Partners in community and economic development

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Predatory Lending

Predatory lending practices are real. There is no mistake that it occurs, and based on anecdotal information and most surveys or reports so far, it appears that the victims are typically older, lower-income, and minority. It is offensive, and it is wrong. But as you might expect, there is more to stopping it than "just say no."

Many of our constituents have worked long and hard to ensure equal and fair access to credit, and the results are impressive. We now boast the highest home ownership rate in our nation's history. Nontraditional underwriting, including higher debt ratios or lower down payments, for example, has revolutionized the home mortgage lending industry. Technology changes that allow more efficient underwriting and the advent of credit scoring have also allowed market penetration like never before. And risk-based pricing has certainly fueled lender willingness to assume higher risks.

Predatory lending practices themselves may not be new, but the stories of abuse have become too common. And public outcry is appropriate. Everybody is speaking out against it and looking for ways to fight back.

Partners is compelled to dedicate this issue to the fight against predatory lending. We begin with a discussion of predatory lending practices. Flipping. Packing. Targeting. Stacking. While individual actions may not be illegal, many of these practices are unjustified and inappropriate at best.

We present a regulatory analysis of the subject of predatory lending, and feature perspectives from the Federal Reserve, Office of the Comptroller of the Currency (OCC), Office of Thrift Institutions (OTS) and the Federal Deposit Insurance Corporation (FDIC). We include a nationally recognized consumer advocate's testimony to Congress (Bill Brennan, Atlanta Legal Aid Society), and the Mortgage Banker's Association of America's "Seven Point Plan" for mortgage reform.

Everybody agrees: these practices must stop. But definitions are hard because nobody wants to cut the flow of credit to under-served markets. One theme is common throughout the industry – the line between predatory and subprime lending is difficult to define, and stopping predatory lending must not reduce access to credit through appropriate risk-based pricing, or "responsible subprime lending."

While this issue of Partners can't resolve the issues surrounding predatory lending, we hope to add additional light on the subject and join forces toward seeking solutions. Along those lines, we feature a summary of the Home Ownership Equity Protection Act and a Consumer Corner on education. We welcome the opportunity to join your organization in speaking out against predatory lending practices. Together we have made great strides in providing fair and equal access to credit, almost to the point that we take it for granted. We have penetrated markets like never before, reaching goals that seemed unimaginable just 10 or 20 years ago, and developing new and improved loan and investment products that knock down old barriers. We must not let unscrupulous lenders damage the progress we have made. In the end, we all have an interest in stopping abusive practices and putting predatory lenders out of business.

-Editor

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What is Predatory Lending?

By Wayne Smith

We have all heard of situations where lenders target more-vulnerable borrowers who have significant equity in their home, with the ultimate intention of seizing the property. The borrowers are typically saddled with excessive costs, often clandestinely. The loans are booked based on the equity in a house, not on the income available to repay the loan. Foreclosure becomes inevitable. But is predatory lending always that clear cut? Unfortunately, no.

Subprime Lending

In order to define predatory lending, one must start with an understanding of subprime lending. "Subprime" refers to lending where borrowers have some form of credit impairment. The term applies to borrowers who do not qualify for the "prime market" and is also known as "B, C, or D paper" – contrasting with the prime market's "A paper."

A borrower's credit history determines his/her credit score as assigned by a credit rating agency. A credit score can be adversely impacted for reasons such as a history of late payments or previous defaults. Whether fair or unfair, such blemishes represent higher risk to a lender in future borrowing requests. To compensate for taking such risks, a lender will typically charge a higher interest rate and/or added fees.

The industry practice of risk-based pricing is nothing new. In fact, it usually represents a positive thing, when done fairly, because it enables a borrower to obtain the credit they may need and work their way back to "A" status. Therefore, responsible subprime lending represents a way for borrowers to maintain access to credit despite past impairment. Where is that line drawn before risk-based pricing goes too far and becomes predatory? There is no magic answer, largely because state and federal laws are rather broad concerning agreements between two parties. Consensus toward a workable definition seems to lie in predatory lending's attributes – the list of practices that can be considered abusive.

The Typical Borrower

Before discussing abusive practices, it's appropriate to provide an example of how the predatory process usually begins. The profile of a typical "victim" is an individual (often minority or elderly) in an older home with a legitimate need, such as a new roof. A disproportionate percentage also seems to be African American or Hispanic, although targets are not confined to these groups. Both urban and rural areas are susceptible, and many middle-income populations are targets due to having problems with past credit histories.

