

**THE HOME OWNERSHIP AND EQUITY
PROTECTION ACT OF 1993—S. 924**

HEARING

BEFORE THE

COMMITTEE ON

BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

ON

S. 924

**TO PROTECT HOME OWNERSHIP AND EQUITY THROUGH ENHANCED
DISCLOSURE OF THE RISKS ASSOCIATED WITH CERTAIN MORTGAGES,
AND FOR OTHER PURPOSES.**

MAY 19, 1993

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THE HOME OWNERSHIP AND EQUITY PROTECTION ACT OF 1993—S. 924

WEDNESDAY, MAY 19, 1993

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10:05 a.m., in room SD-538 of the Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

OPENING STATEMENT OF CHAIRMAN DONALD W. RIEGLE, JR.

The CHAIRMAN. The committee will come to order.

Let me welcome all those in attendance this morning. Today, the committee is meeting to hear the views of Federal regulators, consumer advocates, and representatives of the financial services industry, and local government, on the Home Ownership and Equity Protection Act of 1993.

I recently introduced this bill with my colleague, Senator D'Amato, and with Senators Bond, Boxer, Dodd, and Moseley-Braun, to combat what we call reverse redlining.

Redlining, of course, is the practice of denying credit in low-income or minority neighborhoods. Reverse redlining is the targeting of these same communities for loans with unfair terms and conditions.

I want to say at the outset how much I appreciate the support and work of Senator D'Amato. We work on this committee on a bipartisan, essentially nonpartisan, basis and the sponsorship and development of this legislation illustrates that both Senator D'Amato and Senator Bond have been extremely helpful in putting together this bill. We hope to have broad cosponsorship from Members of the Senate as a whole.

Back in February, this committee heard highly disturbing testimony that as banks have tended to withdraw from low-income communities, a parade of shady lenders has moved in to fill the void peddling high-rate, high-fee mortgages to cash-poor homeowners.

Witnesses described lenders and brokers who operate door-to-door, offering promises of home improvements or debt consolidation.

Unsophisticated borrowers do not understand and often do not receive the proper and adequate disclosures about the terms of these loans. They then wind up struggling to meet overwhelming mortgage payments and all too often soon lose their homes to foreclosure. This is the whole point of their lending operation—to steal these homes from the people involved.

Among others, the committee heard from a woman, Ms. Eva Davis, an elderly resident of San Francisco, California. After an earthquake damaged her front steps, Ms. Davis was approached by a contractor who offered to repair the damage and arrange financing.

A finance company representative arrived within hours offering to finance the repairs and consolidate her debts. By day's end, she had closed on a \$150,000 second mortgage at a 17 percent interest rate, with an up-front charge of \$23,000. In fact, the monthly payments exceeded her entire monthly income.

Ms. Davis is currently facing foreclosure, and she left us with this plea:

I hope Members of Congress can do something to protect people like me, whose only mistake was to trust people who sounded honest.

The legislation that we're considering this morning attempts to answer this request without limiting the overwhelming majority of traditional lending that should be encouraged in distressed areas. The bill targets mortgages with high rates or high up-front fees and mortgages which will use up a large percentage of the borrower's income.

For these loans, the bill requires increased disclosures to ensure that the borrower is fully aware of the terms. It also prohibits these mortgages from containing certain terms that have led to abuses in the past.

Particular provisions may need adjustment, such as the trigger for which mortgages are classified as "high cost." But certainly, the bill offers a sound beginning framework and it's important that we move forward.

I hope we will hear today how the bill might be improved to better achieve its aims. As I say, this is being brought forward on a bipartisan basis and I think what we have crafted here is legislation which will go a long way to prevent homeowners like Eva Davis from becoming victims in the future of reverse redlining.

But I must also say that people like Eva Davis will not be truly safe until we get traditional credit back into our distressed communities. That's why it's very important that our regulators are here today, because there has to be an affirmative obligation to make the credit system work not just for some, but for every person who should properly be eligible for credit.

Where credit is available on fair terms, there is no market for predatory lenders. The Comptroller of the Currency, who will be testifying today, recently proposed a bold initiative to combat lending discrimination. As a supporter of the use of testers and statistical analysis which the initiative endorsed, I very much salute him.

He told us when he came for his confirmation hearing that he intended to move directly and importantly in this area and he has done so. The committee is very grateful for that leadership.

I hope that other regulators will follow your lead. I'm also looking forward to the report you're developing on using market discipline and enhanced disclosure as supervisory tools.

I want to welcome all of our witnesses and again extend a very special welcome to Terry Drent of Ann Arbor, MI, Community Development Department. He testified on this important problem in

February and we're very glad to have him back today to testify on this legislative initiative which comes out of those earlier hearings and comments.

I also want to welcome several members of our audience from the Union Neighborhood Assistance Corporation. They've played an active role in bringing the reverse redlining issue to light and provided valuable testimony at our previous hearing.

Finally, Mr. Ludwig, I want to say that the Comptroller's office has traditionally submitted independent testimony to the Congress, and that is as it should be. I appreciate the fact that you're here today continuing that tradition.

Senator D'Amato.

OPENING COMMENTS BY SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. Well, thank you very much, Mr. Chairman. And in the interest of time, I'm going to ask that my full statement be included in the record, as if read in its entirety.

The CHAIRMAN. Without objection, so ordered.

Senator D'AMATO. Let me say that it's been a relatively short time ago, 3 months ago, February, when you, Mr. Chairman, held a hearing that demonstrated just how greedy some can be, and the terrible impact that these practices have. Those who are making the loans and responsible for the loans know there's little if any opportunity that these people can make these payments.

Indeed, in order to prevent some of the consumers who find out that they're paying these exorbitant rates from escaping their dilemma, from refinancing, there have been provisions that also have tremendous penalty clauses which make it economically unrealistic to refinance.

I think the fact that our legislation addresses this crucial area and not only contains key components in terms of making consumers aware and giving them additional time, even after they sign that paper, but, more importantly, that it will provide them the opportunity to refinance without these incredible payments that have no validity as it relates to the cost of the loan. I think that is just terribly important so that the consumer doesn't find himself locked into a no-win situation.

I know that we crafted this legislation together, as you indicated, in a bipartisan manner and did it in such a way so that while we would be protecting consumers, we would not interfere and set artificial limits as it relates to making capital available, with that careful balance that we attempted to approach this.

I hope that our witnesses today might share with us any additional insights as to how we could improve the bill and I look forward, Mr. Chairman, to having a speedy mark-up with you, hopefully, within the next several weeks or soon thereafter, so that we can enact this important legislation. And let me commend you for your leadership in this legislation.

The CHAIRMAN. Well, thank you very much, Senator D'Amato. Again, I'm most appreciative of the work that you and your staff have done on this and of the spirit in which we're moving ahead. I am interested in getting us to a mark-up at an early date.

Senator Campbell, any opening comments?

Senator CAMPBELL. No, I have no statement, Mr. Chairman.

The Chairman. Senator Boxer.

Senator BOXER. No, I don't. I would just ask that my statement be made a part of the record.

The CHAIRMAN. Without objection, it is so ordered.

Senator BOXER. Thank you.

The CHAIRMAN. Gentlemen, let me welcome you here today as witnesses.

Mr. Ludwig, we'll start with you and we'll make your full statement a part of the record, as we will with all the people testifying today. We'd like to ask for your summary comments at this time.

STATEMENT OF EUGENE LUDWIG, COMPTROLLER OF THE CURRENCY, WASHINGTON, DC

Mr. LUDWIG. Thank you, Mr. Chairman. Thank you, Senator D'Amato.

Mr. Chairman, Members of the committee, I welcome this opportunity to testify on the problem of reverse redlining—that is targeting low-income consumers for loans that are secured by the borrower's home and that have unfair terms and conditions. I have a statement that I would like to submit for the record, and I'll briefly summarize that statement this morning.

The run-up of real estate values during the 1980's left many homeowners—including those in low- and moderate-income communities—with substantial equity in their homes. In some neighborhoods, this pool of equity has become the target of lenders charging excessive interest rates and loan origination fees in order to siphon off homeowners' equity.

National banks are unlikely to originate such loans, which typically involve door-to-door marketing techniques that banks do not employ. Moreover, the rates and fees that characterize reverse redlining loans often result in extremely high debt service ratios.

The OCC requires all national banks to adhere to standards for real estate loans that ensure that borrowers have the capacity to repay their loans. Banks are also likely to be concerned that high debt service ratios could ultimately lead to default, resulting in charges against capital and involving the bank in expensive foreclosure proceedings. Finally, banks are likely to be concerned about the damage to their reputation in a community if they become involved in unfair and deceptive practices. These disadvantages tend to outweigh any potential profit for making such loans.

But more and more home equity lending is taking place outside the banking system in sectors of the market that are largely unregulated. Most of this lending by finance companies and others serves legitimate credit needs. It offers expanded credit opportunities for many borrowers.

Some banks participate in this relatively unregulated market indirectly by purchasing loans originated by finance companies and other nonbank mortgage lenders. In addition, finance companies can be subsidiaries or holding company affiliates of commercial banks.

The OCC is working to determine to what extent national banks may be involved, either through nonbank subsidiaries or through loan purchases, in indirectly financing home equity loans that

would violate sound credit standards if they were originated by the bank.

Unfortunately, home equity lending originated by less regulated institutions has opened the door to the abuses that are the subject of this hearing. I believe that consumers must receive basic protection against unfair and deceptive practices—regardless of whether they are dealing with banks, thrifts, mortgage companies, finance companies, or any other financial service provider.

We all recognize Government policies that are too restrictive, can prevent honest lenders from satisfying the legitimate credit needs of their customers. The task facing policymakers is to strike a balance between consumer protection and market efficiency.

I commend the sponsors of the Home Ownership and Equity Protection Act of 1993 for addressing this serious national problem. Public confidence in the financial system, and the credit system in particular, is strengthened when markets are fair and avoid the abuses that the sponsors of this bill have worked diligently to contain.

It is true that to deal with this problem as the bill proposes to do will impose some compliance costs on lenders and, as you are aware, the administration is committed to reducing the cost of financial regulation. But concern over compliance costs must not lead to regulatory paralysis. We must be willing to act when regulation is needed to protect the public and can be provided in a cost-effective way.

My own belief is that as currently drafted the act's disclosure requirements and restrictions on loan terms will not prevent any lender from making mortgages that serve legitimate credit needs. The only loans that will be deterred are those that charge excessive up-front fees and have repayment terms that borrowers cannot possibly meet. For example, it is difficult for me to imagine that interest rates that are 10 percent above Treasury rates serve legitimate purposes.

This is a sensible response to reverse redlining—but it will not eliminate all abusive lending practices. Some lenders will continue to find ways to victimize borrowers who are under-served by traditional lenders. The best way to reduce such discrimination is to encourage reputable lenders to enter the market.

This past Saturday, I spent 2 hours at a bank fair co-sponsored by ACORN, which is a coalition of community groups, and six banks in the Washington, DC area. This fair was designed to bring together bankers and low-income borrowers—individuals and small businesses—so they could learn from each other. The fair went right to the heart of what is best in America—our willingness to get together to solve our problems as a community. ACORN should take pride in having spearheaded this effort.

At individual bank booths and at workshops on a variety of topics—including home mortgages and home equity lending—several hundred people had a chance to ask lenders how they could qualify for credit. These are men and women who, all too often, have been forgotten or ignored by our so-called traditional banking system because they don't fit a standard pattern. For example, many banks are reluctant to lend if a loan applicant has no credit history. So where does that leave the nurse at last weekend's workshop who

had no credit history because she has always paid in cash? How does she qualify for a loan?

One of the bankers at the bank fair had a creative answer for her and for others like her. And in listening to the men and women who came to this meeting, I learned a great deal. I intend to go to other events like this across the country in the coming year, because I do not believe we can develop workable solutions to these problems unless we talk to the people who live with them every day.

At the OCC, we are looking for ways to improve incentives for banks to provide credit in low-income and minority neighborhoods. Consistent with the President's overall pledge, the administration is also looking for ways to substitute performance for paperwork in the implementation of the Community Reinvestment Act. By taking this kind of action, we are working to expand credit opportunities for low-income and minority households—and thereby reduce their vulnerability to unfair and deceptive lending practices.

Mr. Chairman, I appreciate the opportunity to testify on this important subject. I will be happy to answer any questions you may have.

Thank you very much.

Senator BOXER [presiding]. Thank you very much.

Mr. Lindsey.

STATEMENT OF LAWRENCE B. LINDSEY, GOVERNOR, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, WASHINGTON, DC

Mr. LINDSEY. Thank you. Today, I'd like to thank the chair and the other Members of the committee for this opportunity to offer the Board of Governors' comments on S. 924, the Home Ownership and Equity Protection Act of 1993.

This bill is a commendable effort to address the complex issue generically called reverse redlining that's received considerable public attention over the past 2 years.

It's clear that the sponsors have attempted to narrowly target the bill to areas of abuse without overburdening the general market. Maintaining a tight focus in this legislation as it progresses is important to avoid adversely affecting many legitimate forms of consumer credit.

The abuses this bill seeks to remedy involve some truly heart-wrenching personal tragedies. Some homeowners, often elderly, with substantial equity in their homes, but with little income, have been targeted for aggressive promotion of credit. When the dust settles, these borrowers may find that they've paid a high number of loan origination and broker points and have agreed to a loan with an interest rate at the highest levels of the market. The borrowers may even end up losing their homes through foreclosure.

Like the Members of the committee, my colleagues and I have been actively considering how such abuses might be prevented in the future. Board members have met with delegations of aggrieved homeowners and have been distressed to hear firsthand of their plight.

We talked with those who currently cannot afford to repay their loans and who risk losing their homes through foreclosure.

Given the particular concern about these practices in Boston, officials and staff at the Federal Reserve Bank of Boston have investigated these practices there. Through all of these efforts, we've come to appreciate the severity of the problems that high-cost mortgages cause some borrowers.

However, it's also become clear that finding a solution that itself does not have adverse consequences is a very difficult undertaking.

Overly restricting credit contract terms could create the risk that credit could be shut off altogether to marginal borrowers, or to those borrowers who happen to need credit due to special circumstances, such as elderly persons seeking reverse annuity mortgages.

The bill might also create a disincentive to lending because a technical violation of just one of the proposed disclosure requirements could subject a creditor to civil penalties, including forfeiture of all interest and fees paid on the loan.

With high-cost mortgages, consumers are already required to receive a substantial amount of information about the terms of the loan.

For example, under the Truth-in-Lending Act, the APR, security interest and payment schedule are disclosed, although later than as proposed under this bill. The benefit of the proposed special disclosures in advance of this information is less than obvious since under current law, most of these homeowners already have 3 days after closing to review their existing disclosures and to cancel the transaction. But it appears that few, if any, rescind these transactions after receiving cost disclosures.

Therefore, despite the good intentions of the sponsors, and our own usual preference for disclosure rules over other restrictions, we have doubts whether simply increasing the information given will have much positive impact.

I therefore conclude that the more realistic way to address these various problems is through some of the substantive restrictions proposed in section 2 of the bill. But here, too, we must be careful.

