other states allow the use of a non-judicial process, where the creditor merely notifies the borrower that the home will be advertised and sold, thereby placing the burden on the homeowner to take legal action to prevent the sale if possible.

Some states go further, affording consumers the right to "cure" a delinquency or default and avoid foreclosure by bringing the obligation current.[106] Even after the time to cure the delinquency has passed,

[105] The descriptions in this section are adopted from the HUD/Fed 1998 report.

consumers generally have the right to "redeem" the property prior to the foreclosure sale by paying off the full amount of the mortgage plus any fees and expenses related to foreclosure. This is sometimes possible through a refinancing or private sale of the property. A few states even allow redemption of the property after the sale.

What is the Problem?
Not all states may adequately protect consumers from abusive practices in connection with foreclosures. Evidence presented in this report on rapidly increasing foreclosures in inner-city neighborhoods suggests that consumers in the subprime mortgage market may benefit from better notices with regard to foreclosure, and from increased protections against foreclosure under state laws. Borrowers in the high-cost loan market may be most in need of procedures to help them avoid foreclosure, especially where those procedures may give them the opportunity to qualify for financing on more affordable terms.

Policy Recommendations

a) **Require certain minimum standards for the notice creditors must provide in home foreclosures –** New federal legislation should establish notice requirements that maximize opportunities for borrowers to cure a delinquency or arrange other financing. Prior to any foreclosure sale, a borrower should receive a written notice that: (1) explains the consumer's substantive rights under state law and how he/she may avoid foreclosure; (2) the process that will be followed if those rights are not exercised; and (3) information about the availability of third-party foreclosure counseling.

b) **Encourage states to adopt foreclosure statutes modeled on "best practice" state laws –** The Task Force will work with states to develop model legislation to provide consumers with new pre-foreclosure protections. This legislation could be modeled on existing state laws that afford consumers substantive pre-foreclosure rights.

F. Actions that the Federal Reserve Board Should Take to Curb Abusive Lending Practices

Throughout Chapter VI, we recommend that the Federal Reserve Board use its existing authority to issue regulations and take new enforcement steps to prevent abusive practices. For ease of reference, this section summarizes HUD's and Treasury's recommendations to the Board.

1) Lower the HOEPA APR threshold to 8% above comparable Treasuries.

2) Include additional fees in the point-and-fee trigger, including costs of single-premium insurance products (if not prohibited) and all compensation received by the mortgage broker.

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[106] A right to cure the default may be subject to limits on how many times or how often the consumer may exercise the right.

3) Define as unfair, deceptive, or abusive practices and prohibit: loan flipping; sale of single-premium products along with mortgage loan; lending without regard to the borrower's ability to repay.

4) Collect additional data items under Regulation C, including manufactured home loan indicator; APR and "all-in" cost of credit; reasons for denial; name of parent institution on transmittal form; loan-to-value ratio.

5) Repeal the Regulation C 10 percent rule.

6) Consider conducting risk-based examinations of non-bank lending subsidiaries of bank holding companies where it has a basis to believe that such subsidiaries are violating HOEPA or otherwise engaging in predatory lending.

VII. Recommendations for Appropriations

It was clear from the five public forums and the testimony of the experts on our National Task Force that funding would help in our fight against predatory lending. Funding directed towards foreclosure counseling, fair housing initiatives, legal services, and regulatory enforcement would be especially helpful.

A. Housing Counseling

HUD's housing counseling program, currently funded at $15 million, provides a wide variety of counseling services to homebuyers, mostly those venturing into the mysterious world of homebuying for the first time. By learning more about mortgage applications, credit histories, and financing options, over 250,000 consumers are making better informed decisions each year. HUD has asked that this budget be increased by $9 million for FY 2001, to help another 150,000 families move into homeownership. Congress should approve this budget request.

B. Local Fair Housing Initiatives

The testimony at our public forums and the data we do have on predatory lending is clear: minorities and minority communities are frequent targets of predatory lenders. HUD's already expanded enforcement of the Fair Housing Act will help address some of this problem. But, as the last month has made clear, we also need to educate more people specifically on the techniques and signs of predatory lending. HUD's Fair Housing Initiatives Program (FHIP) funds private, nonprofit fair housing groups to help HUD monitor, enforce, and educate the public about the Fair Housing Act. HUD has asked that the Congress increase the FHIP funding in 2001 by $5 million bringing the total to $29 million.