With limited cash flow, but with accumulated equity in their home, the borrower is approached by a lender with a loan to repair the roof. Through confusion or fine print, the borrower often finds out after it's too late that their loan contains added costs that have escalated the monthly payment to the point of unmanageability. Even if suspicion is raised at the time of loan closing, borrowers may go through with the deal because of the overwhelming need as well as the perception that they have no other options.

Abusive Practices

Having noted the positive aspects of subprime lending and the typical borrowing situation, what exactly makes a loan predatory? The line is usually crossed with a series of practices that have come to be viewed as abusive. A sample of some of the more common adverse practices include the following:

- "Targeting" vulnerable homeowners (e.g. seniors, less-educated) who have substantial home equity;
- Lending on a home's equity rather than the borrower's cash flow capacity;
- "Packing" unnecessary items such as high-cost single-premium life and other insurance products on top;
- "Stacking" high origination and other fees that are rolled into the note;
- "Flipping" -- frequent refinancings with additional fees that strip equity;
- Requiring a balloon payment after 5 years on a 30-year interest-only note; and
- Imposing an excessive prepayment penalty.

Conclusion

The definition of predatory lending remains rather elusive because of gray areas within each of the adverse practices listed above, and because taken by themselves, they may not be illegal. Misrepresentations, including fraud, are clear cut predatory practices and are illegal. Other practices cross the line as predatory when the basic tenets of safe and sound lending are not upheld, especially with regard to Fair Lending laws and a borrower's ability to service an obligation out of income.

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Consumer Advocate Perspective
By William J. Brennan, Jr.

On May 24, 2000, William J. Brennan, Jr., gave testimony before the House Committee on Banking and Financial Services concerning predatory lending. Mr. Brennan, an attorney, is the director of the Home Defense Program of the Atlanta Legal Aid Society, Inc., and a national spokesman on predatory lending issues. Below is a summary of his recent remarks.

Based on my 32 years at the Atlanta Legal Aid Society, 12 years as director of the Home Defense Program, and hundreds of subprime lending cases that have come through my program, I have never seen a subprime mortgage lender not engage in one or more of three distinct categories of predatory practices.

They overcharge on interest and points. Since these companies only lend at 70-80% loan-to-value ratios, they have a 20-30% cushion to protect them if they have to foreclose.

They perpetrate other profitable abuses. They purposely engage in other abusive lending practices that effectively allow the lenders to collect hidden, indirect interest and thereby increase profits. Examples are loan flipping; packing the loan with overpriced single premium-financed credit life, disability and unemployment insurance; balloon payments; high prepayment penalties; using scam home improvement companies to generate originations; paying kickbacks to mortgage brokers to generate originations; and paying off low cost or forgivable mortgage loans.

It is crucial to understand that the profitability of the subprime mortgage lending business is derived not just from overcharging on interest and points, but also from engaging in the listed abusive lending practices set out above. The profitability is inextricably intertwined. While the price of the loan product should be related to actual risk, the abusive practices listed have nothing to do with risk and cannot be justified.

They target groups based on age, race, income, and sex. Predatory mortgage lenders purposely target vulnerable elderly, minority, low and moderate income, and women homeowners with high cost abusive mortgage loans. Elderly homeowners, who tend to have substantial equity but live on fixed incomes are perhaps the principal targets. Some banks and other mortgage lenders engage in redlining by designating entire communities as bad financial risks and refusing to make them prime rate loans. Redlining creates a credit vacuum filled by the predatory lenders. These predators target these same areas with overpriced loan products, knowing that the residents are a captive market with no access to reasonably-priced credit. This is called reverse redlining. Finally, a disproportionate number are women. Most of these are elderly, African American, and widowed.

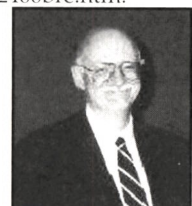
Although most banks have played no role in the subprime lending business, some banks have played a very significant role. We have numerous cases involving these bank-owned subprime entities. In these cases, we have seen countless examples of abusive lending practices, including high interest rate and points, loan flipping, home improvement scams, credit insurance packing, high prepayment penalties, etc.

Some banks make capital loans to support the operations of subprime mortgage companies. Other banks support subprime mortgage companies by acting as trustees in the securitization process. Some banks down stream [prime credit] potential customers to their subprime mortgage subsidiaries where they are subjected to high cost, abusive mortgage lending practices. Some banks engage in redlining practices. In sum, the involvement of these banks with subprime lending has been a devastating development in terms of the expansion of abusive, predatory mortgage practices in low and moderate income and minority communities.

