

**Testimony of
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Predatory Mortgage Lending
Before the
Committee on Banking and Financial Services
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Mr. Chairman, Congressman LaFalce, and Members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation on predatory lending and related issues. My testimony today will discuss the distinction between subprime and predatory loans, describe what the FDIC is doing to address predatory lending, and provide some comments on legislative proposals to address predatory lending.

As your letter of invitation suggests, abusive lending practices in the home mortgage industry are often directed at low-income and elderly borrowers. We believe that federally insured depository institutions have a good record of avoiding involvement in such activities. Nonetheless, the FDIC recognizes that predatory lending practices raise a number of consumer concerns as well as safety and soundness issues. Predatory lending can:

- cause substantial harm to financially vulnerable and unsophisticated consumers and undermine the stability of the neighborhoods where the loans were made;
- lead to a high volume of foreclosures which are costly to the holder of the mortgage;
- undermine the reputation of individual financial institutions and the public's trust in the financial services industry as a whole; and
- subject institutions that might unwittingly support predatory lending to the risk of costly litigation.

The Distinction between Subprime Lending and Predatory Lending

So that there is no misunderstanding, let me clarify two terms that are sometimes confused: "subprime" lending and "predatory" lending. Although a precise definition of "subprime" lending remains subject to debate, the "Interagency Guidance on Subprime Lending" issued by the federal banking agencies on March 1, 1999, defines subprime lending as "extending credit to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers." Subprime lending is linked to the credit status of the borrower. That is, subprime lending serves the market of borrowers whose credit history would not permit them to qualify for the conventional "prime" loan market. A well-managed subprime lending program, with appropriate capitalization and loan pricing, provides an important source of credit for

these borrowers in a manner consistent with safe-and-sound banking. Consequently, the FDIC does not want to inhibit subprime lending which meets these criteria. Lenders should have the flexibility to effectively manage their risk without reducing credit availability for those who must rely on "subprime" products to obtain the financing that they need.

While most predatory loans are made to subprime borrowers, predatory lending is product-driven. We would describe as "predatory" those loan products that use certain marketing tactics, collection practices, and loan terms that, when combined, deceive and exploit borrowers. Practices and terms that in combination are commonly found in predatory lending, principally home equity lending, include:

- High-pressure and/or misleading marketing and sales efforts;
- Excessive fees and interest rates at levels well beyond those appropriate or necessary to cover risk and a profitable return;
- Excessive origination fees and/or excessively priced or unnecessary products, such as can be the case with single premium credit life insurance, that are included in the loan balance;
- Large prepayment penalties that are intended to trap borrowers in an unfavorable or unaffordable loan;
- Balloon payments that have unrealistic repayment terms and often result in foreclosure;
- "Loan flipping," or frequent refinancing, with fees folded into the loan balance repeatedly, resulting in rising loan balances and the "stripping" of equity; and
- Aggressive, often abusive, collection practices.

One example of how predatory lenders strip equity from homeowners is through repetitive refinancing. In some instances, a loan may be refinanced two or three times in a single calendar year. The lender convinces the borrower to do so ostensibly to get lower interest rates and/or lower monthly payments. However, at each refinancing, new points and fees are charged and made part of the loan balance, so that the loan payment savings that the borrower hopes to realize are lost. This repetitive process dips into the owner's equity in the home and may ultimately lead to foreclosure.

Predatory lending is more successful in reaching its targets in the subprime market as these borrowers have fewer options for getting credit and are often less financially sophisticated. Predatory loans can also be marketed to conventional borrowers, such as elderly homeowners or low-income borrowers, who may have been unfairly steered to high cost products by lenders who are well aware that these borrowers could qualify for reasonably priced credit, but who do not offer it. Some of these individuals may have had the misfortune of previously doing business with a lender that failed to report their sound credit performance to the credit bureaus.

FDIC Efforts to Address Predatory Lending

The FDIC has not uncovered evidence that indicates insured depository institutions are actively originating loans with predatory features. However, the FDIC is concerned that

banks and thrifts, like other institutional investors, may be involved in the predatory loan market in an indirect fashion.

One indirect form of funding predatory loans is through the relationships that banks may have with mortgage brokers. Brokers, who often function as the primary point of contact for borrowers during the application phase of the loan process, have a substantial influence on the terms of the loan products eventually received by lenders. This influence can be either positive or negative. When negative, such influence may encompass deceptive or misleading practices which deny borrowers the opportunity to be fairly informed of the true costs of their loans and which encompass compensation arrangements which drive up these costs. Lenders should not encourage predatory practices by supporting brokers who misuse their influence over borrowers.