C. Legal Services

One of the most important findings of the field hearings was that Legal Services Attorneys throughout the United States are in the front line addressing the explosion of foreclosures confronting low- and moderate-income families. By increasing their training and expertise, we will directly help more consumers avoid and escape from the clutches of predatory lenders. The President's FY 2001 budget requests $340 million for the Legal Services Corporation, a $36 million or 12% increase over the FY 2000 enacted level.

D. Regulatory Enforcement

Congress should fully fund the President's requested increase in the budget for the Federal Trade Commission. Full funding will help the agency to meet the urgent need to increase its focus on combating abusive home mortgage lending practices.

VIII. Recommendations for FHA and Other Initiatives

There are several policy decisions that can be made and put into action without waiting for new legislation, expanded funding or regulatory changes. HUD's FHA has already done intensive work on predatory lending in Baltimore in the last few months. HUD and Treasury together have also developed new ideas from the public forums. In most instances, these ideas can take effect in the next few weeks and begin to have an immediate impact on predatory lending.

A. New Initiatives from the Baltimore Task Force

In March, 2000, United States Senator Barbara Mikulski held a hearing in Baltimore that focused on abusive real estate practices, including asset flipping and the sale of homes at inflated prices. The hearing revealed that predatory practices were being visited upon both subprime and FHA borrowers. Of great concern to Senator Mikulski was the blighting effect that these practices, and the resulting wave of foreclosures, were having on low- and moderate-income communities, and the financial hardship imposed on Baltimore families. In partnership with HUD Secretary Andrew Cuomo, Senator Mikulski proposed the creation of a Baltimore Task Force to learn more about these abuses. The Task Force's goals were to use Baltimore as a laboratory to gather information on the cause and extent of mortgage scams and resulting foreclosures, and develop recommendations that would benefit Baltimore and serve as a model for FHA programmatic reform throughout the nation.

Working with the Baltimore Task Force, FHA developed a series of new initiatives to address predatory practices targeted at FHA and its borrowers, including inflated appraisals, fraudulent underwriting, asset flipping and other lending abuses. FHA's reforms to protect homeowners from predatory lending focus on two main areas: (1) providing relief to those FHA borrowers already in distress, especially those who have been victimized by abusive lending practices; and, (2) strengthening FHA endorsement and fraud detection procedures to prevent predatory practices from occurring in the first place. The new reforms build on existing FHA efforts to streamline operations and eliminate abusive practices including Credit Watch, the Homebuyer Protection Plan, and a variety of reforms of the FHA property disposition program including the new Marketing and Management Contractors, the Good Neighbor Sales Program, and the Teacher and Officer Next Door Programs.

In some instances, the new initiatives will be immediately available on a national basis. In other instances, FHA will operate pilot efforts in Baltimore and other selected "Hot Zone" cities (defined as those with excessively high default and claim rates) to further test and refine the concept before moving to national implementation. In all cases, this new Fraud Protection Plan will better protect FHA, FHA borrowers and the communities FHA serves from the harmful effects of the rampant growth of predatory practices in the home finance market. Details of these initiatives follow.

1. Helping Victims Avoid Foreclosure and Retain Their Homes

Although the goal of FHA's reform initiatives is to prevent predatory lending practices from occurring in the first place, FHA also is developing a full array of tools to help those borrowers who already have been victimized to avoid foreclosure, retain their homes with a reasonable level of debt and, if necessary, repair their credit. New initiatives to help the victims of predatory lending include:

a. Counseling Borrowers in Default. HUD's network of more than 1,200 approved counseling agencies nationwide help thousands of families every year make well-informed home purchase decisions. But the availability of counseling services is uneven across geographic areas, and there are far too few agencies with the capacity to provide specialized foreclosure avoidance counseling to borrowers in default. Therefore, FHA is launching a new initiative to directly fund default counseling in select "Hot Zones". Through this program, FHA will offer borrowers in default a voucher for counseling services, redeemable at their local HUD-approved counseling agency. Once completed, the counseling provider agency can redeem the voucher with HUD to receive payment. As an eligible FHA foreclosure avoidance effort, this initiative will be funded from FHA's mortgage insurance fund.

b. Restructuring Inflated Mortgages. Once FHA identifies a mortgage based on a fraudulent appraisal, FHA will move to force the lender to write the mortgage down to a level consistent with true market value. If needed, the family will be provided a 203k purchase rehab loan to fund the cost of needed repair. In the case of a recalcitrant lender, FHA loss mitigation specialists will intervene directly, cancel the insurance, take possession of the deed, and resell the property with FHA insurance to the family for the fair market price.