I'm sure we all agree that we want to avoid the unintended consequence of making loans more difficult to get. And we believe the bill currently runs this risk. One option is to raise the thresholds proposed for each of these three criteria for a high-cost mortgage that triggers the bill's provisions.

We believe that a better option is to look for a pattern of abusive terms by requiring that at least two of the three criteria be met before designating the loan as high cost.

Absent such change, it would be difficult for us to conclude that this legislation would not risk significant impairment of loan availability in many legitimate and nonabusive instances.

Consider one at a time the criteria these loans bear. First, interest rates more than ten points above the current rate on Treasury securities of equal duration.

In the present rate environment, this requirement implies an interest rate threshold of 14 or 15 percent. Yet many individuals, and not just those with low- and moderate-incomes, currently finance moderate-sized home repair items by using their credit cards.

The effective interest rate on these cards may well be in the 18 to 21 percent rate. Therefore, extensions of credit at 14 or 15 percent rate do not seem to be necessarily high-cost loans—

Senator D'AMATO. Mr. Lindsey.

Mr. LINDSEY. Yes.

Senator D'AMATO. Mr. Lindsey, I don't mean to interrupt but I have to tell you something.

The difference between a loan made on a credit card and one secured by a mortgage and property are obvious. Therefore, it is much more acceptable—one does not pledge as collateral anything other than his or her name. They may have little in the way of security that compares the two rates. So, please, that is preposterous. I'll leave it there. Go ahead.

Mr. LINDSEY. I'll finish my statement.

Senator BOXER. Mr. Lindsey, you can complete it.

Mr. LINDSEY. Therefore, it seems to us that extensions of credit at 14 or 15 percent rates should still be available to individuals who now often accept much higher rates to accomplish the same purpose.

Second, consider the 60 percent of income test. I've regularly opposed the use of such a factor since income is often a poor guide to the ability to repay due to what I call the "widow situation."

Let's imagine a widow who's left with her home, a little income, say from the proceeds of her husband's life insurance, and some real estate that could be fixed up and sold to improve her financial situation.

To live, she's consuming capital. And indeed, that's the reason why she's seeking to liquidate some of her property.

But it's easy to imagine that the financing costs on the repairs she must undertake will exceed 60 percent of her income on a short-term basis.

Would you put at risk her ability to borrow by defining her loan as high cost simply because of temporarily low income?

Other individuals who could be the unintended victims of this legislation would be those who are starting small businesses and using their homes as equity for fixed-term second mortgages. Because the incomes of these individuals are temporarily depressed, use of income as the sole criterion for the high-cost designation is particularly ill-advised.

Finally, the third criterion, an 8-percent limit on points and fees, is unduly restrictive for small loans for many reasons, including the paperwork cost imposed by law and regulation. There is a substantial fixed-cost involved in processing any loan.

Indeed, this is often cited as the reason why many banks do not make small loans at all. Restricting terms on loans with 8 percent in total points and fees could make these loans even scarcer.

Consider a \$2,000 loan for a new roof, for example. The 8-point test translates into \$160 threshold.

The committee is to be commended for attempting to resolve a complicated and important problem caused by high-cost mortgages. It's clear that the issues raised by high-cost mortgages are complex and the appropriate Federal response to the problem they raise is equally complicated.

Although we do not favor Federal restrictions on credit terms, we believe that these restrictions would better address the problems created by high-cost mortgages than the additional disclosures that have been proposed.

In crafting the final form of this legislation, it's essential for the committee to avoid the problem of unintended consequences.

Given the reported difficulties that some sectors of the economy have in accessing credit, it would be an unfortunate outcome of well-intended legislation if these sectors were cut out of the credit market even more than they are.

I'd recommend to this committee that during the course of their deliberations, they solicit information from creditors active in second-mortgage lending to determine how the proposed legislation might affect the availability of credit. This could assist in keeping the focus of this legislation as narrow as possible in order to eliminate abusive practices while minimizing adverse consequences which the Congress clearly would not have intended.

Thank you.

OPENING COMMENTS OF SENATOR BARBARA BOXER

Senator BOXER. Thank you very much, Mr. Lindsey.

On behalf of the Chairman, I'm going to ask a few questions that he had proposed. And before I do, I want to say that you really touched a nerve up here with both Senator D'Amato and myself when you talked about credit cards and suggested that there is no problem with credit cards that have 20 percent interest: high credit card interest rates is a problem. But the other point is that people don't have to use credit cards but they have to pay their mortgages. It's a real apples and oranges situation.

The Chairman wanted me to ask you this. He said—

Mr. LINDSEY. Would you like an answer to that?

Senator BOXER. Sure.

Mr. LINDSEY. When I thought this bill through—by the way, and again, I commend the committee for trying to tackle a very difficult situation—I talked to a lot of people involved in this. And the lady who gave me the credit card example—Cynthia Parker, who is head of the Neighborhood Housing Services of Anchorage, Alaska. She regularly deals with low- and moderate-income people. And it was her suggestion, actually, that it come in.

What I'm talking about is not how we all wish the world could run, but the way it actually runs. And the unfortunate fact is that people of low- and moderate-income means, and even some people of not so moderate-income, use their credit cards in these types of circumstances.

I'm simply pointing it out as she pointed it out to me, that that is a fact of life in the world.

Senator D'AMATO. I don't see it. You want to tell me that they use a credit card, they use a credit card and they pay 16, 17, 18 percent. But when they secure their life savings, an elderly woman, and has a 16, 17, 18, 19, 20 percent mortgage and has up-front payment fee of \$7,000, that is usurious, that is all of the pejoratives that you want, ripping off, and I hate to use that, but that is scandalous, and is shocking.

And Mr. Lindsey, for you, and I understand you're an economist, to try to compare the rates that are applicable with credit cards, which have no security other than that person's signature, as opposed to a mortgage, which has property underlying in value, we understand that the rates for one are considerably, and should be considerably lower. And that's what we want to see take place.

Now nobody says we're shutting off loans. We're just simply saying that if you're going to charge 16 or 17 or 18 percent, you've got to make these disclosures and you've got to give these people an opportunity to cancel out without burdening them with huge costs.

I thank the Chair for indulging me in expressing this as you raised this point.

Senator BOXER. No, I'm very pleased that you did because it is a shocking comparison, in my opinion, it's irrelevant as to who told it to you. With all due respect, she may be a wonderful woman, but I don't happen to agree with her on this point.

Mr. Lindsey, you and other representatives of the Federal Reserve Board have recently met with victims of reverse redlining and you've heard the testimony they gave before the Congress on the extent of the problem.

Chairman Riegle wants to know whether the Board is considering taking any steps on its own initiative to address their concerns, and could you express what those steps might be?

Mr. LINDSEY. Well, we have worked quite extensively with the staff of this committee, and I'm here today to offer the Board's assistance in trying to craft legislation.

The enforcement issues involved in this problem, as my colleague, Gene Ludwig pointed out, are overwhelmingly the FTC's. The other major enforcement players are State agencies.

We are not in general the enforcer here. We do, however, share the concern of this committee for the abuses that are going on.

I agree with Senator D'Amato completely in his characterization of these loans. That's why I'm here. That's why the staff has been here, to try and work with the committee to try and find a way of sorting through the problem.

Senator BOXER. Well, the question was whether the Board is considering taking any steps on its own initiative to address their concerns?

Mr. LINDSEY. I think that we're quite limited as to the steps that we can take on our own. Again, the FTC is the primary enforcer in this area.

Senator BOXER. What about stronger education programs or stronger regulatory efforts?

Mr. LINDSEY. Well, there's no question that stronger education programs are something that my colleagues and I have been pushing. We are working with a number of consumer groups on consumer education and I think, ultimately, that is going to be one of the key ways of solving the problems here.

Senator BOXER. Mr. Ludwig, in attempting to combat reverse redlining in this legislation, Chairman Riegle and Senator D'Amato have sought to strike a careful balance targeting the loans that have been particularly troublesome without restricting the flow of credit on fair terms.

What is your assessment of how well that balance has been struck in the legislation?

Mr. LUDWIG. I think this is really a commendable effort. This is a very balanced effort. I realize that one has to be concerned about the cost and the enforcement burden. But this is an abusive situation and the direction taken by Senator Riegle's and Senator D'Amato's bill is highly commendable.

Disclosure is a hard thing to get right. It is fundamental to our society and the way we operate, however. That's one of the strongest parts of the bill.

The details of the disclosure provisions may not be exactly right, but the approach is right, and it deserves a try. If more disclosure or different types of disclosure is needed, we ought to work on that because it really supports what's good about free markets—an empowerment of people.

I think the bill strikes a healthy balance. We may well have some comments and want to work with you as you get ready for mark-up, work to tighten it up here and there, if that's called for, but it's a good piece of work.

Senator BOXER. Thank you, Mr. Ludwig. I wanted to mention that the Chairman had to run down to the Finance Committee, so he will be back soon, we hope.

At this time, I'd like to call on Senator D'Amato.

Senator D'AMATO. Thank you very much.

Let me point out to you, Mr. Lindsey, that I think that you have made a very valid observation as it relates to the problem where there is a rather small loan and therefore, if we put just 8 percent as a fee, that indeed could impede credit for a loan, let's say, of \$10,000 or \$15,000.

And so, it seems to me that it would be reasonable to establish a dollar amount; so that you'd have the 8-percent figure or \$500 or \$200, or some floor.

I'm wondering if the staff couldn't take a look at that because I think that's a very valid point. We don't want to preclude people who are going to make a home repair from getting a second mortgage just simply because that of that 8-percent factor.

Now, the second thing I would note is that we really don't preclude people from making the loan. We just say you have to have full disclosure. They can still make this loan at this high cost.

But I do think that makes a valid point as it relates to having an alternative to just 8 percent. There should be some dollar amount and/or 8 percent, whichever is higher, before that provision is triggered in.

Mr. Lindsey, I've indicated to you my thoughts as it relates to the differentials which obviously take place where you have security proposed. But in your testimony, you state that the Board strongly supports the bill's exclusion of open-end home equity lines of credit.

Why do you believe so strongly open-end home equity lines should be excluded? Is it possible when this bill, or one like it, gets into effect, that the con artists will simply move into this line of business in order to avoid compliance with the safeguards this bill contains?

And I'd suggest these are very innovative, creative people. So why would you be opposed to this?

Mr. LINDSEY. With regard to open-ended lines of credit, even the most open-ended often has an end and it's often a long time from now, say 15 years. That's your typical right of termination for, say, a home equity loan.

The enforcement mechanism that the bank has in that case, the standard old home equity loan, is effectively a balloon, the balloon that must be paid at the end of that 15 years.

I'm afraid that if the bill in its current form, therefore, were extended to these so-called open-ended lines, that we might see severe potential problems for almost every home equity loan out there because it does in fact use a balloon, many of them, anyway—

Senator D'AMATO. What's the problem? Tell me the problem.

Mr. LINDSEY. If you prohibit, as this bill does—

Senator D'AMATO. No, we don't prohibit the loan. We just say you have to comply. You have to make disclosure. And we say that you can't prevent repayment in one of the most arbitrary and capricious manners that we've seen exacted from people.

Mr. LINDSEY. Let me go back to my testimony and explain why. You are correct in saying the word prohibit.

What I think the effectiveness of this bill comes from is not necessarily the disclosure portions, but the enforcement sections.

Now enforcement could involve a judgment against a creditor for actual damages. Civil penalties of up to \$1,000 per violation, up to \$500,000 in a class action, and forfeiture of all interest and fees earned. In addition, State regulators could sue.

I think that those risks are quite high. And I think that what we're going to see, the reason I think this bill is going to work is that those risks are sufficiently high to discourage individuals from going into this kind of lending.

Although you are technically correct that all you're doing is disclosing, I think the effectiveness of the bill works through these sanctions, as opposed to the disclosure provisions. Indeed, I think that is the genius of the bill.

Senator D'AMATO. Well, the genius of the bill is that we do provide disclosure. There are penalties and the penalties are only for a violation. They're not for making a loan, a high-interest loan. But they're only for a violation of the provisions.

Mr. LINDSEY. It could be a technical violation.

Senator D'AMATO. Let me tell you. If you're talking about a technical violation, we also provide an exception from the penalties for good faith, a bona fide error, and as a bona fide error, we're not going to pursue that.

I'd like to ask you one thing which I think is critical. You expressed concern about the provisions of the bill extending liability to third-party purchasers.

Well, if you don't do that, then what you're going to do is have the con artists just continue to do this and sell these off to another institution and you're sheltering that institution from any liability.

Don't you think that a bank or a financial institution that is purchasing these instruments should have knowledge as to what the

rate of interest is and that they're going to be foreclosing pretty soon on some poor guy's house and throwin him out?

Don't you think they should? Couldn't they understand the terms and conditions and don't you then keep the fly-by-night from operating? You're not restricting credit because you're seeing to it that the scam artist doesn't have the ability to sell these things off without recourse to the third party and that puts responsibility on the third party. Shouldn't a bank take responsibility when it purchases this kind of paper?

Mr. LINDSEY. In the cases of abusive lending which are here, you and I have no disagreement. I am concerned about how this bill might evolve. And if that were extended say to more general types of mortgages, I am quite concerned about the impact of that on the secondary mortgage market where, frankly, it is assumed that mortgages are legitimate, in part, because a lot of these extra tests are not imposed. That would be my concern.

Senator D'AMATO. Mr. Ludwig, do you think that provision would have any impact on the secondary mortgage market?

Mr. LUDWIG. Senator, I have a lot of respect for my colleague, Governor Lindsey, but I see the bill's impact differently. If you look at the bill as it stands, only targets abusive practices. And as it stands, I don't think it's going to be restrictive on the secondary mortgage market. We're only talking here about second mortgages. We're talking about abusive practices. I don't think we're going to have that problem.

Senator D'AMATO. I want to thank the panel. I have no further questions. And I want to thank you, Mr. Lindsey. I have to tell you, I admire you. I don't agree with you, but I admire you for putting forth those observations. And as I did indicate, I believe that you did point out an area, and there may be other areas of concern. And I'm certain, I'm going to ask the staff to take a look and speak to some of the investment bankers in that secondary mortgage market. I don't think it will have an impact, but we should ascertain what, if any, impact it might have.

Second, I think we have to put a floor in there, and I don't know what that should be—\$250?, \$500?—but there should be some number, not just 8 percent.

Senator BOXER. One last question for Mr. Ludwig from Chairman Riegle.

You took the lead among the banking regulators when you announced a few weeks ago a bold initiative to combat discrimination in lending. In addition, the OCC and HUD yesterday formed a working group to coordinate their efforts to eradicate discrimination.

The Chairman and I applaud you for these initiatives. What additional steps should we take to promote the availability of credit on fair terms to low-income and minority communities? In particular, how might we strengthen enforcement to make the Community Reinvestment Act more effective?

Mr. LUDWIG. Senator Boxer, thank you very much for your kind remarks.

As you know, this is an area that I really care about quite deeply. We are spending a great deal of time at the OCC studying it, as you've indicated. Some of the things we've already announced.