The fact that these banks are federally regulated has made little difference. So far, the bank regulators have done little to stop the overcharging on cost and the other abusive practices. Now, to my dismay, Fannie Mae and Freddie Mac have announced they are getting into the subprime mortgage lending business. Unfortunately, self-reform does not seem to be occurring. Lenders might very well refrain from the few prohibited practices, but would simply expand into the permissible abuses because they are so closely tied to profitability.

All the abuses must be stopped. HOEPA should be amended by substantially lowering the interest rate and points and fees triggers. Further, all of the abuses discussed above should be prohibited. In addition, HUD and/or Congress should require that Fannie Mae and Freddie Mac expand their support for conventional mortgage lending in minority and low and moderate-income communities, and prohibit them from entering into subprime mortgage lending.

For a full text, refer to www.house.gov/banking/52400bre.htm.



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Trade Association Perspective on Predatory Lending

The Mortgage Bankers Association of America is a national association representing the real estate finance industry. Among other goals, they "work to ensure that federal legislation and regulation provide for safety and soundness, and consumer protection, without undue burdens and costs on private industry or on consumer choice." The MBAA has published a "Position Paper on Predatory Lending: An Opportunity to Benefit All Consumers Through Comprehensive Mortgage Reform," which is excerpted below. Their web site, www.mbaa.org, contains the full text of this paper.

When used appropriately, subprime lending makes homeownership possible for families who might not otherwise have access to financing. While the vast majority of lenders who make subprime loans provide a valuable service, a few unscrupulous operators take advantage of vulnerable consumers by charging excessive fees, using deceptive practices, and imposing debt that the borrower will never be able to repay.

The Mortgage Bankers Association of America (MBAA) is an active participant in the dialogue with Congress, federal agencies, and consumer advocates concerning abusive lending. As a member of the HUD/Treasury Joint Task Force on Predatory Lending, the MBAA is working closely with all of these parties to formulate solutions that work.

The MBAA believes that the heart of the problem is the complexity of the mortgage transaction, which allows unscrupulous operators to exploit the process and take advantage of consumers. That is why the MBAA has developed a seven-point comprehensive approach to reform the mortgage process and increase consumer protections.

This approach combines increased disclosures to borrowers, a simplified mortgage transaction, more consumer education and counseling, a commitment to fair lending practices, and increased enforcement authority.

1. **Fully Enforce Consumer Protection Laws**
Most cited abuses are illegal under current federal and state law. Consumer protection agencies should be fully funded and given the resources necessary to enforce these laws effectively.

2. **Simplify the Mortgage Transaction to Protect Consumers: The Loan Closing Costs Guarantee**
Pass legislation to establish a "Closing Costs Guarantee" program, which would require lenders

to provide mortgage applicants with an up-front loan closing price guarantee. The lender's guaranteed maximum loan closing price would be binding from the time of disclosure (prior to application) through the actual closing. The approach will enhance shopping while protecting from "bait and switch tactics."

3. **Increased Disclosures for Consumers**
Required disclosures would include a mortgage information booklet detailing the process, protections, warnings on common abuses, information about mortgage counseling, and a loan closing costs guarantee disclosure.

4. **Enhance Enforcement Tools/Provide Effective Remedies For Consumers**
Identify, strengthen and enforce federal penalties against prohibited practices, such as steering borrowers to high-rate lenders, intentionally structuring high-cost loans with payments the borrower can not afford, requiring credit insurance, failing to report good payment on borrowers' credit reports, etc. Also, provide and facilitate remedies for consumers, under law including the prohibition of final foreclosure without first ensuring the right of the consumer to list and make a good faith effort to sell the property [some exceptions apply].

5. **Increase Availability and Quality of Counseling for Prospective Borrowers**
The Federal Reserve and HUD should lead an effort to develop a uniform counseling program. The American Homeowner Education and Counseling Institute (AHECI), the MBA, and others should be involved.

6. **Increase Consumer Education Programs**
Support increased education, including financial literacy in the schools, to help potential borrowers make informed decisions.

7. **Industry Commitment to Fair Lending Practices**
Support fair lending initiatives, including a fair lending training program.

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Federal Reserve Viewpoint
By Gov. Edward M. Gramlich

Federal Reserve Board Governor, Edward Gramlich, spoke last April to the Fair Housing Council of New York, Syracuse, New York, on predatory lending. The following summary highlights the complexity of both defining predatory lending and resolving issues -- without eliminating access to credit for borrowers not eligible for the prime market.

This should be a time of great satisfaction for the advocates of low-income and minority borrowers because various technological changes and innovative financial products have caused an upsurge of credit to this market segment. Much of this expansion appears to be in the subprime lending market, which has opened up the possibility for many borrowers to realize their dream of owning a home and to have a chance for acquiring the capital gains that have increased the wealth of upper-income households.