Another indirect method of funding involves banks and thrifts purchasing loans or securities backed by predatory loans, or by offering credit lines to nonbank predatory lenders. These indirect means of funding predatory lending may subject an institution to increased credit, reputation and legal risk because the institution does business with predatory lenders or mortgage brokers.

The FDIC is addressing the issue of predatory lending in a number of ways. We are writing guidance for insured depository institutions describing effective practices to keep them from inadvertently acquiring loans (or securities backed by loans) that have predatory features. Second, we will work on an interagency basis to revise Community Reinvestment Act (CRA) examination practices so that a bank's purchase of loans (or securities backed by loans) that have predatory terms or features cannot be used to improve the bank's CRA rating. Third, we are giving positive CRA consideration to bank sponsored programs which combat predatory lending by fostering financial literacy. Fourth, we are working on an interagency basis to review other consumer laws and regulations to determine whether regulatory changes may be warranted. Fifth, we are holding several public forums across the country in which community organizations, government officials, and members of the financial community can meet and explore effective means to protect consumers. Finally, the FDIC is working on a financial literacy campaign to educate consumers about the risks of predatory lending.

More specifically:

- We are developing a set of effective practices that lenders could voluntarily implement to avoid involvement in predatory lending in any manner. This guidance will offer suggestions to lenders to ensure that they are not facilitating the predatory practices of others.
- We should not permit loans with predatory terms to be used to improve a bank's CRA rating and will work on interagency guidance to assist examiners in determining whether loans in low- and moderate-income neighborhoods exhibit such terms. Because we do not have evidence to date that insured depository institutions originate such loans, the examination guidance should focus on

purchased loans and mortgage-backed securities targeted to low- and moderate-income census tracts.

- We already acknowledge the community service provided by bank-supported financial literacy programs in our assessments of bank CRA performance. As these programs combat predatory lending, we recognize that they warrant heightened consideration -- particularly where they are coupled with broader efforts that demonstrate bank commitment to fight abusive lending practices in their communities. Examples of activities which show a strong commitment to reducing predatory lending include: (1) opening a branch office in a low income neighborhood to give consumers greater choice of lenders and loan products, or (2) implementing a program to assist borrowers to refinance their outstanding predatory loans.
- We are working with the other banking agencies, the Federal Trade Commission, the Department of Justice, and the Department of Housing and Urban Development to address predatory lending issues. We are assessing the effectiveness of disclosures made to loan applicants under the Truth in Lending Act, Real Estate Settlement Procedures Act, and other consumer protection laws and regulations to determine whether those laws can be used to address predatory practices or whether any legislative initiatives may be necessary. We also are consulting with those agencies to develop a policy statement on predatory lending practices and a list of effective practices for lenders.
- We are conducting a series of roundtable discussions with banking and community groups to encourage banking industry awareness on the issue of predatory lending and to share information on effective practices to address the problem of predatory lending. Yesterday, we hosted our first public forum, "Predatory Lending: Banking on Solutions," in Boston, Massachusetts. We met with leading experts, including representatives from state and local government, financial institutions, bank trade groups, and government-sponsored enterprises to explore critical issues associated with the financing of predatory loans. We also are holding a series of meetings with consumer groups to develop educational material for consumers who are targets of abusive lending practices. As part of that initiative, we held two meetings in April. Finally, we are collaborating with the U.S. Department of Health and Human Services, Administration on Aging, on a national financial literacy campaign targeted to older women. The FDIC will participate in the first two educational seminars under this initiative, "POWER 2000: Take Control of Your Financial Future," which are scheduled in June in New York City and upstate New York.

Suggestions to Address Predatory Lending

The FDIC is tracking the efforts of various states and cities that are pursuing predatory lending efforts. I would like to highlight some of these initiatives to provide you a broader perspective on this issue.

- The Department of Financial Institutions (DFI) of Washington State has identified the types of predatory lending practices conducted by mortgage brokers, mortgage lenders, banks, or others with access to financing arrangements. The

DFI found that the majority of deceptive practices take place in refinance transactions for "subprime" or "hard money" loans. The apparent reason for this is that a refinance transaction involves fewer parties than a purchase transaction, which makes the deception easier to cover up.