There are other things that are underway that are not quite ready for announcement.

There are two things that I can mention that are baked enough to talk about. First is the fair that I saw over the weekend. This was really a remarkable event. I would recommend to the Senators here and the staff to go to one of these, where you have lenders and borrowers coming together under the aegis of a community group. We are going to try to work with community groups and banks to encourage this all across the country. We are going to be much more aggressive at trying to let the free market system work in the way I think it works best, encouraging people to come out and get together.

Second, we are, along with other members of the administration, looking very hard at CRA. The President has said on a number of occasions during the campaign and more recently that he wants to move to a system of performance not process.

We are very actively looking at that. I don't want to pre-empt the administration. I know the President is going to have a statement on this in the coming weeks. But there is a great deal we can do in this area to move the system in a more objective direction that will reduce paperwork in the end and get more credit out to low- and moderate-income people.

Senator BOXER. Thank you very much, Mr. Ludwig, Mr. Lindsey. Thank you for making our hearing much more interesting than it would have been had you not been here. We appreciate your giving us your opinions, even though we sometimes respond in a way that is not so easy on you.

So we do thank you very much, and we would ask that the second panel now come forward.

Thank you very much. We're going to move along here and get started with the second panel, which I will introduce.

Panel Two is: Terry Drent, Ann Arbor Community Development, Ann Arbor, Michigan, is Housing Coordinator at Ann Arbor Community Development. Mr. Drent has assisted several Ann Arbor homeowners with severe financial problems associated with second-mortgage abuses;

Dianne Lopez, First Interstate Bank, Houston, Texas. Ms. Lopez is a senior vice-president with First Interstate. She will testify on behalf of the Consumer Bankers Association and American Bankers Association;

Margot Saunders, National Consumer Law Center, Washington, DC. Ms. Saunders is managing attorney for the Washington, DC office of the National Consumer Law Center. NCLC published a report in December, 1991, entitled, "Second Mortgage Lending—Abuses and Regulation."

Robert Elliott, Household International, Incorporated, Prospect Heights, Illinois. Mr. Elliott is a group executive in charge of Household Finance Corp., the largest finance company in the United States;

And Michelle Meier, Consumer's Union, Washington, DC. Ms. Meier has covered banking issues for the past 9 years at Consumer Union, publisher of Consumer Reports magazine.

We welcome you all and we would like to ask if you could possibly summarize your testimony in about five minutes. That would

be helpful. We will, of course, put everything in the record that you submit to us.

And we'd start with Mr. Drent.

STATEMENT OF TERRY DRENT, HOUSING COORDINATOR, ANN ARBOR COMMUNITY DEVELOPMENT, ANN ARBOR, MI

Mr. DRENT. Thank you. I'd like to thank the chair and the committee Members for inviting me here today. I'd also like to thank Senator Riegle for his aggressive exposure and investigation of the reverse redlining issue.

This is my second time testifying before this committee and I've noticed that I've been the only representative of local government. I think it's a tribute to Senator Riegle and his staff that local government from his home State of Michigan is involved in these proceedings.

Senator Riegle knows that the policies set in Washington have ramifications that affect people personally and his recognition that city and county personnel are the front-line troops speaks well of his leadership and effective actions in solving some of our Nation's major problems.

I want to thank Senator Riegle and Senator D'Amato for working together on this reverse redlining issue. The two of them have managed to do what the last three Presidents have failed, and that's to end gridlock in the Senate.

As we're all aware, many of the most vulnerable citizens in our community, the elderly, people with health problems, the unemployed and disadvantaged, are being targeted by unscrupulous lending institutions because they have substantial equity in their homes.

Now this population is experiencing difficulty paying for health care, home repairs, and basic sustenance, and they're forced to supplement their incomes with debt.

I've worked with victims of reverse redlining for 3 years and generally they're people who believe in paying their bills on time. Most of them have already paid off their original mortgage on their homes and they tend to demonstrate independence, rugged individualism, and hard work, characteristics that we as a Nation certainly value.

These people typically come from impoverished backgrounds and they're very proud of their accomplishments in fulfilling a segment of the American dream, and that's home ownership. But now they're vulnerable because of age, illness, and problems of education, and their pride and desire to pay their own way is being used against them.

In Michigan, people who are unable to pay property taxes are targeted by finance companies with loans. They send them a sheet like this that says, the State will take your home if you can't pay your taxes, basically. I'm summarizing it. No credit or income requirements. And they give them a loan at frequently three to four times market.

Now just because reverse redlining issues have not been taken into consideration in the past involving CRA compliance or checking the soundness of banking institutions that want to engage in

mergers and acquisitions, doesn't mean that the lackluster regulation has to continue.

People are suffering from the inactive bureaucratic mindset that says, don't do anything different and don't try anything new. The costs of prevention of reverse redlining abuses is less than the potential harm to the fabric of our community.

The Home Ownership and Equity Protection Act of 1993 is a great start in controlling abusive mortgages. Clearly, there's a desire expressed by the committee to not manipulate or regulate traditional lending practices that are necessary for home ownership. Yet, it defines a type of mortgage that has been detrimental for many of our citizens.

The disclosures and timeframes allow a homeowner to think about the true price of a high-cost mortgage, as it will be provided with a payment breakdown that shows how much money they will have left after each mortgage payment.

I suggest that you require that lending institutions provide the name and phone number of a local nonprofit legal services agency which people can consult and contact. I think that with the 3-day window, having a number and a name to call will spur some people to check on other means of credit.

This is consistent with HUD guidelines for reverse mortgage and I don't think it's an onerous burden on the lending institutions.

The civil liability and holder in due course sections will empower citizens and their attorneys to seek protection for abuses under this act.

It's a good idea to empower citizens to seek their own remedies, especially when you see the lack of zeal on the part of our regulatory agencies.

I suggest that damage recovery limits be increased to ensure stricter compliance and send the legal eagles after the loan sharks.

In closing, I'd just like to thank the Members of this committee for your efforts that deal effectively with reverse redlining. This committee represents a cross-section of America like no other and you're serving your constituents well.

Thank you.

Senator BOXER. Thank you very much, Mr. Drent.

The next speaker will be Dianne Lopez, senior vice president of First Interstate.

Welcome. This is in Texas, Houston, Texas.

**STATEMENT OF DIANNE LOPEZ, SENIOR VICE PRESIDENT,
FIRST INTERSTATE BANK, HOUSTON, TX**

Ms. LOPEZ. Mr. Chairman, and Members of the committee, my name is Dianne Lopez. I'm senior vice president and compliance division manager for the First Interstate Bank of Texas.

I'm a member of the American Bankers Association's Compliance Executive committee and am pleased to be here to testify on behalf of the American Bankers Association and the Consumer Bankers Association regarding Senate Bill 924.

I should note that in Texas, we do not make home equity loans—except for home improvement purposes—but we are concerned about this legislation, nonetheless. We do make home improvement

home equity loans and first mortgage refinancings, which are covered.

First, I wish to commend the Chairman and the committee for their attention to this area. Clearly, there have been abuses in this mortgage lending area and the committee is right to be concerned. We share that concern and agree that such abuses should be stopped.

Simply put, low-income consumers should not be subjected to these abusive practices. However, as you are aware, the banking industry is highly concerned about regulatory burden. Too often, well-intended legislation has resulted in unintended consequences. Simple concepts have been translated into complicated exercises. Working together with your committee, we believe a proper balance can be achieved.

We believe that you and your staff have gone a long way to make the new requirements consistent and compatible with existing laws. Nonetheless, we have serious concerns about the bill. We believe it will sweep too widely, unintentionally subjecting lenders to significant new compliance burdens.

Even banks not making high cost mortgages will still have to prove to bank examiners that their refinancing and closed-end home equity loans are not high cost mortgages. These lenders will still have to calculate debt-to-income ratios according to a regulatory formula.

Broader coverage than necessary includes, for example, loans not targeted by the legislation, such as loan workouts and loans to high income borrowers. Including all fees with points when calculating the percentage of up-front costs, effectively covers many small mortgage loans that are not abusive.

In addition, even banks not making high cost mortgage loans will have to document to prove to bank examiners that points and fees do not exceed the limit and that loan applicants do not exceed the debt-to-income ratios.

Obtaining, documenting, and retaining this information will be an additional compliance requirement for legitimate lenders. While lenders usually calculate debt-to-income ratios, under the bill, they will have to be calculated according to a specific and rigid formula which promises to be complex and ever-changing. Dozens of new pages of regulation will be needed to define and explain debt and income.

Small banks particularly may choose to avoid any closed-end home equity loans or mortgage refinancings because distinguishing between loans subject to the bill and those not will be too complex and costly. Many small banks already shy away from adjustable-rate mortgages for those reasons.

We are also concerned that the bill could inadvertently chill availability of legitimate and desirable loans. For example, as I previously mentioned, the 8-percent limit on the total fees and points could cover many small home improvement or other home equity loans. Some lenders may choose to avoid making these loans if they are unable to recover costs or if compliance is too complex and costly.

The bill may also adversely affect the secondary market. Assignees will be subject to civil liability for violations they cannot know

from the face of the documents. We believe it is important that assignees have the liability presently used in the Truth-in-Lending Act; that is, liability only for violations apparent on the face of the disclosure statement.

Finally, any new disclosures should be provided at the time of settlement, with the right of rescission notice. At present, lenders generally provide a notice of the 3-day right of rescission along with detailed Truth-in-Lending disclosures at settlement for most home equity loans and refinancings.

Consumers have 3 business days to back out of the transaction, for any reason and with a full refund of everything paid. This would seem to be the appropriate time for the new disclosures. Providing disclosures earlier, as the bill does, means consumers must lock in earlier than they may wish, even if interest rates are falling.

We do not believe that the bill is intended to create these additional compliance and liability burdens or discourage certain consumer lending. We would like to continue to work with you and your staff to target the bill more directly to ensure that it effectively discourages abusive practices without imposing unnecessary and inadvertent compliance burdens and lending restrictions.

Once again, we commend the chairman and the committee for their attention to this matter. Thank you, and I'd be happy to answer any questions.

The CHAIRMAN. Thank you very much.

Ms. Saunders, we'd like to hear from you now, please.

**STATEMENT OF MARGOT SAUNDERS, MANAGING ATTORNEY,
NATIONAL CONSUMER LAW CENTER, WASHINGTON, DC**

Ms. SAUNDERS. Thank you, Mr. Chairman.

Mr. Chairman, Members of the committee, we very much appreciate your invitation to us to testify today on behalf of our low-income clients.

The National Consumer Law Center is a national support center for legal services attorneys. We receive calls and letters from legal services attorneys from all over the country regarding home equity and lending practices. On a daily basis, these attorneys request our assistance with analysis of these cases and help in formulating claims and defenses to help save homes.

The CHAIRMAN. Can you pull the mike a little closer so you can be heard better? Thank you.

Ms. SAUNDERS. Yes, I'm sorry.

The CHAIRMAN. That's OK.

Ms. SAUNDERS. As a result, we've seen examples of home equity abuses in almost every State in the Nation.

On behalf of our low-income clients, we heartily commend Chairman Riegle and Senators D'Amato, Bond, Dodd and Moseley-Braun, for the introduction of this bill. The bill is an excellent start at addressing a very serious problem that our clients are facing.

In our written testimony, we spend a considerable amount of space setting out the justification for many of the specific terms that are in the bill. We won't spend time doing that orally today, but I'd like to explain now why we don't think you've cast the net wide enough.

Despite your excellent intentions, only a fraction of the evils this legislation intends to address would in fact be stopped by this bill.

The first issue is the trigger. One of the three methods by which a particular loan is caught within coverage of the act is based on the annual percentage rate of the loan.

Inclusion of a particular loan within the parameters of this act does not mean that that loan will not be made. The prohibitions included in the act and the disclosures required by the act are not that onerous. In fact, very few legitimate lenders make loans which have terms which are prohibited by the act, such as negative amortization, balloon payments or prepayment penalties.

Currently, the act would only cover loans which are 10 percent over Treasury bills of comparable terms. That means that in today's market, a first mortgage loan at 16.75 percent would not be covered by this bill.

Most of us can get a first mortgage loan at 7 or 8 percent with no points. That's much too wide a difference between 7 percent or 8 percent and 16 percent. That means that scam lenders could make a 15, 16 percent first mortgage loan and still not be covered by this bill.

A 6-percent difference between market rate and coverage by the act would be more appropriate. A 6-percent spread would mean that the legitimate lenders, lenders who had reasonable bases for charging higher than marketplace interest rates could still avoid coverage by the bill. There would be ample room between market rates and inclusion in the bill.

One of the worst problems that Congress created by the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980, was pre-empting first mortgage interest rates throughout the States.

The effect of that law encourages scam lenders to push borrowers to refinance legitimate, low-cost, first mortgage loans so that these lenders can take advantage of the removal of the interest rate ceilings. Thus borrowers seeking small second mortgage loans find themselves repaying not only the new amount borrowed but also their entire first mortgage loan at a very high rate of interest.

One of the things that S. 924 should do is discourage that type of unnecessary refinancing so that when a borrower goes in for what should be a legitimate second-mortgage loan, that loan actually remains a second-mortgage loan and the borrower is not pushed to refinance a low-cost first mortgage loan by the lender.

This goal would be achieved by establishing a dual trigger for the APR. For example, one trigger of 8 percent for junior lien loans and another 6 percent for first-mortgage loans.

The bill prohibits four specific abusive practices. But the lenders that are engaged in the type of lending that this bill is trying to address are extremely imaginative in coming up with innovative ways to steal from borrowers. And they're ingenious in coming up with ways of avoiding the law.

The best way to stop abusive practices would be to try to identify every ill that we're trying to address and specifically prohibit each one in the bill. Failing that, we propose that you add a simple section that prohibits unfair or deceptive or evasive practices.

We would like to see a Federal interest rate cap. But given that that may not happen, we would encourage you, at the least, to allow States to establish their own interest rate caps for nonpurchase money first mortgages.

In 1980, when DIDMCA was passed, its purpose was to create a healthy secondary market for home purchase loans. The goal was to ensure that this market would not be affected by States' statutes limiting first mortgage interest rates. While this goal was accomplished, DIDMCA went too far and removed usury ceilings altogether for first mortgage loans. That removal is one of the primary reasons for the growth of the abusive mortgage lending this legislation is designed to address. Yet a lot of States still have laws on the books limiting interest rates which are legally avoided by these lenders because of DIDMCA, and there's nothing a State can do about it.

It's very unfortunate. We encourage the committee to add a provision to S. 924 allowing States to impose caps on interest rates for nonpurchase money first mortgage loans.

Finally, the Holder-in-Due-Course rule. Under current law, in every State, if a borrower gets a loan from a lender who lies to him, commits fraud upon him, charges a usurious interest rate if there is an applicable usury ceiling, or commits an unfair or deceptive trade practice, and that loan is then sold to an assignee, and the assignee forecloses on the loan, there is nothing the borrower can do. He cannot raise as a defense the fraud or the usurious claims.

This bill would not affect that scenario, unless the original lender had happened to make a technical violation of this bill.