c. Repairing Credit of Abused Borrowers. In cases of default or foreclosure linked to fraudulent appraisals or underwriting, FHA will instruct the lender to issue a "credit repair letter" to the borrower and notify the credit reporting agencies of this action.

d. Approving New Software to Empower Default Counselors. Working in cooperation with national venders, FHA has developed guidance on new computer software which assists default counselors in examining FHA foreclosure avoidance options and advising clients as to the best course of action. The first software package approved for use under this new initiative, "BackInTheBlack" loss mitigation application, was developed by a Baltimore based company, and is available free of charge to local housing counseling agencies. FHA is also currently reviewing additional software programs at the request of other developers. FHA is pleased to participate in the development of these foreclosure avoidance software packages which, when used properly, promote effective early response and appropriate use of FHA's foreclosure avoidance actions.

e. Focusing Resources on Loss Mitigation Assistance. In "Hot Zone" areas with high default and foreclosure rates, FHA will establish teams of loss mitigation specialists to work with lenders and borrowers to ensure that every effort is made to help families remain in their homes.

2. Protecting FHA Homeowners From Predatory Lending

FHA's new preventive measures include initiatives designed to: (1) strengthen FHA loan endorsement policies and procedures; and, (2) enhance FHA's ability to identify and discipline perpetrators of fraud and predatory lending practices.

a) Initiatives to Strengthen FHA Endorsement Policies and Procedures

1. Identifying Flipped Properties Prior to Loan Endorsement. One of the most prevalent predatory practices among some FHA lenders in Baltimore is financing property flips. This occurs when a property is purchased by an investor for a relatively low price then quickly resold, or flipped, to an unsuspecting purchaser for a much higher, inflated price with little or no improvements to the property. With an inflated appraisal and loan amount, the ultimate purchaser pays too much for their home and is set up for failure. To prevent this practice, FHA will use newly available data on prior homes sales to check each application for FHA insurance and determine if the requested mortgage amount is consistent with the property's previous sales price history. Those cases evidencing asset flipping will be denied FHA insurance, pending further investigation. As part of this initiative, FHA also will monitor future applications for FHA insurance to prevent former FHA REO foreclosed properties from being flipped and returned to the portfolio at an inflated price.

2. Restricting Loan Points and Fees. The Baltimore Task Force identified some cases in which FHA borrowers were charged unreasonably high points and fees, as is the case with many subprime loans. Given that FHA provides 100 percent insurance coverage and that FHA loans have simple, uniform terms, the costs associated with making an FHA loan should be comparable to other conventional loans. Therefore, FHA will impose a cap on the total amount of points and fees charged FHA borrowers.

3. Tightening Use of Gifts for Downpayment. The Baltimore Task Force identified the fraudulent use of gift letters as another practice used by unscrupulous lenders to qualify borrowers for inflated mortgages. FHA will release new and clearer guidance designed to tighten controls on FHA gift letters and enhance monitoring of these provisions.

b. Initiatives to Identify and Discipline Perpetrators of Fraud and Predatory Practices

1. Using "SWAT" Teams to Identify Unscrupulous Appraisers and Predatory Lenders in Hot Zones. In Baltimore, FHA sent a SWAT team to review all foreclosures taking place from January through March of 2000. Based on this review, FHA identified a number of apparently fraudulent practices on the part of FHA appraisers and lenders. These individuals and firms will be referred to FHA's Quality Assurance Division for further action, and if appropriate, to HUD's Enforcement Center or Office of Inspector General. By immediately stopping such bad actors in their tracks, communities can begin to recover. HUD plans to immediately extend the SWAT team approach to assess potential fraudulent activities in other cities now experiencing high numbers of FHA defaults and foreclosure

2. Implementing Credit Watch for Appraisers. The Baltimore Task Force identified fraudulent appraisals as a key contributor to subsequent default and foreclosure. FHA is currently implementing a new automated appraisal review system. To increase the effectiveness of this system, and building on the Credit Watch for Lenders, FHA will create a Credit Watch System for Appraisers that will rate appraisers on the performance of the loans linked to their appraisals. Appraisers with a consistent pattern of participating in loans that quickly move to foreclosure will be targeted for further review and, if appropriate, removed from the FHA Appraisal Roster. Like FHA's Credit Watch for Lenders, this new system will allow FHA to discipline appraisers simply based on poor performance.