But with the good news there is also bad news, or at least sobering news. Just as the expansion of subprime lending has increased access to credit, the expansion of its unfortunate counterpart, predatory lending, has made many low-income borrowers worse off.

Subprime Vs. Predatory Lending

The distinction between subprime and predatory lending is important. Subprime lending involves borrowers who do not qualify for "prime" rates – those rates reserved for borrowers with virtually blemish-free credit histories. Premiums range from about 1 point over prime for "A-minus" loans to about 6 points over prime for "D" loans. While these premiums have been questioned, long-run market forces work to minimize spreads.

Predatory lending, however, is difficult to quantify because the practices are shady, and information is incomplete or anecdotal. Abusive practices include outright fraud, excessive fees and interest rates, hidden costs, unnecessary insurance, and deceptive uses of balloon payments.

The ultimate difference between subprime and predatory lending comes back to the competitive assumptions. If one is a market optimist and believes that both lenders and borrowers are rational and well-informed, then subprime credit markets with proper rate differentials will open up. If one is a market pessimist and believes that borrowers are not well-informed and may not be fully rational, then some lenders will have opportunities to exploit these borrowers with predatory practices.

Distinguishing positive subprime lending from negative predatory lending is obviously important, particularly for regulators trying to encourage one type of lending and discourage the other.

Who Are the Subprime and Predatory Lenders?

Subprime lending tends to be done primarily by nondepository institutions, either finance companies or mortgage companies that are not subject to routine regulatory compliance audits and connected with regulated financial institutions.

In the mortgage market, relatively few of these loans are for first-time home-buyers – mostly they are for mortgage refinancings, second mortgages, or consolidating debt. Often these loans are securitized and sold to investors such as insurance companies and pension funds.

As mentioned, one distinguishes predatory lending from subprime lending by the features of the loan and, importantly, by whether the borrower understands the terms of the loan. Thus, there is no ready way to distinguish predatory from subprime lending, to identify predatory lenders, or to measure amounts. Yet most anecdotal reports or legal cases against predatory lenders have involved subprime lenders, and it is certainly logical to expect these practices to flourish in entities where regulators are remote.

Predatory lending is made possible by inadequate information. The fundamental weakness is the desire of uneducated borrowers for cash up front, typically reflecting a need for home repairs. Couple this with a lack of understanding of complex credit terms or conditions, and a resulting bargaining imbalance will often subject borrowers to outright fraud, falsifications, and even forgery. Apart from outright fraud, however, regulators and legislators feel reluctant to outlaw *potentially* abusive practices if these practices have legitimacy most of the time.

What Can be Done?

The Home Ownership Equity Protection Act (HOEPA) defines a class of "high cost" home purchase loans. While most analysts consider HOEPA to have been effective, many lenders reportedly skate just below the HOEPA requirements and still engage in egregious practices.

Most present attempts to deal with predatory lending try to broaden

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the HOEPA net by lowering the threshold cost levels and by preventing abusive practices.

Many states have also attempted legislative remedies. In July 1999, North Carolina enacted laws that prohibit prepayment penalties, loan-flipping, and single-premium credit life insurance on most home loans.

Other federal statutes address predatory lending less directly. The Truth in Lending Act requires all creditors to calculate and disclose costs in a uniform matter. Under this statute, lenders must disclose information on payment schedules, prepayment penalties, and the total cost of credit, expressed as a dollar amount and as an APR.

The Real Estate Settlement Procedures Act prohibits lenders from paying fees to brokers that are not reasonably related to the value of services performed by the broker. The Equal Credit Opportunity Act prohibits discrimination in lending on the basis of a number of "prohibited basis characteristics" such as age and race. The Federal Trade Commission Act prohibits unfair and deceptive practices.

And yet, with all this legislation, predatory lending may still occur. To address this issue, the Federal Reserve joined a nine-agency working group in the fall of 1999 to develop solutions. The agencies include five that regulate depository institutions (Federal Reserve, OCC, FDIC, OTS, and NCUA), two that regulate housing (HUD and the Office of Federal Housing Enterprise Oversight), and two that regulate or prosecute deceptive trade practices in general (DoJ and the FTC). The complete regulatory net of these agencies would cover all predatory lending. The aims of the group are to tighten enforcement of existing statutes, to identify those predatory practices that might be limited by tightened regulations or legislative changes, and to establish a coordinated attack on predatory practices.