What we strongly suggest to you is that you allow the elimination of the Holder-in-Due-Course status for all high-cost mortgages. We know the lenders will say, "the sky is falling, the sky is falling: You will limit credit completely." But, in fact, in 1973, when the FTC passed the preservation of claims and defenses rule, which eliminated the Holder rule for credit sales, lenders said the same thing. And now the automobile finance market is as strong as ever. In fact, that market has trebled since that time.

Senator D'AMATO. Isn't that going too far?

Ms. SAUNDERS. No, sir, I don't believe so.

Senator D'AMATO. Well, let me ask you. Mr. Chairman?

The CHAIRMAN. Yes, please.

Senator D'AMATO. Now, under the bill, as I understand it, and I've been speaking to counsel, it would provide that if you violate the terms of the bill, then you lose your Holder-in-Due-Course status.

Ms. SAUNDERS. Yes, sir.

Senator D'AMATO. Don't you believe that is sufficient?

Ms. SAUNDERS. No, sir, because, even under the bill, if a high-cost mortgage is usurious, charges more than the State law allows that mortgage to charge, so long as the original lender did not violate the disclosure requirements of the bill, that usury claim or any other related claim, cannot be used as defense in a foreclosure action.

Senator D'AMATO. That's right, if they have not violated provisions of the bill and there is a high-cost mortgage and they have complied with all of the provisions, that's correct.

Ms. SAUNDERS. That's right.

Senator D'AMATO. But I think we're trying to design a bill that puts forth the kind of disclosure, puts forth penalties and, in addition, provides them with the ability, something they don't have now, to refinance out of that high-cost mortgage. And I find that really offensive when people can't do that, without the enormous penalties that otherwise would be there.

So I think you take it to another level, another step, and you would have a great deal of opposition in moving further than what we've suggested. That's just my observation. But I wanted to see if I understood you.

Ms. SAUNDERS. Senator, if I might respond to that in one other way.

Senator D'AMATO. Sure.

Ms. SAUNDERS. One of the best effects that such a provision would have is that we would then have a market that polices itself.

We have seen that with the automobile financing market. Legitimate banks regularly buy paper from automobile dealers. If they have doubt about the legitimacy of the underlying paper or the underlying lender, they will have a recourse agreement against that lender.

Such protection for the assignees or the buyers of the paper is not required. But what happens in the auto financing market is that the legitimate credit market will ensure that it is only buying paper from lenders who are in fact not violating State laws.

Senator D'AMATO. It's interesting. I don't know what that impact would be on the cost of loans. I don't know what that impact would be on the markets, on the secondary market, and I'm not going to make a judgment at this time. But I certainly am going to look at it.

Ms. SAUNDERS. Thank you.

Senator D'AMATO. I thank you and I thank my colleagues for permitting my indulgence.

Ms. SAUNDERS. We have additional technical changes that we've recommended, but they're in our written testimony.

Thank you.

The CHAIRMAN. Very good. Very good. Well, that's the purpose of this hearing, is to gather all these suggestions and think about what refinements may be needed.

Mr. Elliott, we'd be pleased to hear from you now. We'll make your statement a part of the record and we'd like your summary comments.

STATEMENT OF ROBERT ELLIOTT, GROUP EXECUTIVE, OFFICE OF THE PRESIDENT, HOUSEHOLD INTERNATIONAL, PROSPECT HEIGHTS, IL

Mr. ELLIOTT. Thank you, Mr. Chairman, and Members of the committee. And thank you for inviting me here today.

My name is Robert Elliott. I work for Household International Corporation. Among my duties are the management of Household Finance Corporation. I've worked for Household for a long time. I

began my career as a trainee in a branch in Lake Ronkonkoma, New York, in 1964. Back then, and to the best of my recollection, we had 20 branch offices on Long Island. We had seven serving Westchester County and 55 in the five boroughs of New York. Eighty-two branches just in downstate New York alone.

These branches served customers of modest means who were not well-served by banks. These people were not poor credit risks. They were simply not great credit risks and they were expensive to serve. We made them modest loans. \$800 signature loans were the largest loans we made in those days. We helped people pay bills, visit sick relatives and take vacations. When adversity overtook them, we worked with them and we did not cut them off for credit when they were back on their feet.

Mr. Chairman, things have changed a lot in 29 years. Today, we have 12 branches in downstate New York, instead of 82. We make few very small, closed-end signature loans. Today, we primarily offer revolving loans so that busy customers don't have to visit our branches to get their credit needs served.

Today, 73 percent of our \$9.2 billion managed- receivable base are home equity loans, and the average size of these loans is \$35,000. A lot, indeed, has changed. We have been forced to reduce our branch presence, change our product focus, and increase our loan size to meet the changing market conditions.

Why did this happen?

Well, credit cards happened. Two spouses working happened. A rising underclass happened. Bankruptcy reform happened. All of these things, some good, some bad, and some just eventual, all served to increase our cost of doing business and to cause us to seek to lower our costs to reach and serve our customers.

But one thing hasn't changed, and that's our customers. We still serve a customer who is not well served by our competitors. It is not that he has no choice. In many regards, our customer represents a diverse cross-section of working class America. He has the basic qualification to go to our competitors. He chooses to come to us and he chooses to stay with us.

We have done extensive research to see why this is so. And here's the answer—we treat him right. We comply with his needs for low monthly payments and fair treatment in time of trouble. And we tell him the truth. As proof of this I offer you the following.

We are the largest provider of home equity loans among consumer finance companies and we are among the largest providers among all lenders of any kind in the United States.

Over the last 7 years, we have spent over \$300 million on systems which improve our ability to serve our customers. These systems have enabled us to significantly lower our cost of doing business. This in turn has helped us seek out new unserved credit customers.

The CHAIRMAN. Mr. Elliott, let me just stop you for a minute. I want to try to get some data in the context of the earlier figures you cited.

Mr. ELLIOTT. Yes.

The CHAIRMAN. I appreciate very much your laying out the evolution of the business.

With respect to the \$35,000, the average home equity loan that's outstanding, what would be the average interest rate or the typical interest rate being charged for—

Mr. ELLIOTT. The overall book of business. That would be every loan that we make as a home equity loan, the average yield—I can't give to you as to the basis point, but it's somewhere around 11.5, 11.6 percent.

The CHAIRMAN. OK.

Mr. ELLIOTT. I do know on a differential or a distribution analysis, basically, 91 percent of the loans are made for less than 12 percent.

The CHAIRMAN. Are made for less than 12 percent. And how high do you go? What would be the ones out at the far end?

Mr. ELLIOTT. Some very small loans, in the \$10,000, \$15,000 range, you might see loans indexed to prime at prime plus 8 or prime plus 9. But, typically, you don't see loans—well, obviously, if 91 percent of them are made for less than 12 percent, we don't do a lot of that business. There are reasons why we don't do a lot of that business.

The CHAIRMAN. Now, if I could just stay on that point for a minute. You've carved out that niche, and you've gone after it, and you've developed a customer base. You've decided that you can do that and make money, given a certain default rate and so forth.

You've obviously decided not to go to a higher rate of interest of the kind that we're targeting here. You've decided not to do that, I assume, as a business decision. Is that right?

Mr. ELLIOTT. Exactly right. And the business decision is driven by the economics of the decision, but as well by the optics.

The natural reaction for us is to be in objection to what you're trying to do because it places restrictions. We as an industry are somewhat distrustful of the restrictions that you've placed because there are unintended consequence of perfectly well-intended acts.

But, my God, if you can't be against some of the things you saw here, what the devil can you be against? And I think some of our consistent antibody reaction to certain attempts by people to redress wrongs are unwise. There are things that are bad that should be fixed. Not everything can be fixed. It's a chaotic world and you can't address all wrongs. But some wrongs you can address.

The CHAIRMAN. I'm struck by the fact that a company of your reputation and longevity has chosen for business reasons not to get into these kinds of exorbitant interest rate situations that we're targeting here. And if that's a proper surmise on my part—

Mr. ELLIOTT. It's a proper surmise insofar as it goes. By our decision, you should not infer that there are not perfectly legitimate lenders who serve the community at a higher cost than we do, or have chosen to do. And as a matter of fact, on the margins, we do reach into some of that area.

However, I'm much persuaded by Senator D'Amato's argument that, look, all the people are saying is disclose. All they are saying is be honest with us.

I'm serious. When we do market research, our customers say, well, what do you like about us? Well, tell us the truth. I mean, we can take it. Is our deal more pricey than the average second-

mortgage at a bank? Yes, it's about 200 basis points more expensive. Well, what do I get for my 200 basis points?

In times of need, when a hurricane sits south Florida, we tell people, OK, we're suspending your payments until you go back to work and you're not going to be considered overdue. We're going to carry you back up to date once you go back to work.

We did that in Florida. But that is implicit in the price we charge. That sort of compliant, needs-based service is implicit in what we do. And we tell them the truth. Do we always tell them the truth or have we made mistakes in the past? You betcha. But it is to our advantage. It is a competitive weapon. It serves our customers' needs to disclose to him exactly what's going on.

And I am not persuaded by some of the arguments that I have heard that say, the customer is unsophisticated and will not understand disclosure. I believe they will. I believe if you set things out in plain, straightforward language, people will make reasonable decisions.

The CHAIRMAN. Go ahead.

Senator D'AMATO. Could you address Ms. Saunders' suggestion that this paper be sold without Holder-in-Due-Course protection?

Mr. ELLIOTT. Let me tell you from what I know rather than what I would surmise because I can't fully surmise.

There are all kinds of buyers in the secondary market. Now we do fairly plain vanilla type business and we package—we're the largest securitizer of home equity loans in the country. In fact, we sell that as a service to others.

These things are—there's an enormous amount of due-diligence that goes into putting together a securitization. If it is going to be sold in the general market, it has to have a credit rating in its own right. That means Moody's or S&P comes in and does a tremendous amount of due-diligence. That means the trustees in the transaction look at credit papers. They look at underwriting standards. They test for consistency.

There's an awful lot that goes on in that aspect of the market. Therefore, I think that it's appropriate that investors do appropriate due-diligence and that's a discipline on the front-end lenders. Whoever's point it was that some of these folks don't have any money, these people that are doing egregious things, they don't have any money. They have to rely on other sources for funding. And so, the market should take care of that.

But there are other secondary buyers who buy, one bank buying from another, assuming another's fiduciary responsibility, may have more difficulty in doing that kind of due-diligence. That may make it much more difficult to enter into those transactions. I just don't know.

Senator D'AMATO. Is it something we should look into?

Mr. ELLIOTT. It is something that you should look into.

Senator D'AMATO. Might that discourage, then, some of the financial institutions from buying from some of these fly-by-night operations?

Mr. ELLIOTT. It will clearly do that. The effect will be to clearly do that. The downside effect will be that you could reduce liquidity and therefore, that will raise costs. In other words—

Senator D'AMATO. We'll have to take a look to see just what would that impact be and if we're reducing liquidity as it relates to people who are really doing these outrageous kinds of things, that might not be so bad.

Mr. ELLIOTT. That's a perfect solution for that problem. But the other part of the problem is as described earlier, is that you may also—these securitizations are, although they take loans off the balance sheet, they are quasi-funding transactions. They are methods of obtaining reasonably costed and capital-efficient funds to do business.

Senator D'AMATO. You generally keep a certain piece with some recourse against it, don't you?

Mr. ELLIOTT. That's true. That's true.

Senator D'AMATO. Thank you.

Senator BOND. Mr. Chairman.

The CHAIRMAN. Yes, Senator Bond.

OPENING COMMENTS BY SENATOR CHRISTOPHER S. BOND

Senator BOND. I apologize. I once again have the great good fortune to have three very important committee hearings going on at once.

I'm pleased to join with you and the Ranking Member to be co-sponsor of this legislation. I believe that the additional disclosures and the other provisions of S.294 will help address issues of reverse redlining. The testimony of this panel is very helpful. I've also had a chance to review the statements.

I would like to submit for the record an opening statement with questions for these and earlier witnesses, and I apologize that I'm going to have to scramble and try to catch up to where I should have been before I started out.

[Laughter.]

The CHAIRMAN. Without objection, it's so ordered.

Let me say in your presence that I acknowledged earlier your participation in drafting this legislation and moving it forward. I am interested in continuing to work together on this as we take all these expert comments and try to weave them into whatever refinements we judge appropriate.

Senator BOND. I thank you. I look forward to working with you and the Ranking Member, Mr. Chairman.

The CHAIRMAN. Very good. Mr. Elliott, do you want to go ahead and finish, or do you feel you've—

Mr. ELLIOTT. Let me get to the part where I'm supporting you.

[Laughter.]

The CHAIRMAN. By all means, don't leave that out.

[Laughter.]

Mr. ELLIOTT. In short, Mr. Chairman, we feel that—well, let me use another paragraph.

That's why we're here today to testify. We share the chagrin of the committee over the abuses uncovered. We would have hoped that market forces would have prevailed to protect the vulnerable individuals cited throughout your deliberations.

We recognize that you were forced to act. Your work is not perfect. We doubt that any such effort could be. There are parts which will put some compliance pressure upon lenders with legitimate

and honorable motives. Yet, you have focused upon straightforward disclosure and we applaud that. You've kept your focus tight upon areas of abuse and you are right to do so.

You have not tried to cap rates or to limit underwriting standards and that is wise. We see relatively little mischief in the Holder-in-Due-Course aspect of the bill and we feel that due diligence in the broad secondary market can and should accommodate the issue.

In short, Mr. Chairman, we feel that your work is temperate and we support it. We note, however, that we are anxious that the bill's tight focus might be altered or broadened. That would go too far and hurt the customers you seek to serve, and then our support would evaporate.

In summary, Mr. Chairman, Household has served many of those customers your bill seeks to protect and has done so for over 115 years. We regret that you were forced to act to offer your protection. We share your desire to see that your constituents and our customers are free of credit abuse, but also have free access to credit. We wish to be reasonable and supportive of your effort and therefore, we support S. 924.

Thank you.

The CHAIRMAN. Thank you very much.

And now, Michelle Meier, who is the counsel for Consumer's Union, a very important organization. And we'd very much like to hear from you now.

STATEMENT OF MICHELLE MEIER, COUNSEL, CONSUMER'S UNION, WASHINGTON, DC

Ms. MEIER. Thank you very much, Mr. Chairman. It's good to be here.

I want to commend both you and Senator D'Amato for addressing this very serious problem, probably one of the most serious consumer problems that's come before this committee in a long time.

Commendations are due for introducing the bill expeditiously, and thank you very much for that, and addressing it. And it's been enjoyable working with your staff on this.

Federal legislation is needed in this area because loan sharks are preying on vulnerable consumers to steal their only source of savings, the equity in their home.

We think the bill is commendable because it will eliminate some of the worst predatory practices. But we're concerned that without some strengthening amendments, the bill will still leave us with very troubled waters.

We're as concerned as anybody is about credit availability. As you know, Governor Lindsey, and I'm sure others will raise concerns about the bill's effect on limiting credit availability in needy communities.

We think that the bill does not in any way deter credit availability or that with strengthening amendments it would. The bill doesn't set interest rate ceilings. All it does in setting the trigger is bring certain loans within its ambit.