Similarly, lenders associated with poorly performing appraisers will be targeted for further review and action. Finally, FHA is releasing a list of the appraisers associated with FHA foreclosed loans reviewed by the Baltimore Task Force (See Appendix B for a list of appraisers and lenders associated with loans reviewed by the Task Force). This summary shows that just five individual appraisers were responsible for the appraisals on nearly 40 percent of all FHA foreclosures in Baltimore City that occurred between January and March, 2000, and were underwritten within the last three years. Likewise, only five lenders accounted for almost 50 percent of all FHA foreclosures in the same period.

3. Tracking Mortgage Brokers. Today FHA electronically identifies the lender, the appraiser, and the non-profit entity (if any) involved in making an FHA loan. With a growing number of FHA-insured loans originating with the significant involvement of mortgage brokers, the Department believes it must also develop the capacity to monitor loan performance by individual mortgage brokers. To further enhance oversight of the underwriting process, FHA will require that the Tax Identification of any Mortgage Broker participating in the transaction be recorded as well. This new information will give FHA, for the first time, the capacity to monitor broker performance and target for disciplinary action those associated with a high loan default and claim rate.

4. Suspending Abusive Brokers. Through listing of properties on Multiple Listing Services (MLS) and the Internet, FHA's new management and marketing procedures have streamlined the sale of FHA foreclosed properties and expanded the number of participating real estate agents. Working with the Baltimore Task force, FHA will review the list of participating real estate brokers and terminate unscrupulous brokers from future participation in FHA programs.

5. Early Warning Indicators. FHA will customize data from its Neighborhood Watch system to develop early warning indicators of emerging foreclosure "Hot Zones." This data will enable local officials and HUD approved counseling organizations to better target outreach to families at risk of foreclosure. FHA will also make available summaries of the appraised values of FHA properties to help local officials better assess real estate trends and spot possible patterns of appraisal abuse. This public information will include performance data on individual appraisers generated by the Credit Watch for Appraisers system and posted on the HUD website.

B. New Initiatives from the Public Forums

Based on the testimony heard in the five field hearings and the advice of the Task Force Members, Treasury and HUD identified two key strategies for fighting predatory lending: increase consumer education about predatory lending abuses and expand our cooperative initiatives with the industry.

1. Housing Counseling

While certainly no cure-all, expanding and strengthening available homeowner counseling will better enable consumers to make intelligent choices in the mortgage market. Without waiting for further legislation or regulatory changes, HUD can increase the counseling activities in the following ways:

a) **Expert Software System.** Working cooperatively with American Association of Retired People (AARP), HUD will develop a new "expert system" to aid housing counselors in identifying loan terms that are not in compliance with HOEPA, TILA or other applicable laws. This initiative will build on ongoing efforts to develop computer aided counseling tools for FHA's Home Equity Conversion Mortgages (HECM).

b) **Activate the Fair Housing Network.** As part of HUD's Best Practices Symposium to be held in August, 2000, HUD will convene a working session of representatives of FHIP other state and local fair housing and legal services agencies to discuss new legal approaches to confronting predatory lending, especially those aspects of predatory lending linked to racial targeting and other potential violations of applicable fair housing laws.

c) **Preventive Consumer Education.** Working with participating Task Force organizations and the NPFE, HUD and Treasury will work to mount a national public campaign to raise consumer awareness of mortgage abuses. Such an initiative could build on a similar campaign now underway in North Carolina and a newly announced campaign in the development phase in Baltimore.

2. Cooperative Initiatives with Industry

It was clear from our public hearings that many industry groups view predatory lending as a threat to their image and success. As a consequence, several private groups are now moving to establish voluntary codes of conduct, best practices, and other efforts to help protect consumers from the abuse of predatory lending. While no substitute for needed legislative and regulatory change, these initiatives are a positive step and an important acknowledgment which the Federal government should recognize and encourage. As a continuation of this Task Force process, HUD and Treasury will be working with industry groups, especially Task Force Members, to encourage them to take will pledges about the actions they will take to help in the fight against predatory lending. The pledges could address the following topics:

a) **Registration of Mortgage Brokers.** The National Association of Mortgage Brokers proposed a national clearinghouse to register mortgage lenders and brokers. This universal registration system will enable national, state, and local regulators to better monitor and take appropriate enforcement actions against abusive loan origination practices. HUD will also take a pledge making a commitment to supporting the development of this system.

b) **Referral Pledge.** The data reveals that some, perhaps significant, number of borrowers in the subprime market, particularly minority borrowers, would actually qualify for prime loans. To expand access to the prime market for these homeowners, Task Force Members should develop a Model Best Practices Agreement that would be signed by major prime market lenders voluntarily agreeing to develop practices that require their subprime subsidiaries or affiliates to "refer up" all borrowers that could qualify for prime loans.