- The City of Boston has implemented a "Don't Borrow Trouble Campaign." Its objective is to educate consumers about predatory lending and provide access to special lending programs, more in-depth education, and credit management or foreclosure prevention counseling. This campaign is noteworthy for its scope and content, as well as for the broad-based collaboration that has made it possible.
- Although a number of states are considering legislation, North Carolina is the only state that has enacted a statute intended to address predatory lending practices. Enacted July 1, 1999, the law applies to loans made on or after July 1, 2000 and focuses on predatory home mortgage and equity lending. This statute defines certain loans as "high cost" and takes an aggressive position in flatly banning a series of practices/loan terms.
- Finally, the Department of Banking in the state of New York has been active in crafting guidelines for financial institutions and developing consumer education materials. In an effort to prevent abuses related to high cost home loans, the Department released three brochures designed to educate consumers about subprime lending generally, and to caution potential borrowers against fraudulent practices particularly in connection with home equity and home improvement lending. A set of guidelines to be formalized later this year will be aimed at the secondary market, including Wall Street investment banks that have been active in the securitization market for subprime loans. The Department has also proposed regulations on high cost home loans that will generate comments and advance the collective thinking on these issues.

At the federal level, several laws and regulations prohibit fraud and certain misleading or deceptive sales and marketing practices. Federal fair lending and consumer protection laws, such as the Fair Housing Act, the Equal Credit Opportunity Act, the Truth in Lending Act as amended by the Home Ownership and Equity Protection Act (HOEPA), and the Real Estate Settlement Procedures Act also provide substantive protection to borrowers. These laws provide disclosure requirements, define high cost loans, and contain anti-discrimination provisions. However, current law does not fully address a number of predatory practices found in some loans in the mortgage market - especially in the markets for refinancing and for home equity loans, such as unrealistic balloon payment terms likely to lead to foreclosures or inappropriately folding certain fees into the loan balance.

The FDIC is evaluating alternatives to current laws and regulations that might curb predatory lending. Our evaluation of those alternatives will be guided by the following principles:

- Allowing continued access to credit for the widest range of qualified customers;
- Protecting against the abuse of vulnerable individuals; and
- Allowing sufficient return for lenders to provide credit on a risk-justified basis.

As you know, several proposed predatory lending bills are aimed at providing consumer protection against abusive practices in connection with mortgage loans. Some proposals ban such practices as balloon payments and prepayment penalties while others prohibit the charging and/or financing of certain fees. While well-intended, outright prohibitions of such practices could unduly limit credit availability or increase the cost of credit to the same consumers that we are trying to protect. For example, a loan amortized over 30 years with a balloon payment due after five years may provide a borrower with a reduced interest rate as well as an opportunity to rehabilitate his or her credit record in order to refinance the loan later at a better rate. Improved disclosure or required credit counseling might be better options than an outright ban on balloon mortgages.

Some of the current legislative proposals include legislative and regulatory changes that are intended to protect consumers, preserve informed consumer choice, and preserve lenders' ability to make use of appropriate risk-management techniques. These ideas include:

- Improving the meaningfulness of disclosures required under current law concerning closing costs, annual percentage rates, and consequences of failure to repay;
- Imposing more limitations on balloon payments and prepayment penalties or requiring better disclosure of such practices;
- Subjecting a larger number of loans to the high cost mortgage protections, including enhanced disclosures, offered under HOEPA;
- Prohibiting the financing of single premium credit life insurance for loans subject to HOEPA;
- Requiring independent credit counseling before closing loans subject to HOEPA; and
- Requiring the reporting of credit payment activity.

The FDIC does not believe these suggestions would materially impede the credit markets that serve lower income, minority, and elderly individuals, nor would they impair bank competitiveness.

The financial services industry as a whole must also take an active role in addressing the issue of predatory lending. Any remedies should be a collective effort between the industry, government, and community groups and would likely include better disclosures and more consumer education. As regulators, we need to: 1) make sure that all loan terms are fair and fully disclosed so that any lending does not cross the line into predatory lending; 2) help prevent banks from unwittingly purchasing or funding loans from predatory lenders; and 3) increase customer awareness.

Once again, the FDIC commends the Committee for focusing attention on this important issue. We look forward to working with the Committee to attempt to craft a balanced solution to combat predatory lending practices.

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