The bill still allows loans to be as profitable as they are now, but it eliminates certain abusive practices. And in fact, it is the whole

structure of the bill that sets forth a trigger and then addresses certain prohibited practices once the loan falls within the trigger that is our concern.

Our concern is that addressing specific abusive practices and loan terms now will only spur the industry to come up with new abusive terms in the future.

So we would encourage in improving the bill, looking at what we think will bring systemic reform to the market place so that the market place will police itself.

We very much in that regard support the reforms that Ms. Saunders' NCLC, has put forward. We think it's critical to get to the price-gouging here, to get to the loan-padding up front with exorbitant fees and the exorbitant interest rates to return to states their traditional authority to act in this market place.

And we think, in response to anticipated claims that that will bring us back to situations in which we'll have reduced credit availability because of usury ceilings, that the clear response to that concern is we're a long way from doing that just by giving States that authority. We're not setting ceilings here, but States should have the authority to eliminate the worst, the highest, the most abusive interest rates that the market place currently allows.

There is certainly a big range between setting State usury ceilings at a low rate that discourages lending and setting usury ceilings that allows credit in the market place, that encourages credit in the market place, but eliminates abusive practices.

A second systemic reform which has already been touched on that we think is critical here is extending the elimination of the Holder-in-Due-Course rule that the bill already dabbles with across the board.

We shouldn't only have those prohibitions in the bill be applicable to the secondary market. Any violation of the law, any unfair practice should be able to be raised by victimized consumers, even though the loan has been sold into the secondary market.

And as you, Senator D'Amato, indicated through your questioning, this will then eliminate those shady operators, but still allow through recourse provisions and other market developments, allow credit and secondary market purchasing.

The unfair and deceptive practice proposal we very much support. And this obviously gets to the fact that the bill does not discourage and prohibit the waterfront of potentially abusive loan terms.

We need a broad Federal prohibition against unfair and deceptive practices in this market place generally so that tomorrow's abusive practice will come under the bill's prohibitions.

When you think about it, the bill, although a very good step forward, would still allow some of the abusive practices that were presented to the committee during the February hearing.

One of the worst problems was loan sharks underwriting consumers and putting them into loans that, at the time of the origination, were clearly unable to be supported by the incoming resources of the borrower.

An unfair and deceptive practices provision would get to that type of abuse and other abuses that could creep up into the market place post-enactment.

Thank you very much and, again, we've enjoyed working with the staff and we look forward to working with you and your staff toward improving the bill down the road.

Thank you.

The CHAIRMAN. Thank you very much. Let me say to each of you, I had to step out to go to a hearing of the Finance committee today. We had a nominee in the trade area that brings into focus the revolving door issue. This is an individual who has been involved in trade law for a variety of foreign and domestic clients, coming into a proprietary position in trade law conduct in our Government. Now at the other end, he will be going back out.

The problem is, in my mind, the back phase of the revolving door. In other words, what prohibitions should be in place to prevent somebody from taking that proprietary knowledge and that superior insight and selling it to foreign clients when there's an on-going tension between United States and foreign interests.

It was necessary for me to be there to pose those questions this morning. Otherwise I would not have been gone.

Let me say to each of you that I appreciate the perspectives that you've brought. We are listening very carefully and we want to make the refinements that are appropriate. We also want a piece of legislation that we can enact. We don't want to march halfway up this mountain and then find that we're not able to carry it through to a legislative conclusion. I want to get legislation enacted.

It's very important that we do this on a bipartisan basis. I'm most appreciative of Senator D'Amato's and Senator Bond's leadership. I want to make sure that we are building a consensus so that this is legislation that we can actually enact, that will be workable and enforceable, and that we solve these problems. Even if we get the law enacted now, we may have to refine it in the future. It will be my intention as chairman of this committee to adjust that law if it needs it.

Making sure that we've got something that changes the status quo, focuses on this practice and begins to hit it head on and stop it, is really important. I want to make sure that we get that done. So I appreciate what's been said.

Mr. Drent, let me say to you, I'm sorry to have missed your statement. I gather you made a kind personal comment with respect to myself. I appreciate that.

In Michigan, you've had a lot of experience in working with low-income borrowers who get in over their head with these home equity loans. Can you tell me why people are not able to connect with the normal system of credit and how they get shoved into the arms of loan-shark operators like those Ms. Meier just described.

Mr. DRENT. Well, there are a variety of reasons people don't pursue or receive traditional credit.

One, I think, is the pride issue. Generally, I'm dealing with senior citizens, people who paid off their mortgage. They're very prideful. They're embarrassed that they're having financial difficulties, but very reluctant to seek traditional credit. These finance companies target them specifically and go to their homes to cut these deals in their living rooms. So they save face, they don't have to go out.

Another issue which has raised its ugly head is one of racism. Over 90 percent of the people I deal with are of African-American descent. For whatever reason, they seem to be denied traditional credit, more so than other groups.

Where I live in Washtenaw County, Michigan, one bank in particular—this bank has the best record in my county of giving loans to African-Americans. Of 926 mortgages, they gave 16 to African-Americans.

The CHAIRMAN. How many? 16?

Mr. DRENT. Sixteen out of 926. That's 1.7 percent.

The CHAIRMAN. What would be the African-American population just in rough percentage in the population there?

Mr. DRENT. Roughly 17 percent.

The CHAIRMAN. Seventeen percent.

Mr. DRENT. Yes, sir.

The CHAIRMAN. So you get this dramatic shortfall in credit going to that part of the community.

Ms. LOPEZ. What was the total number of applications received from African-Americans?

Mr. DRENT. I don't know. I'm sure it was over 1.7 percent.

The CHAIRMAN. The implication of your question being that, until you know that, you can't really—

Ms. LOPEZ. Right.

The CHAIRMAN. I think that's a fair point. Wouldn't it also be a fair point to say that when you see that kind of disparity, that something is wrong? In the banks that you represent, would we tend to see that kind of pattern?

Ms. LOPEZ. Right. One of the problems that we've wrestled with in our HMDA data is the lack in numbers of applications from minority individuals. And therefore, we've targeted our marketing accordingly.

We are struggling with why aren't they asking us for applications. Is it because we don't have our marketing materials in Spanish or because we're not advertising in the right minority newspaper, or what have you? Therefore, we've adjusted all of our marketing strategies accordingly to try to increase the numbers of applications.

The CHAIRMAN. Can you tell me for the banks you represent what percentage of the loans would now be going to, say, African-Americans, as opposed to others?

Ms. LOPEZ. The HMDA-reportable loans?

The CHAIRMAN. Yes.

Ms. LOPEZ. What percentage? I don't have those figures with me, but I'd be happy to send you a summary of our 1992 HMDA data.

The CHAIRMAN. I'll tell you what I would appreciate. You've asked the question of Mr. Drent, and I'm sure he'll try to provide that for our record. I'd be interested in knowing, given those percentages that he's just outlined, which are, I gather, for the bank with the best record.

Mr. DRENT. Right. I have the numbers she was asking for, also.

The CHAIRMAN. OK. Let's hear those.

Mr. DRENT. It was 10.4 percent of the applicants were African-American. 1.7 percent of the 926 were approved.

The CHAIRMAN. A pretty dramatic fall-off between applications and approvals. Of course, each application must be considered in its own right, but I think on its face, that's a troubling statistic.

This is what we're finding in other places. It isn't unique to Washtenaw County. We're finding this in the Fed data out of New England and other places. It's a real problem.

I would be interested in knowing two things from your bank. I would be interested in knowing the comparative of application rates of African-Americans and others, and then, also the percentages of loans approved for each group we can see how that measures up to what he's just cited here.

Ms. LOPEZ. We'll also provide you with the reasons for denial broken out by category.

The CHAIRMAN. I think that is important. I say this because we want to solve the underlying problem as well here. We want to get the normal lending channels to open up and to work better. Part of it, the problem I think, is racism, quite frankly. I don't aim that at any particular institution, but we've got patterns of racism in our society. In many different places, discrimination just happens. It happens a lot to African-Americans, but not just African-Americans. It happens to other people, too. It's a problem in our society that has to be confronted and solved.

We're determined to do that in the flow of credit. We want to make sure that the traditional channels of credit are as open as they can be, are fair, and nondiscriminatory. We're pushing very, very hard to see that is done. In every piece of legislation we pass, we are putting in various requirements to deal with that problem. There will be no piece of legislation that comes through here that does not address those issues. We've got to open up the traditional channels.

But we're here today to talk about the nontraditional channels and the loan-sharking problem. These two run on parallel tracks. If people can't get credit through traditional channels or through a Household Finance, then they're often pushed into the arms of these other unscrupulous lenders.

There is a relationship between these two things and we want to make sure that we're dealing with both sides of this.

I think we've got a hearing record today that will help us do that.

I'm going to conclude by asking if there anything else you wanted to add before we finish?

Mr. DRENT. I would like to add a couple of comments.

When we've had people who have been suffering from reverse redlining and facing foreclosure, we've sponsored them with traditional lenders and brought them in the door under the auspices of CRA. And the banks have made the loan.

They'll take someone who's got a loan with an interest rate of 25 percent and give them something at 7½ or 8 percent, whatever the market is, something that they can manage. CRA seems to be the key here. We say CRA. They hear CRA. Maybe it has to be adjusted somehow to compel banks to go out to meet the credit needs of the community more than they have. They're making money on these loans, even with the lower rates. Why can't they expand the service?

The CHAIRMAN. Well, we're going to send this part of the hearing record to Mr. Lindsey over at the Federal Reserve. I gather that my partner in my absence took Lindsey over the jumps earlier, as Senator D'Amato can do very effectively, and which it sounds to me like Mr. Lindsey needed.

I think our regulatory authorities have an obligation and an ability to deal with this problem forcefully and promptly so that they don't get into a boxed vision problem where they let their own personal circumstances blind them to what's happening to people who are in less favored circumstances.

That often happens in Government. I will make it a point to send this part of the hearing record over to Governor Lindsey at the Federal Reserve. He will have an opportunity to get a flavor for this problem that he may not be fully sensitive to.

Thank you very much.

Senator D'Amato, any closing comment for you here?

Senator D'AMATO. Yes. I want to commend the Household people. I don't have any stock in your company. I don't know if it's a stock company. But I think you've taken a very enlightened approach.

Ms. Lopez, I'm wondering if you wouldn't continue to work with us and our staff in attempting to deal with some of the problems and see if we—I think we're a lot closer to the mark than we are apart.

Ms. LOPEZ. I'd be happy to. I take a rather simplistic view of this whole issue because I understand the customer is already being told the Truth-in-Lending. The customer is already being given a three-day right to cancel, and in the disclosure that's already being given to the lady in San Francisco, for instance, it says, we are taking a security interest in your home. You have three business days within which to cancel this transaction and all fees will be refunded. So, my simplistic attitude is what are we not doing that would help better educate this consumer?

Senator D'AMATO. How about the ability to be able to prepay so that we don't have a situation where there's an enormous penalty, and this person finds out 6 months down the line?

Ms. LOPEZ. To prepay the loan?

Senator D'AMATO. Yes.

Ms. LOPEZ. I can't speak for other banks, but our banks don't have prepayment penalties.

Senator D'AMATO. So wouldn't you be supportive of that?

Ms. LOPEZ. Yes.

Senator D'AMATO. I mean, allow a person to escape a situation that they put themselves in with knowledge, but maybe circumstances are such that they had to take this. Why should they be held later on with the failure to prepay, or not be permitted to pay?

Ms. LOPEZ. I can tell you from our bank's perspective, in a scenario like that where 6 months down the line there are medical problems or what have you, and the payments became impossible, we wouldn't foreclose for a small-dollar home improvement loan. It's just too costly to foreclose. We would work out with the customer.

Senator D'AMATO. Right. Let's see if our staffs can't look at some of the areas that you think there are some concerns.

I think Ms. Saunders brought up some very legitimate, and Ms. Meier, it's always good to see you.

Ms. MEIER. Me, too.

Senator D'AMATO. Some concerns as it relates to the issue of how far we can take this, what protection we should afford the purchasers of these loans, whether there should be nonrecourse or with recourse. Let's take a look at that because I do not want to destroy or impair the secondary market. I think we have to keep a balance on it.

But I think Mr. Elliott's testimony, he doesn't feel that it will. But there are others. Let's take a look at it. That's the purpose of the hearing. And I commend the chairman and our staffs for moving as expeditiously and providing this hearing.

Thank you all for coming.

Ms. LOPEZ. Thank you.

The CHAIRMAN. Thank you all very much. We appreciate it.

The committee stands in recess.

[Whereupon, at 11:47 a.m., the committee was recessed.]

[Prepared statements, response to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR ALFONSE M. D'AMATO

Mr. Chairman, three months ago, on February 17, you held a hearing to highlight certain abusive lending practices. At that hearing the nature and extent of these abuses became clear. While most financial institutions and mortgage lenders are responsible corporate citizens—providing a vital economic service to the community—a small sector of the lending community is taking advantage of the elderly, inner-city residents and other innocent people.

These lenders are making abusive mortgage loans. Coupled with high up-front fees and high rates, the terms of these mortgages are unconscionable by any standard. Yet because of gaps in State and Federal law, adequate legal remedies are often lacking, resulting in hard working individuals and families being forced out of their homes when they cannot make the payments on these mortgages.

At the February hearing I announced my intention to introduce legislation to remedy this problem. Other Members of the Committee expressed interest in joining in this process, and during the past two months I have worked closely with the Chairman and other Members, to develop a solution. Together, we have introduced a bipartisan bill. This legislation builds on my original proposal. It carefully targets abusive mortgage loans and lending practices, and takes remedial action to protect consumers that wish to enter into these transactions. This bill arms innocent consumers with a real "loan shark repellent."

The bill does not prohibit the making of any loan. The bill does not restrict credit. Instead, the bill defines a category of loans called "high cost mortgage loans." It requires additional disclosures, including a clear warning to the borrower that he or she could lose their home if the mortgage is not repaid according to its terms. To prevent high pressure sales tactics, a three day cooling off period must pass between the time of these disclosures and the settlement date.

A high cost mortgage cannot contain certain terms that have led to consumer abuse. These terms include:

- *negative amortization* provisions under which the amount of the principal actually increases during the life of the loan;
- *balloon payment* provisions which call for large payments (often beyond the reach of the consumer) at the end of the loan term; and
- *prepayment provision*, under which a substantial portion of the original loan amount is withheld from the borrower as an "advance payment of principal and interest."

In some cases, after a consumer takes out a high cost loan, they learn that a lower cost loan is available. To prevent the consumer from re-financing at a lower rate, some high cost loans contain prepayment penalties that make it economically unrealistic to pay off the loan early. To prevent unscrupulous lenders from "locking in" consumers in this fashion, the bill provides that high cost loans may not contain prepayment penalties after the first 90 days. During the initial 90 day period, prepayment penalties are limited to no more than one month's interest.