Secondary mortgage institutions such as Fannie Mae and Freddie Mac have a role. If Fannie and Freddie were merely to buy subprime loans without added inspection, these secondary market institutions could actually subsidize predatory lending. But if Fannie and Freddie were to inspect the practices of subprime lenders from whom they purchase loans, or to limit purchases of certain types of loans, they might effectively extend the domain of subprime regulations.

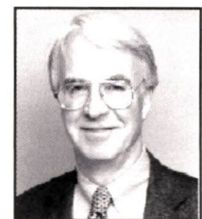
A final factor is consumer education. Predatory lending would not exist, or would be relatively rare, if prospective borrowers understood the true nature of their loan contracts. The Neighborhood Reinvestment Corporation (NRC) has an active borrower education program to promote just that type of understanding, and many other public and quasi-public agencies are thinking of following suit.

Conclusion

Predatory lending causes obvious difficulties for borrowers, is difficult for enforcers to track down, and is difficult to regulate. So far as we can tell, predatory lenders generally operate outside the main financial regulation network. These lenders are sometimes fraudulent, but probably more often they take advantage of low-income and less-educated borrowers who need cash up front and are unlikely to fully understand the loan provisions. When and if borrowers default, they can either lose their house or be induced to signing up for still more exploitative terms.

Because predatory lenders are less regulated, and because predatory loans are often difficult to identify and define, it becomes both a regulatory and an enforcement challenge to stop predatory practices. Currently, nine agencies are meeting to design a coordinated attack on the problem, and a number of legislative options are under consideration in both the federal and state legislatures. The goal is to eliminate or limit bad practices that are the unfortunate byproduct of recent efforts to democratize credit markets.

For a full text of Gov. Gramlich's speech, refer to www.federalreserve.gov/boarddocs/speeches/2000/



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FDIC Viewpoint
By Chairman Donna Tanoue

Chairman Tanoue gave testimony on May 24, 2000, before the House Committee on Banking and Financial Services concerning predatory lending. Below are excerpts from Ms. Tanoue's remarks.

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 serves the market of borrowers whose credit history would not permit them to qualify for the conventional "prime" loan market. Therefore, a well-managed subprime lending program provides an important source of credit in a manner consistent with safe-and-sound banking, and the FDIC does not want to inhibit subprime lending that meets these criteria. While most predatory loans are made to subprime borrowers, predatory lending is product-driven – exhibiting certain marketing tactics, collection practices, and loan terms that, when combined, deceive and exploit borrowers.

While the FDIC has not uncovered evidence that insured depository institutions are actively originating loans with predatory features, concern exists that banks and thrifts, like other institutional investors, may be involved in the predatory loan market in an indirect way. One indirect form of funding predatory loans is through the relationships that banks may have with mortgage brokers. Another involves banks and thrifts purchasing loans or securities backed by predatory loans, or by offering credit lines to nonbank predatory lenders. These indirect means 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, including:

- 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;

- Working on an interagency basis to revise 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;

- Giving positive CRA consideration to bank-sponsored programs that combat predatory lending by fostering financial literacy;

- Working on an interagency basis to review other consumer laws and regulations to determine whether regulatory changes may be warranted;

- 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; and

- Working on a financial literacy campaign to educate consumers about the risks of predatory lenders.

A number of laws and regulations prohibit fraud and certain misleading or deceptive sales and marketing practices by providing disclosure requirements and limitations. However, current law does not fully address a number of predatory practices found in some loans, especially in the markets for refinancing and for home equity loans. But while banning certain practices (e.g. balloon payments and prepayment penalties,) may be well-intended, outright prohibitions of such practices could unduly limit credit availability.

In evaluating alternatives that might curb predatory lending, the FDIC is applying a framework of 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.

For a full text of Chairman Tanoue's testimony, refer to www.fdic.gov/news/news/index.html

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OCC Viewpoint
By Chairman John D. Hawke Jr.

Chairman Hawke, from the Office of the Comptroller of the Currency, gave testimony before the House Committee on Banking and Financial Services on May 24, 2000, concerning predatory lending. Below are excerpts from Chairman Hawke's remarks.

The competitive market works best when consumers have a wide array of choices and, importantly, the necessary information about price, other terms and conditions, and their available options to make well-advised decisions. Furthermore, many practices that have been characterized as predatory tend to strip away borrowers' equity in their homes, and to make foreclosure more likely, if not inevitable. Thus, some forms of predatory lending undermine a central objective of our national social and economic policies: the promotion of home ownership and its attendant virtues of neighborhood stability, decreased crime, and the building of wealth for a broad spectrum of families. These practices should be condemned.