This bill makes a reasonable attempt to balance the need for consumer protection with the needs of the consumer to borrow funds. It was carefully drafted so that no loan would be prohibited based on interest rates or up-front fees. On the other hand, loans that meet the definition of being "high cost" are subject to additional regulatory protection that will add to the cost of making such loans, and might cause some lenders to withdraw from the market altogether. *I would therefore like to hear from the witnesses today whether or not the factors we used in this bill to trigger additional protections are appropriate, and if not, what alternatives they would recommend.* I would also be interested in hearing ideas about other methods that could be used to provide the consumer protection that is vitally needed, without unduly hampering the provision of credit to those in need of funds.

Mr. Chairman, following this hearing, I hope that we can expeditiously proceed to a mark-up on this important legislative initiative.

PREPARED OPENING STATEMENT SENATOR BARBARA BOXER

Mr. Chairman, earlier this year this committee held its first hearing on the allegations that some in the second-mortgage finance industry are using predatory lending practices to strap high-priced loans with unfair terms on low-income, inner-city homeowners. This practice is sometimes called "reverse-redlining" or "equity-skimming."

Home equity scams have generated billions of dollars for second mortgage or home repair companies whose salespersons have talked homeowners into taking out high-interest loans to pay off medical bills, avoid foreclosure, or repair aging prop-

erty. This committee heard testimony from one of the major players in the home equity market, Fleet/Norstar Financial Group Inc., that its home equity loans carried an average annual interest rate of 15.9 percent with some rates as high as 29 percent. The exorbitant fees and usurious rates charged by some second-mortgage companies has resulted in the victimization of hundreds of thousands of homeowners.

Persons who have accumulated equity in their homes—despite their modest incomes—are prime targets because they often live in communities where mainstream banks have long since retreated or are reluctant to lend money. South Central Los Angeles, for example, is rife with check-cashing outlets—places that charge anywhere from 1 to 21 percent of the check's value but don't take deposits or make loans. With a paucity of banks and savings and loans, the residents of this area are "property-rich but credit-starved," making them prime targets for home equity schemers.

Mr. Chairman, this current situation is intolerable and I want to commend you for your leadership regarding this issue. S. 924, The Home Ownership and Equity Protection Act of 1993 is clearly a step in the right direction. I am proud to be an original co-sponsor.

I look forward to hearing from the witnesses regarding S. 924 and how we can best allow the market to work while providing protection from the financial predators who thrive in this market. Again, I thank the Chairman for calling today's hearing.

PREPARED STATEMENT OF SENATOR CHRISTOPHER S. BOND

I want to thank each of the witnesses who will be testifying today before the Banking Committee on S.924, the "Home Ownership and Equity Protection Act of 1993." This bill was introduced by Chairman Riegle and Senator D'Amato, the Ranking Member of the Banking Committee. I am also proud to say that I am an original co-sponsor of this legislation.

S. 924 represents an initial response to issues raised before this Committee on February 17, 1993 during a hearing titled "Reverse Redlining: Problems in Home Equity Lending." The February 17th hearing provided significant and often tragic testimony of certain "predatory" credit practices that are robbing poor homeowners of the equity in their homes. That testimony highlighted numerous examples of abusive loans which contained unconscionable terms or which were obtained or coerced through promises of home improvements and repairs that were over priced, defective, or never provided.

S.924, the "Home Ownership and Equity Protection Act of 1993," is designed to address these issues through a balanced approach of increased disclosures to consumers, a new three day waiting or cooling off period, and substantive prohibitions against certain loan terms that are unfairly burdensome to consumers. I believe this legislation is well-balanced in that it provides adequate safeguards for homeowners, while, at the same time, it should not adversely impact the availability of credit to communities, especially low-income and distressed communities.

I see S.924 as a new starting point for a continuing dialogue on consumer protection issues in home equity lending. I would like to add that I consider your testimony well-considered, thoughtful, and a vital contribution to our consideration of these issues as we move forward with S.924.

PREPARED STATEMENT OF SENATOR RICHARD C. SHELBY

Mr. Chairman, I want to commend you for holding this hearing this morning. You and the distinguished Ranking Member are to be commended for moving so quickly to introduce legislation to resolve a serious problem.

This committee held a hearing earlier this year at which witnesses testified to shocking abuses by unscrupulous lenders. We heard a number of disturbing tales of the elderly and the unsuspecting being preyed upon by lenders seemingly more interested in the value of the borrower's collateral than the borrower's ability to repay the loan.

In most cases, I am more interested in reducing the regulatory burden than adding to it. But the evidence presented at the last hearing indicates that some type of additional disclosure may be necessary. S. 924 calls for a disclosure written in plain English that explains to the unsuspecting borrower that he has put his home at risk. It is my understanding that this disclosure would apply only to "high cost" mortgages or those with an annual percentage rate 10 points higher than comparable Treasury security rates.

Mr. Chairman, I am not yet a cosponsor of your legislation. I am here today to hear the comments of the witnesses before I sign on. However, I commend your leadership for taking steps to address this problem and I look forward to seeing these abuses eliminated.

**SUMMARY OF STATEMENT OF EUGENE A. LUDWIG
COMPTROLLER OF THE CURRENCY**

The run-up in real estate values in many parts of the United States during the 1980's left many homeowners in low-income communities with substantial equity in their homes. This pool of equity has become the target of lenders charging excessive interest rates and loan origination fees that often result in the homeowner's losing his or her equity in the home.

National banks are not likely to originate such loans, which often result in extremely high debt service ratios. But an increasing volume of home equity finance is taking place outside the banking system, in sectors of the market that are largely unregulated. Banks generally do not operate in these sectors directly, but some banks may do so indirectly through loan purchases or through non-bank subsidiaries or affiliates. The OCC is working to determine to what extent national banks may be involved indirectly in financing home equity loans that would violate sound credit standards if they were originated by the bank.

While most loans that originate outside the banking system serve legitimate credit needs, and home equity lending that takes place outside the banking system has expanded credit opportunities for many borrowers, it has also opened the door to the abuses that are the subject of this legislation.

Reverse redlining and other deceptive financial practices are particularly pernicious because they undermine general public confidence in financial institutions. It is the responsibility of government to restrict practices that lend themselves too easily to abuse. One of the ways the government exercises that responsibility is by supervising the banking industry to ensure that banking practices are safe, sound, and fair.

Policies that are too restrictive, however, can prevent honest lenders from satisfying the legitimate credit needs of their customers. The task facing policymakers is to set boundaries on permissible transactions that strike a reasonable balance between consumer protection and market efficiency.

The Home Ownership and Equity Protection Act of 1993 addresses the major issues in reverse redlining: disclosure, loan terms, and the lender's access to funds.

- The Act's disclosure requirements—and the requirement that disclosures be made at least three days before a loan is consummated—would make it more difficult for a lender to pressure a homeowner into a disadvantageous mortgage, while still allowing the homeowner to obtain a high-cost mortgage if that is his or her informed choice.
- Restrictions on the use of loan terms that reverse redliners often use to make the terms of their loans appear more affordable would provide additional protection. To avoid interfering with the provision of traditional banking services that have these features, the Act's restrictions on loan terms—as well as its new disclosure requirements—would apply only to "high-cost" mortgages: those with interest rates, fees, or debt service ratios that exceed specific threshold values set well above typical levels for loans made by traditional mortgage lenders.
- The Act would allow purchasers of high-cost mortgages to be held responsible for the original lender's failure to provide disclosures or to observe the Act's restrictions on loan terms. This would not interfere with legitimate loan transactions, but it would constrain reverse redliners, who are often thinly capitalized and must therefore sell the loans they originate before they can make more loans.

The Act would impose some compliance costs. This is a matter of concern to the Administration, which is committed to reducing the cost of financial regulation. But concern over compliance costs must not result in regulatory paralysis. Policymakers must be willing to act when regulation is needed to protect the public, and can be provided at reasonable cost.

I do not believe the Act's disclosure requirements and restrictions on loan terms would prevent any institution from making mortgages that serve legitimate credit needs. The only loans that the Act would deter are those that charge excessive interest rates or up-front fees, and have repayment terms that borrowers cannot possibly meet.

The Home Ownership and Equity Protection Act would not eliminate abusive lending practices. A few lenders will probably continue to find ways to victimize bor-

rowers who are underserved by traditional lenders. The best way to reduce such discrimination is to encourage reputable lenders to enter the market. We are looking for ways to improve the incentives for banks to provide credit in low-income and minority neighborhoods. Consistent with the President's pledge, the Administration is also looking for ways to substitute performance for paperwork in the implementation of the Community Reinvestment Act. Through initiatives such as these, we hope to expand legitimate credit opportunities for low-income and minority households, and thereby reduce their vulnerability to unfair and deceptive lending practices.

TESTIMONY OF EUGENE A. LUDWIG

MAY 19, 1993

Mr. Chairman and Members of the Committee, I welcome this opportunity to testify on the problem of reverse redlining: the targeting of low-income communities for loans secured by the borrower's home that have unfair terms and conditions. The Committee deserves credit for drawing attention to this problem, and for drafting sensible legislative remedies that deter abusive home equity lending practices. Consumers should receive the same basic protection against unfair and deceptive financial practices, whether they are dealing with banks, other depository institutions, mortgage companies, finance companies, or non-financial firms.

Reverse Redlining

The run-up in real estate values in many parts of the United States during the 1980's left many homeowners in low-income communities with substantial equity in their homes. In some neighborhoods, this pool of equity has become the target of lenders charging excessive interest rates and loan origination fees that result too often in the homeowner's losing his or her equity in the home.

These lenders rely on the borrowers' trust, lack of sophistication, and limited access to other financial resources, to talk them into loan repayment terms they cannot possibly meet. They also use a variety of devices, many of which are legitimate banking practices in other contexts, to conceal from borrowers the true cost of their loans. These include collecting loan origination fees and prepaid loan payments directly from loan proceeds, imposing high prepayment penalties, and employing reverse amortization and balloon payments to make monthly payments appear more affordable. In some instances, borrowers end up losing their homes to foreclosure. Meanwhile, the lender has made a quick profit from up-front fees, sold the loans, and moved on to the next victim.

National banks, which are regulated by my office, are unlikely to originate such loans, which typically involve door-to-door marketing techniques that banks do not employ. Moreover, the rates and fees that characterize reverse redlining loans often result in extremely high debt service ratios. The Office of the Comptroller of the Currency requires all national banks to adhere to standards for real estate loans which ensure that borrowers have the capacity to repay their loans. Loans that failed to meet that requirement would be subject to criticism by bank examiners. Banks would also be concerned that debt service ratios that exceeded the borrower's capacity to repay would ultimately lead to default, resulting in charges against capital and involving the bank in expensive foreclosure proceedings. Finally, banks would be concerned about the effect that their involvement in unfair and deceptive practices would have on their reputation and goodwill in the community. These disadvantages would tend to outweigh any profit from making such loans.

But an increasing volume of home equity finance is taking place outside the banking system, in sectors of the market that are largely unregulated. Finance companies, mortgage companies, and other non-depository financial intermediaries now originate a significant fraction of loans secured by homes. Home equity lending is also taking place on the fringe of financial markets, in non-financial firms such as the home improvement contractors who are often mentioned in connection with reverse redlining. While most loans that originate outside the banking system serve legitimate credit needs, and home equity lending that takes place outside the banking system has expanded credit opportunities for many borrowers, it has also opened the door to the abuses that are the subject of this legislation.

Although, for the reasons already mentioned, banks generally do not operate in these non-traditional sectors directly, some banks may do so indirectly by purchasing loans originated by finance companies and other non-bank mortgage lenders. In addition, finance companies can be operating subsidiaries or holding company affiliates of commercial banks. We simply do not know a great deal about these credit

flows. The OCC is working to determine to what extent national banks may be involved indirectly, either through non-bank subsidiaries or affiliates or through loan purchases, in financing home equity loans that would violate sound credit standards if they were originated by the bank.

The Role of Public Policy

Reverse redlining and other deceptive financial practices are particularly pernicious because they undermine general public confidence in financial institutions. One of the basic functions of government is to provide a foundation of honesty in the marketplace. Without that foundation, financial markets cannot operate efficiently. Citizens must have confidence in the knowledge that major financial transactions are not rigged against them. That confidence is shaken when they learn of homeowners who have lost their homes because they fell prey to clearly unfair or deceptive practices.

It is the responsibility of government to set limits on what is permitted in financial markets, and to prohibit practices that lend themselves too easily to abuse. One of the ways the government exercises that responsibility is by supervising the banking industry to ensure that banking practices are safe, sound, and fair. Policies that are too restrictive, however, can prevent honest lenders from satisfying the legitimate credit needs of their customers. The task facing policymakers is to set boundaries on permissible transactions that strike a reasonable balance between market efficiency and consumer protection.

In particular, policymakers must recognize that some homeowners obtain high-cost mortgages not because they are poorly informed, but because they do not qualify for credit from traditional sources and are willing to pay the higher price for a nontraditional mortgage. Such borrowers would not necessarily benefit from a blanket prohibition on high-cost mortgages.

Policymakers must also recognize that the same financial instrument can have both fraudulent and legitimate applications. For example, negative amortization is used by reverse redliners to conceal the true cost of their loans, but it is also a feature of legitimate banking products such as reverse mortgages for elderly homeowners, and adjustable rate mortgages with frequent (i.e., monthly) rate adjustments that offer the convenience of equal monthly payments.

Home Ownership and Equity Protection Act of 1993

The Home Ownership and Equity Protection Act of 1993 addresses the major issues in reverse redlining: disclosure, loan terms, and the lender's access to funds.

Disclosure. One of the keys to curbing deceptive lending practices is to provide borrowers with better information. The Act's disclosure requirements—and the requirement that disclosures be made at least three days before a loan is consummated—would make it more difficult for a lender to pressure a homeowner into a disadvantageous mortgage, while still allowing the homeowner to obtain a high-cost mortgage if that is his or her informed choice. We recognize, however, the difficulties involved in providing effective disclosures, particularly to unsophisticated borrowers who may have pressing financial needs and have no other sources of credit.

Loan Terms. Because there are some questions about the ability of disclosure requirements, by themselves, to eliminate abusive lending practices, the Act would also restrict the use of several devices—such as balloon payments, negative amortization, and prepaid payments—that reverse redliners often use to make the terms of their loans appear more affordable than they actually are. To avoid interfering with the provision of traditional banking services that have these features, the Act's restrictions on loan terms—as well as its new disclosure requirements—would apply only to "high-cost" mortgages: those with interest rates, fees, or debt service ratios that exceed specific threshold values set well above typical levels for loans made by traditional mortgage lenders.

Lender's Access to Funds. Under the Act, purchasers of high-cost mortgages could be held responsible for the original lender's failure to provide disclosures or to observe the Act's restrictions on loan terms. This would not interfere with legitimate loan transactions, but it would constrain reverse redliners, who are often thinly capitalized and must therefore sell the loans they originate before they can make more loans.

Compliance Costs

While the sponsors of the Act have taken care to avoid unduly burdensome requirements, the Act will impose some compliance costs. This is a matter of concern

to the Administration, which is committed to reducing the cost of financial regulation. But concern over compliance costs must not result in regulatory paralysis. Policymakers must be willing to act when regulation is needed to protect the public, and can be provided at reasonable cost.

As I stated earlier, I do not believe that the Act's disclosure requirements and restrictions on loan terms would have any effect on mortgage lending by commercial banks or other federally insured depository institutions. Nor do I believe that the provisions of the Act would prevent any institution outside the banking system from making high-cost mortgages that serve legitimate credit needs. The only loans that the Act would deter are those that charge excessive interest rates or up-front fees, and have repayment terms that borrowers cannot possibly meet. Consequently, I do not believe the remedies contained in the Act would impose unreasonable compliance costs or interfere with legitimate financial transactions.

Conclusion

The Home Ownership and Equity Protection Act is a sensible response to reverse redlining, but it would not eliminate abusive lending practices. A few lenders will probably continue to find ways to victimize borrowers who are underserved by traditional lenders. The best way to reduce discrimination lending is to encourage reputable lenders to enter the market. We are looking for ways to improve the incentives for banks to provide credit in low-income and minority neighborhoods. Consistent with the President's pledge, the Administration is also looking for ways to substitute performance for paperwork in the implementation of the Community Reinvestment Act. Through initiatives such as these, we hope to expand legitimate credit opportunities for low-income and minority households, and thereby reduce their vulnerability to unfair and deceptive lending practices.

STATEMENT BY LAWRENCE B. LINDSEY

MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. Chairman, I am glad to appear before your Committee today to offer the Board's comments on S. 924, the Home Ownership and Equity Protection Act of 1993. The bill would amend the Truth-In-Lending Act (TILA) to require additional disclosures to consumers who take out "high cost mortgages" on their homes and to restrict the terms of such mortgages.

The bill is a commendable effort to address the complex issue generically called "reverse redlining" that has received considerable public attention over the past two years. It is clear that the sponsors have attempted to narrowly target the bill to areas of abuse, without overburdening the general market. If the bill progresses further, I think it is extremely important to maintain this focus. As my comments will make clear, it is the Board's view that failure to maintain a tight focus in the drafting of this bill entails substantial risk to many legitimate forms of consumer credit.

We can all agree that the abuses this bill seeks to remedy involve some truly heart wrenching personal tragedies. Some homeowners often elderly, with substantial equity in their homes but with little income have been targeted by home improvement contractors, loan brokers, finance companies, and mortgage companies for aggressive promotion of credit. Sometimes the potential borrowers seek the credit to consolidate other loans that are about to mature. They also obtain this type of credit for home repairs or other emergencies.

When the "dust settles," these borrowers may find that they have paid a high number of loan origination and broker points (often financed in the borrowed amount) and have agreed to a loan with an interest rate at the highest levels in the market—sometimes with monthly payments that even exceed their monthly income and often with a balloon payment due. In some cases, it is maintained that borrowers have been defrauded because the terms of their credit have been misrepresented to them. Apparently, in a substantial number of cases, borrowers are unable to keep up the payments and end up losing their homes through foreclosure.

My colleagues and I, as well as officers and staff throughout the Federal Reserve System, have been closely following these issues and have, like the Members of this Committee, been actively considering how such abuses might be prevented in the future. Board members have met with delegations of aggrieved homeowners, and have been distressed to hear first hand of their plight. We talked with those who currently cannot afford to repay their loans and who risk losing their homes through foreclosure. Given the particular concern about these practices in Boston, the Federal Reserve Bank of Boston has investigated these practices there, meeting with public officials and community groups to work on a practical response, working with

affected borrowers, and conducting workshops on deceptive credit practices. It also reviewed the activities of one large nonbank subsidiary of a bank holding company in considerable detail.

Through all of these efforts we have come to appreciate the severity of the problems that high cost mortgages cause some borrowers. However, it has also become clear that finding a solution—that itself does not have adverse consequences—is a very difficult undertaking. The problem is multifaceted and complicated.

General Comments on the Legislative Proposal

The bill would define a high cost mortgage as one that meets at least one of the following characteristics: (1) the annual percentage rate (APR) exceeds the yield on U.S. Treasury securities having maturities comparable to the transaction by more than 10 percentage points; (2) the consumer's percentage of total monthly debt to income exceeds 60 percent after the transaction is consummated; or (3) all points and other fees paid prior to closing exceed 8 percent of the loan amount. We strongly support the bill's exclusion from its coverage home purchase loans and open-end home equity lines of credit.

The proposed disclosures for high cost mortgages would be required three days before loan consummation. The special disclosures for these mortgages would be made earlier than the disclosures which are already required under the TILA (required before consummation) and would provide the borrower three days before closing to review these special disclosures and to decide whether to close the loan.

Under the bill, consumers would receive information about the effect of the security interest in the home, the APR, a statement of the consumer's remaining monthly income after making the payments on the transaction, information about variable rate features, and a statement that submitting a loan application and receiving disclosures does not obligate the consumer to complete the transaction. Some of this information (or some form of it) is already required by the TILA to be given before consummation of the transaction. The bill would also amend the TILA to restrict the terms of high cost mortgage loans—for example, by prohibiting prepayment penalties, balloon payments, and negative amortization in such loans. Enforcement of these requirements is accomplished through the federal regulatory agencies and the courts, which could issue a judgment against a creditor for actual damages, civil penalties of up to \$1,000 per violation (up to \$500,000 in a class action) and, under the bill, forfeiture of all interest and fees earned.

In general, we believe that these problems should be addressed in a way that benefits consumers without undue compliance burden on creditors. For instance, overly restricting credit contract terms could create the risk that the cost of credit could increase or that it could be shut off altogether to marginal borrowers, or to those borrowers who happen to need credit due to special circumstances. The bill might create a disincentive to lending to these borrowers because a technical violation of even one of the proposed disclosure requirements could subject a creditor to the serious monetary penalties mentioned above. The risk of substantial litigation is likely to deter many legitimate lenders from entering this market. This should make us all the more careful to avoid having unintended results affect legitimate borrowers.

Everyone wants to protect consumers—particularly those whose age or income makes them vulnerable to abusive lending practices—against losing their homes, perhaps their only substantial asset. Appealing as it is to assume that more disclosure will cause people to act prudently, the Board is not convinced that more TILA information even if provided separately from and earlier than all other disclosures—will effectively deter consumers from entering into high cost mortgages or ensure that they better understand the possible consequences. For example, it is likely that people facing default on preexisting loans would agree to any (even high cost) terms after full disclosure to fend off losing their homes. Ordinarily, given the choice of addressing a consumer protection issue with disclosure requirements or credit restrictions, we would opt for informing consumers about their credit choices, such as through TILA disclosures. We believe the credit market works best when it is unencumbered and when consumers have the information they need to compare available credit terms.

With high cost mortgages, however, consumers are already required to receive a substantial amount of disclosures about the terms of the loan. They receive the APR, a disclosure of the security interest and the payment schedule on such loans, for example, although later than is proposed under the bill. The benefit of the special disclosures in advance of this information is less than obvious since most of

these homeowners already have three days after closing to review their existing cost disclosures and to cancel the transaction under current law.¹

Obviously despite these protections, there are problems today. Borrowers nevertheless enter into these high cost obligations. It appears that few if any rescind these high cost transactions after receiving cost disclosures—even consumers who may have been misled about their credit terms or were subjected to high pressure sales tactics. Thus, despite the good intentions of the sponsors and our own usual preference for disclosure rules over other restrictions, we have doubts whether simply increasing the information given will have much positive impact.

Thus, it may be that the more realistic way to address these various problems is through some of the substantive restrictions proposed in section 2 of the bill. The principal substantive restriction under the TILA now affecting these loans—the right of rescission—could be enhanced somehow for high cost loans, for example by lengthening the rescission period, as an alternative to adopting restrictions on credit terms. This may prove particularly efficacious in cases where the borrower is actively solicited by a broker or lender, rather than having initiated the credit shopping. We would be happy to work with Committee staff on such an alternative, although I am not confident that high cost mortgage borrowers who may desperately need credit would be any more likely to rescind their loans with greater disclosures about rescission or a longer “cooling off period” than they are now.

Specific Comments on the Legislative Proposal

We have attached, for the Committee’s information, detailed comments on the entire bill. However, I would like to make a few comments on the provisions. Our objective is to have the Congress avoid the unintended consequence of terminating legitimate credit options in the process of enacting this bill. We suggest that the definition of a high cost mortgage be changed to be a transaction in which *two or more* of the conditions are satisfied. Consider each point in turn:

First, consider the criterion that high cost loans bear interest rates at more than 10 points above the current rate on Treasury securities of equal duration. I can understand that 10 percentage points may seem to be a large spread. In the present rate environment, however, this criterion implies an interest rate threshold of 14 to 15 percent. Yet many individuals, and not just those with low- and moderate-incomes, currently finance moderate sized home repair items by using their credit cards. The effective interest rate on these cards may well be in the 18 to 21 percent range. It does not seem appropriate to consider extensions of credit at 14 or 15 percent rates as high cost when individuals now often assume much higher rates to accomplish the same purpose. The interest rate alone should not be considered the basis for establishing a loan as “high cost” unless a substantially higher spread is adopted.

Second, consider the 60 percent of income criterion. I have regularly opposed the use of such factors since income is often a poor guide to the ability to repay a loan. Consider first what I call the “widow situation.” Let us imagine a widow who is left with her home, a little income (say, earnings on her husband’s life insurance), and some real estate that could be fixed up and sold to improve her financial situation. She is consuming the capital represented by the life insurance proceeds. She realizes that cannot continue and indeed that is the reason why she is seeking to liquidate some of her property. But it is easy to imagine that the financing costs on the repairs she must undertake will exceed 60 percent of her income on a short term basis. Would you put at risk her ability to borrow by defining her loan as “high cost” simply because of her temporary low income? Again, I think that using simply one of the three criterion listed as sufficient for that definition creates an overly broad scope for this bill.

A second class of individuals who would be unintended victims of this legislation would be people who are starting small businesses and using their homes as equity for fixed term second mortgages. Because the incomes of these individuals are temporarily depressed, use of income as the sole criterion for the high cost designation is particularly ill advised. Yet these types of mortgages may be the best source of credit available to these potential entrepreneurs.

I might add that preliminary research at the Federal Reserve suggests that many government sanctioned mortgages implicitly involve loans to families which require more than 60 percent of their income to be used for credit purposes. In 1987, for

¹Over twenty years ago a federal “cooling off” period was established in the TILA to resolve the problems caused homeowners by high pressure home improvement contractors. Under the TILA, consumers have a right to rescind most credit (except home purchase loans) secured by the home—not just credit sales including most refinancings.

example, roughly 10 to 12 percent of all FHA-insured refinancings involved borrowers with debt to income ratios greater than 60 percent. To avoid limiting the availability of credit under government sponsored programs, you might consider exempting these mortgages from coverage under the legislation.

Finally, the third criterion, an 8 percent limit on points and fees, is unduly restrictive for small loans. For many reasons, including the paperwork costs imposed by law and regulation, there is a substantial fixed cost involved in processing the loan. Indeed, this is often cited as the reason why many banks do not make small loans at all. An 8 percent limit on points and fees would make these loans even scarcer. Consider a \$2,000 loan for a new roof, for example. The 8 point test translates to a \$160 threshold. By any of the cost standards I am aware of, this is uncomfortably low.

Again, I am sure we all agree that we want to avoid the unintended consequence of making loans more difficult to get. My colleagues and I have wrestled with the conflicting tradeoffs involved. One option is to raise the thresholds proposed for each of the three criteria cited above. We believe that a better option is to look for a pattern of abusive terms by requiring that two of the three criteria be met before designating the loan as "high cost." Absent such a change, it would be difficult for us to conclude that this legislation would not risk significant impairment of loan availability in many legitimate and non-abusive instances.

Of all of the provisions in section 2 of the bill, the substantive limitations on balloon payments, negative amortization, and prepayment penalties seem particularly focused on the problems associated with high cost mortgages. Without the bill's exclusion of home purchase loans, some common balloon mortgage products such as the so-called "7-23" loans, could have been affected by the restrictions. And, without the exclusion, the negative amortization restrictions might well freeze out many potential home buyers from the market if the rate environment of the late 1970's should return. Further, as mentioned in our attached technical comments, the definition of negative amortization may have the unintended consequence of restricting reverse annuity mortgages because the balance on these loans increases with the payouts to the elderly borrower over the loan term. Thus, I again stress it is very important to keep the focus of the bill narrow.

We also have some concern about the provision that would amend the TILA assignee liability and expose an assignee to all the claims and defenses the consumer could assert against the creditor from failure to comply with any TILA requirement. The Federal Trade Commission's rule on unfair and deceptive practices addresses this issue to some degree already. That rule has essentially eliminated holder in due course status for assignees of consumer credit sale contracts, but not of direct loans. Also, the provision would create a second, more expansive standard for assignee liability than is present in the TILA, which now specifies that assignees are liable only for TILA violations that are apparent on the face of the documents for the loan assigned. In addition, the penalties are much more severe (loss of all finance charges paid) than under existing law. This potential for increased liability could discourage the purchase, and ultimately the origination, of loans—and therefore restrict the availability of credit to marginal borrowers without alternative sources of credit.

Finally, to the extent the Congress chooses not to defer regulatory policy to the states, the Board believes a clear and complete federal preemption should be considered to clarify coverage and reduce regulatory compliance burdens.

Conclusion

The Committee is to be commended for attempting to resolve a complicated and important problem caused by high cost mortgages. It is clear that the issues raised by high cost mortgages are complex, and the appropriate federal response to the problems they raise is equally complicated. Many of these issues, relating to fraud and misrepresentation or usury, are already regulated by the states. Other issues, such as disclosure about the cost of credit and the ability to rescind a loan entered into through high-pressure tactics, are already handled to a great degree in federal law. The other issues raised, such as the terms of the credit contract, would be addressed in S. 924 by imposing restrictions on the parties' ability to contract for those terms. Although we do not favor federal restrictions on credit terms, we believe that these restrictions would better address the problems created by high cost mortgages than the additional disclosures that have been proposed.

In crafting the final form of this legislation, it is essential for the Committee to avoid the problem of unintended consequences. Given the reported difficulties that some sectors of the economy have in accessing credit, it would be an unfortunate outcome of well intentioned legislation if these sectors were cut out of the credit

market entirely. I would recommend to this Committee that during the course of their deliberations they solicit information from creditors active in second mortgage lending to determine how the proposed legislation might affect the availability of credit. We need to be better informed of this market, but absent perfect information, it is essential to keep the focus of this legislation as narrow as possible in order to eliminate abusive practices while minimizing adverse consequences which the Congress clearly would not have intended.

ATTACHMENT

FEDERAL RESERVE BOARD STAFF COMMENTS ON S. 942

The Home Ownership and Equity Protection Act of 1993

The following are technical and substantive comments of the Federal Reserve Board staff on S.942, a bill amending the Truth-In-Lending Act (TILA) to provide additional disclosures and substantive prohibitions for certain high cost home-secured loans.

Section 1. SHORT TITLE.

Section 2. CONSUMER PROTECTIONS FOR HIGH COST MORTGAGES.