I do not think it's necessary, however, or even particularly helpful, to arrive at a general definition of predatory lending. Attempts to attack an abstract conception of predatory lending may tend to focus on broad classes of lending activity, and to distract us from the particular troubling practices we wish to address.

For example, the idea that predatory lending is a unified problem, capable of being generally defined, may have contributed to a tendency to equate predatory lending with subprime lending. The OCC, in fact, encourages responsible, risk-based subprime lending. Lending to subprime credit applicants, whose credit histories, or lack thereof, indicate a higher than normal risk of default, can be conducted in a fair and responsible manner.

But loans predicated on real estate collateral where the borrower does not demonstrate the capacity to repay the loan as structured will be adversely classified, and, depending on the circumstances, further accrual of interest may not be allowed. In addition, if examiners find loan terms, lending practices, or other factors that may indicate a higher risk of problems in this area, we will take a closer look, from both safety and soundness and other appropriate perspectives. We will bring enforcement action where we find violations.

When confronted with proposals involving subprime lending that require our approval, we have acted to ensure that any such lending activity by national banks or their subsidiaries will be conducted responsibly, and with appropriate consumer protections, in accordance with the applicable legal criteria.

We also examine banks for compliance with specific laws that may be relevant to predatory lending practices, particularly the provisions of the Truth in Lending Act ("TILA") and the provisions for high-cost home loans included as part of the HOEPA.

Our examination and other activities relating to the CRA are designed to promote competitive alternatives for low- and moderate-income borrowers. We will continue to explore, both on our own and on an interagency basis, how we might be able to make more effective use of these and other tools to enhance competition in financial services.

Finally, many have raised a significant regulatory concern about the appropriate consideration under the CRA of loans -- whether made or purchased -- that can be characterized as abusive or predatory. I welcome the opportunity to work with our fellow regulators on an interagency basis to achieve a consistent interagency approach to this issue.

I urge the Congress to consider all the potential consequences of the different proposals for reform. For example, at some point, lowering the interest rate and fee thresholds for loans subject to the HOEPA restrictions risks limiting credit access for subprime borrowers. Further, a general ban on prepayment premiums could limit a consumer's product choices and ability to negotiate other concessions, such as a reduced interest rate, in exchange for accepting the risk of a prepayment premium.

Thus, while we clearly need to address the real abuses that exist, particularly in connection with home loans, we also need to preserve and encourage consumer access to credit, meaningful consumer choice, and competition.

For a full text of Chairman Hawke's remarks, refer to www.house.gov/banking/52400.htm

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OTS Viewpoint By Director Ellen Seidman

Director Seidman, from the Office of Thrift Supervision, gave testimony on May 24, 2000, before the House Committee on Banking and Financial Services concerning predatory lending. Below are excerprts from Director Siedman's remarks.

A discussion of predatory lending must start with the frank admission that defining it is not easy. In Deborah Goldstein's predatory lending study, "Understanding Predatory Lending: Moving Towards a Common Definition and Workable Solutions," [1] the author states that "predatory lending describes a set of loan terms and practices that fall between appropriate risk-based pricing by subprime lenders and blatant fraud."

Ms. Goldstein suggests that loans become predatory when they target a particular population (most frequently low-income minorities and the elderly), taking advantage of the borrower's inexperience and lack of information to manipulate a borrower into a loan the borrower cannot afford to pay.

Risks

In addition to risks to consumers and communities, predatory lending can present safety and soundness risks such as "legal" and "reputation." A second major risk involves market liquidity with high loan-to-value loans. Finally, there are operational and credit problems when borrowers are strained in servicing their debt.

OTS's Advance Notice of Proposed Rulemaking (ANPR)

As concerns intensified about predatory lending practices, the OTS decided to review its own regulations to determine their effect in today's market on thrifts and their customers and, under the Alternative Mortgage Transaction Parity Act of 1982, on state housing creditors. The ANPR sets forth the following six goals:

1. Encourage safe and sound lending.
2. Encourage innovation in identifying potential customers and meeting their needs.
3. Discourage lending that preys upon customers' lack of knowledge or limited options.
4. Enable thrifts to compete with other types of lenders.
5. Maintain the uniform system of regulation that applies to federal thrifts.
6. Minimize regulatory burden on thrifts.

The Three "E's" of Combating Predatory Lending

In fighting against abusive predatory lending practices, the OTS is taking a three-prong approach. The emphasis is on three "E's."

- Examination for enforcement of applicable laws and regulations;
- Encouragement of responsible subprime lending; and
- Education of consumers and investors.

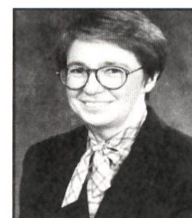
Responsible Subprime Lending

Subprime lending refers to lending to borrowers who do not qualify for the most favorable interest rates and other loan terms because they are not among those with the best credit histories and most stable employment. Responsible subprime lending means making those loans at a price and with terms that appropriately compensate the lender for any enhanced risk, including a reasonable return, and marketing the loan in a manner that is fair to, and understandable by, the borrower.

Freddie Mac has estimated that from 10 to 35 percent of borrowers with subprime loans could have qualified for a prime loan, but were steered to a higher-cost loan anyway – a practice that clearly conflicts with responsible subprime lending.

In working to curtail predatory lending, the flow of credit to low- and moderate-income families, elderly individuals, and their communities must not be impeded. Lending to underserved communities and individuals, whether prime or responsibly done subprime lending, provides necessary credit safely and soundly.

For a full text of Director Siedman's testimony, refer to www.ots.treas.gov/docs/87077.html



[1] *This study was written under the support of the Neighborhood Reinvestment Corporation's Emerging Leaders in Community Economic Development Fellowship and was issued in October 1999.*

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HOEPA

By Keenan Conigland

What is HOPEA?
The Home Ownership Equity Protection Act of 1994 (HOEPA) is a federal disclosure law designed to address certain unfair lending practices.

HOEPA, as implemented through Section 32 of the Federal Reserve's Regulation Z, seeks to protect homeowners targeted by predatory lenders that characteristically use high interest rates, exorbitant fees, and unreasonable repayment terms. HOEPA does not prohibit creditors from making a particular type of home-secured loan. Instead, the law classifies groups of high-cost mortgage loans through rate and fee triggers. Loans above the triggers are subject to greater disclosures and restrictions.

Covered Loans
HOEPA covers loans that have (1) an annual percentage rate (APR) exceeding the rate on a comparable-maturity Treasury note by more than 10 percentage points, and (2) total nondiscount points and fees exceeding the larger of $451 (effective 1-1-00, adjusted annual for changes in the CPI) or 8 percent of the total loan amount. The rule does not cover reverse mortgages or home equity lines of credit.

Required Disclosures
For covered loans, a borrower must receive a written disclosure of the APR and regular payment amount. For variable rate loans, the maximum monthly payment also must be presented.

The notice must warn the borrower in plain language that because the lender will hold the mortgage, the borrower could lose the residence and any money put into it if the payments are not made. The lender must give the borrower a written notice at least three business days before the loan is finalized stating that the loan need not be completed, even though the agreement has been signed, and the borrower may rescind the agreement at any time during this period. These HOPEA disclosures are in addition to the other Truth in Lending Act disclosures that must be made no later than the closing of the loan.

Limitations / Prohibited Practices
Under HOPEA, the following practices are generally banned:

- Balloon payments within 5 years;
- Negative amortization;
- Advance payments (where two or more payments are paid in advance from the proceeds);
- Increased interest rate (where interest is higher upon default);
- Rebates (where a refund is calculated by a method less favorable than the actuarial method for rebates of interest arising from a loan acceleration due to default);
- Prepayment penalties, except within the first 5 years of the loan if the source of the prepayment funds is not a refinancing by the same creditor and the borrower's total monthly debt-to-income ratio is under 50%;
- Extending credit without regard to the payment ability of the borrower; and
- Disbursing funds for home improvement loans directly to the contractor rather than directly to the borrower, jointly to the borrower and the contractor, or to the escrow agent.
- Selling or otherwise assigning a mortgage without furnishing the following statement to the purchaser or assignee: "Notice: This is a mortgage subject to special rules under the federal Truth in Lending Act. Purchasers or assignees of this mortgage could be liable for all claims and defenses with respect to the mortgage that the borrower could assert against the creditor."

Rule-Writing Authority
The Board of Governors has rule-writing authority under HOPEA to lower the triggers for interest rates and associated fees by two percentage points, and modify the limitatins and prohibited practices. HOEPA authorizes the Board to hold hearings periodically to keep abreast of the home equity credit market.

In 1997, the Federal Reserve Board held its first public hearings concerning this subject. This summer, the Board hosted four more public hearings to ascertain whether the HOPEA should be changed to better speak to the issue of predatory lending. The Board invited a cross-section of consumers, advocates, and lenders to participate in the hearings, which were held in Charlotte (July 27), Boston (August 4), Chicago (August 16), and San Francisco (September 7).

The hearings bore out the complexity and enormity of the issue and raised many suggestions that will be considered by the Board. Any tightening of the regulations implementing the law would have to take into consideration the potential effect on responsible subprime lending.

Because HOPEA is but one tool in addressing predatory lending, broader solutions must be multi-faceted and incorporate both a regulatory and non-regulatory approach.

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Consumer Corner

By Wayne Smith

Education of Consumers and Investors

An important element in combating predatory lending is education of both consumers who are potential victims of predatory lenders and of investors in subprime mortgage loans and securities backed by subprime loans.

A well-informed consumer is better equipped to avoid the predatory lender. Three basic considerations in this regard include the following:

- Understanding one's options for obtaining credit;
- Using only responsible lenders; and
- Being aware of the abuses used by those who prey on the vulnerable.

OTS Director Ellen Siedman noted in her Congressional testimony that community-based organizations can play a big role in helping to bridge the gap between financial institutions and communities vulnerable to predatory lending. Many already work with homebuyer education and counseling and can expand into post-purchase counseling to teach clients about how to be discerning homeowners and how to avoid potential home equity scams.

Learning what questions to ask and how to evaluate the answers—or where to find help—is critical to making informed choices. So is developing the discipline to say "no" to deals that are just too good to be true.

Reaching community residents who already own their own homes and are not involved in existing homeowner education and counseling programs is difficult. Community-based organizations and financial institutions whose constituents are likely to be targeted by predatory lenders need to reach out aggressively to potential borrowers and arm them with valuable information to give them a shield against the lies and deceit of predatory lenders. For example, community groups can:

- Identify reliable home improvement contractors and home equity lenders;

- Establish early warning networks and intervention game plans for implementation when unscrupulous contractors or lenders invade a neighborhood;
- Encourage community members to build broad-based banking relationships with federally insured depository institutions, including, for example, electronic benefits transfer programs and first-time investor programs; and
- Work with local schools, faith-based organizations, and seniors groups to get out the word about predatory lending scams—how to avoid them, where to report them, and how to get answers to questions.

As for investors, they must be more discerning in their purchase of securities backed by high-cost loans to avoid providing liquidity to the unscrupulous. The activities of large predatory lenders will quickly shrivel if they are denied financing. Participants in the secondary market are beginning to recognize that predatory loans are not good business—not just because they are unethical but also because they can damage their reputation and hurt their stock price.

It is critical, however, not to pursue this in a manner that threatens the viability of responsible subprime markets. There will still be a vital and large market for securities backed by subprime loans. The well-oiled machine of loan securitization will not seize up when it ceases to accept fraudulent or abusive loans. Fannie Mae and Freddie Mac have responded not as regulators, but as investors who recognize the hazards predatory loans bring to their loan portfolios.

Together, lenders, borrowers, secondary markets, and regulators must work together to eliminate these abusive practices.

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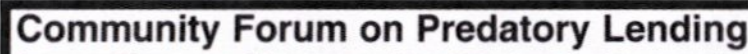

Community Forum on Predatory Lending
Lang-Carson Community Center in Reynoldstown, Atlanta, GA, September 16, 2000

This conference is sponsored by the Atlanta neighborhood Development Partnership (ANDP) and will help community organizations and individuals identify and prevent predatory lending practices. For further information, please contact Myke Harris Long, ANDP, at (404) 522-2637.

Minority Entrepreneurs' Conference
Federal Reserve Bank of Philadelphia Philadelphia, PA , September 27, 2000

The purpose of the conference is to inform existing or prospective entrepreneurs of the opportunities for businesses in the Philadelphia area. Presenters will include venture capital firms and banks as well as representatives from city, state, and nonprofit programs that offer special financing or technical assistance.

For further information, please contact Grace Theveny, Community and Consumer Affairs Department, Federal Reserve Bank of Philadelphia, at (215)574-6457 or grace.theveny@phil.frb.org

Community and Economic Development Conference 2000:
Seizing Opportunities in a Changing Financial Landscape
The Westin Michigan Avenue Chicago, Illinois, October 30 - November 1, 2000

Sponsored by the American Bankers Association and the Federal Reserve Banks of Chicago and St. Louis, the conference will explore community and economic development with an emphasis on seizing financial opportunities and growing institutions and organizations.

For further information, please contact Barbara Sims-Shoulders at (312) 322-8232 or Barbara.E.Shoulders@chi.frb.org.

National Community Capital 2000 Conference
Philadelphia, PA November 1-4, 2000

National Community Capital's Annual Training Conference attracts more than 350 CDFI practitioners, investors, funders, and policymakers. The conference features training sessions specifically developed for CDFI investors and funders.

For further information, please contact Adina Abramowitz, National Community Capital at (215) 923-4754, ext. 205.

For other events that may be of interest to you, visit www.frbchi.org/cedric.html.

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