(a) *DEFINITION.* A new paragraph defining a "high cost mortgage" loan would be added to section 103.

- We suggest adding the new definition as new section 103(x), not section 103(v), to minimize the need to make conforming changes in the current law. For example, several provisions of the TILA refer to the definition of a residential mortgage transaction under section 103(w). (See TILA, §§ 125(e) and 128(b)(2).) Existing definitions in section 103(x)–(z) would be redesignated section 103(y)–(aa).
- We concur that the scope of coverage of the legislation should be limited to consumers' principal dwellings and not second homes, vacation homes, and the like. The concern about "high cost mortgages" is associated with loans secured by consumers' primary residences. It also seems appropriate that residential mortgage transactions (home purchase loans) and transactions under open-end credit plans (home equity lines of credit) would be exempt.

We suggest that certain other loans or loan programs be considered for exemption to avoid covering transactions not intended to be covered by the legislation, for example, reverse mortgage loans (discussed at p. 7) and government sponsored loan programs.

Excessive annual percentage rate (APR). A "high cost mortgage" would include a loan that at the time of origination has an APR that will exceed by more than 10 percentage points the yield on Treasury securities having comparable maturities, as determined by the Board.

- We suggest substituting the phrase "at consummation" for "at the time the loan is originated." Under Regulation Z, which implements the TILA, consummation is defined to mean the time that a consumer becomes contractually obligated on a credit transaction. 12 C.F.R. § 226.2(a)(11)
- We suggest deleting the sentence beginning "[i]n the case of a variable rate loan... as unnecessary. Currently under Regulation Z, if a creditor sets an initial interest rate that is not determined by the index or formula used to make later rate adjustments, the APR must be a composite based on the initial rate for as long as it is charged and, for the remainder of the term, the rate that would have been applied using the index or formula at the time of consummation. 12 C.F.R. § 226.17(c)(1)–10 (Supp. I)

If the sentence is retained, for clarity (and consistent TILA terminology) we suggest substituting the phrase "rate that would have been applied using the index or formula at the time of consummation" for the phrase "rate or rates that will apply during subsequent periods." Also, at the end of the sentence "rates" would be changed to "rate." In spite of the first sentence of the paragraph which refers to the APR at consummation, the phrase "rates that will apply during subsequent periods" in the second sentence could be misconstrued to mean that at no time during the term of a variable rate loan may the rate be adjusted to exceed by 10 percentage points the yield on the relevant Treasury security. Such a rule would effectively require creditors to monitor variable rate loans to ensure that a rate adjustment during the loan term would not become "excessive." As an alternative to monitoring variable rate loans (which seems extremely burdensome), a creditor would likely automatically comply with new section 129, particularly given the civil liability that attaches for noncompliance.

- We suggest revising paragraph to read as follows:

The annual percentage rate at consummation, whether the interest rate is fixed or variable, will exceed by more than 10 percentage points the yield on Treasury securities having comparable maturities, as determined by the Board.

Excessive debt-to-income ratio. A "high cost mortgage" would include a loan entered into by a consumer whose debt-to-income ratio exceeds 60 percent, immediately after the loan is consummated.

- This provision does not require creditors to undertake a debt-to-income analysis. If the consumer provides information about income and other debts and the debt-to-income ratio exceeds 60 percent, the new law would be triggered. Since this analysis is not done oftentimes on high cost loans, the condition would not have much of an impact. Nonetheless, requiring all creditors to conduct such an analysis may have the unintended consequence of adversely affecting certain government programs or credit availability generally, for example, for marginal consumers.
- If the condition is retained, it might be more narrowly tailored to target loans to consumers with a lot of equity in their homes and high debt-to-income ratios. For example, a requirement to do a debt-to-income analysis to determine whether it is in excess of 60 percent could be limited to loans to consumers with a certain amount of equity in their homes. Further, to ensure that government programs (like HUD's FHA low documentation refinancings) are not inadvertently covered, they could be exempted.
- The legislation provides that the Board may establish a different debt-to-income ratio that is in the public interest and consistent with the purposes of the act. The phrase "is in the public interest" seems unnecessary.

Excessive points and fees. A "high cost mortgage" would include a loan with all points and all fees payable at or before closing that exceed 8 percent of the "total loan amount."

- We suggest clarifying the phrase "all points and fees" in any accompanying report. For example, is use of the phrase "all points and fees" intended to exclude other finance charges (other than interest) such as origination fees, required credit life insurance and required broker fees? Does it apply only to points and nonfinance charge fees such as appraisal fees, property surveys, title examinations and other closing costs, brokers fees, and voluntary credit life insurance premiums?
- We suggest explaining the term "total loan amount" in any accompanying report to clarify whether the percentage is applied to the loan amount exclusive of any charges or fees that are financed (which we presume to be the case). Such fees would generally be considered part of the total loan amount.
- This condition may be overly broad. With regard to small loans, all fees and points of 8 percent above the loan amount are not inherently excessive. For example, under the proposed formula, a \$10,000 home-secured loan with closing costs exceeding \$800 would be considered a "high cost mortgage." To avoid coverage of loans not intended, a de minimis rule might be appropriate.
- We suggest revising this paragraph to read as follows:
For loans above \$10,000, finance charges, fees and other charges payable at or before closing will exceed 8 percent of the total loan amount.

(b) **MATERIAL DISCLOSURES.** No comment.

(c) **DEFINITION OF CREDITOR CLARIFIED.** A new definition of creditor for purposes of section 129 only would be added to section 103(f).

- Under Regulation Z, a person may be a creditor if consumer credit is extended more than five times for dwelling-secured transactions. (12 C.F.R. § 226.2(a)(17)n.3.) It is our understanding that the purpose of the proposed amendment to section 103(f) is to define as creditors persons extending consumer credit two or more times for home-secured transactions defined as high cost mortgages under section 129. The amendment is not intended to generally expand the definition of creditor by making arrangers of credit "creditors." We also assume the term "originates" is intended to mean that the loan is initially payable to the person extending the credit.
- We suggest that the phrase "or who originates a high cost mortgage loan through a broker" be deleted as unnecessary or that it be clarified. If a person who originates two or more high cost mortgages a year is a creditor for purposes of section 129, that would be the case whether or not the loan is originated through a broker. If the provision is intended to mean that a person who originates one loan through a broker is a creditor for purposes of section 129 and if no broker is involved, then the test is the origination of two or more loans, we suggest clarification of that point.

- We suggest that any accompanying report clarify the purpose of this provision, for example, by providing an example of the type of situation this provision is intended to cover (i.e., door-to-door salespersons).

(d) **DISCLOSURES REQUIRED AND CERTAIN TERMS PROHIBITED.** A new section 129 relating to "high cost mortgages" would be added.

Disclosures. Section 129(a) contains the disclosures that would have to be provided.

- We suggest deleting the word "initial" in paragraph (a)(2) as unnecessary. There is only one APR for purposes of TILA disclosure.
- The disclosure in paragraph (a)(3) seems to implicitly require a creditor to collect income information once a loan is determined to be a high cost mortgage. We suggest this point be clarified in any accompanying report. It is our understanding that a creditor would not be in compliance by disclosing "inapplicable" or "unknown" under the consumer's monthly gross cash income.

We suggest that the word "cash" be deleted as unnecessary. If the term is intended to distinguish different types of income, we suggest that any accompanying report provide examples to clarify "cash" and "noncash" income.

We suggest substituting "total monthly loan payment" for "total initial monthly payment."

- The disclosures in paragraphs (4) and (5) generally duplicate disclosures required under the current Regulation Z disclosure scheme for variable rate or adjustable rate mortgage (ARM) loans, though in the legislation the information required is more transaction specific. Generic disclosures about variable rate products must be given to consumers *at the time of application*, including a "worse case" payment example and a historical table illustrating how payments and a loan balance would be affected by interest rate changes, based on a hypothetical \$10,000 loan. The ARM disclosures also include an explanation of how a consumer may calculate his or her actual monthly payment for a loan amount other than \$10,000.
- Paragraph (4) would require disclosure of the maximum interest rate and payment. It is virtually impossible to determine a precise maximum monthly loan payment prior to consummation on a specific transaction because it is not clear when the maximum rate may be reached during the loan term. Under the ARM rules, in calculating the maximum rate and payment, the creditor must assume that the interest rate increases as rapidly as possible under the loan, and the maximum payment must reflect the amortization of the loan during this period. We would assume the same hypothesize should apply to the disclosure in this paragraph.
- In paragraph (5), we believe that the intended disclosure is a statement about the initial interest rate (typically a discount rate), not the APR (which is required under Regulation Z to be a composite of the initial rate and the fully-indexed rate or one based on a formula). In addition, the legislation does not require that the initial interest rate be disclosed, just the period of time that the rate will be in effect. We assume disclosure of the initial rate was intended as well, otherwise the information required to be provided seems incomplete.

Disclosure of the rate that will be in effect after the initial period is over, assuming that current interest rates prevail, is required.

We recommend that paragraph (5) be revised to read as follows:

In the case of a variable rate loan with an initial rate that is not based on the index or formula that would apply at consummation, a statement of the initial rate, the period of time the initial rate will be in effect, and the rate that would have been in effect at consummation.

Time of disclosures. Section 129(b) would require that applicable "high cost mortgage" loan disclosures be given no later than three business days prior to consummation.

- We interpret the last sentence of paragraph (b) to mean that creditors may not change the terms of the loan between the time disclosures are given under section 129 and consummation of the loan (i.e. changes during the loan term are not prohibited by this provision).

No prepayment penalty. Section 129(c) would prohibit "high cost mortgage" loans from including prepayment penalties. It also prohibits the imposition of points and other fees when certain high cost mortgage loans are refinanced.

- Paragraph (c)(2) prohibits the use of the Rule of 78s to compute the rebate of interest on high cost mortgages, presumably those where interest is precomputed. Under section 933 of the Housing and Community Development Act of 1992, beginning September 30, 1993, creditors must compute refunds on any precomputed consumer credit transaction of a term exceeding 61 months based on a method

which is at least as favorable to the consumer as the actuarial method. For consistency, we suggest the following: *For purposes of this subsection, any method of computing rebates of interest less favorable to the consumer than the actuarial method using simple interest is a prepayment penalty.*

- Under paragraph (c)(3), points, discount fees and prepaid finance charges would be prohibited on the portion of a high cost mortgage loan that is refinanced by the same creditor or an affiliate. Presumably if additional funds are advanced as part of the refinancing, points and other fees could be imposed on the "new advance" portion.

We suggest that any accompanying report clarify what charges "discount fees" are intended to cover.

As a technical amendment, we suggest the proposed paragraph (c)(3) be added as a new paragraph (g), *LIMITATIONS ON REFINANCING FEES*, as it seems to have no relationship to prepayment penalties.

- We believe that the exception in paragraph (c)(4) for prepayment penalties is too narrow. We recommend deleting "if the consumer prepays the full principal of the loan within 90 days of origination." It is not uncommon for a creditor at any time during the loan term to charge interest that would have been earned to the end of the month or the next payment due date when a consumer pays a loan in full between payment due dates. Moreover, it is our understanding that concerns about interest penalties are of a more severe nature, for example where a penalty of several additional months of unearned interest are imposed when a loan is prepaid.

No balloon payments. Section 129(d) would require that the aggregate of periodic payments in a high cost mortgage loan fully amortize the principal balance.

- We suggest that the section be amended to read, "A high cost mortgage may not include terms under which, at the time of consummation, the aggregate amount of the regular periodic payments would not fully amortize the outstanding principal balance." As amended, the language would ensure that consumers will not become obligated for a payment schedule that does not amortize the outstanding principal in even installments. At the same time, the text addresses changes in circumstances during the loan term (such as missed payments) that would result in a higher payment being due at the end of the loan term.

No negative amortization. Section 129(e) would prohibit high cost mortgage loans from including a term that results in an increase in the principal balance during the loan term.

- A hypertechnical reading of this provision causes some concern about its potential impact on reverse mortgages, also known as reverse annuity or home equity conversion mortgages, assuming such transactions might be defined as high cost mortgage loans under one of the three conditions. Typically, the reverse mortgage loan is made on the basis of the consumer's equity in his or her home. Monthly payments are disbursed to the consumer (so the debt increases) for a fixed period or until the occurrence of an event such as the consumer's death. Repayment of the loan (generally a single payment and accrued interest) may be required at the end of the disbursement period or, for example, upon the consumer's death. We suggest language in any accompanying report clarifying that this provision does not apply to such loans. Alternatively, we suggest that such loans be exempted from this provision (or from the legislation generally).
- Negative amortization involves a loan payment schedule in which the outstanding principal balance goes up, rather than down, because the payments do not cover the full amount of interest due. The unpaid interest is added to the principal. We suggest clarifying by either revising the text or by a discussion in the legislative history that this prohibition is not intended to cover increases to principal balances due to events other than a change in interest rates, such as default provisions. For example, if a consumer fails to purchase property insurance as required by the mortgage documents, creditors typically may purchase insurance to protect the collateral and add the premium to the principal balance.
- We suggest the following revision to this paragraph:

A high cost mortgage may not include terms under which the outstanding principal balance will increase over the course of the loan, because the payments do not cover the full amount of interest due.

No prepaid payments. Section 129(f) would prohibit high cost mortgage loans from including a term that deducts payments from the loan proceeds in advance of the regular due date.

- We suggest clarifying in the legislative history examples of the abuses this subsection is attempting to curb. Also, if the abuse affects regular installment pay-

ments, perhaps the prohibition against balloon payments addresses the issue, and the text of section 129(f) could be deleted in its entirety.

(e) **CONFORMING AMENDMENTS.** No comment.

Section 3. CIVIL LIABILITY.

(a) **DAMAGES.** We concur that the proposed amendment regarding damages should be a new paragraph (4) to section 130(a) of the TILA.

(b) **STATE ATTORNEY GENERAL ENFORCEMENT.** No comment.

(c) **ASSIGNEE LIABILITY.** Section (c) would add to the TILA a new standard for an assignee's liability when a creditor fails to comply with new section 129.

- An assignee of a high cost mortgage loan would be liable for all the claims and defenses a consumer could assert against the creditor. Recovery would be limited to the total amount paid by the consumer in connection with the transaction. This provision would be a substantial departure from the liability provisions for assignees, which became part of the TILA as a part of TIL simplification and limited assignee liability to violations on the face of the TILA disclosure statement.

Section 4. EFFECTIVE DATE.

The Board would be required to publish final rules implementing this legislation within 180 days of enactment. The mandatory compliance date for creditors would be 60 days following publication of the Board's final rule.

- Although 60 days is a relatively short period following publication of a final rule for creditors to prepare themselves to comply fully with the substantive and disclosure provisions of this proposed legislation, providing two months' lead time will be helpful to creditors.

TESTIMONY BY TERRY DRENT

HOUSING COORDINATOR, COMMUNITY DEVELOPMENT DEPARTMENT, ANN ARBOR, MI

Problem

Many people living on fixed incomes in Michigan and the rest of the country are facing a crisis. For many the cost of medical care, housing, and basic sustenance is so high that they have to supplement their incomes with debt in order to survive. In Southeastern Michigan we are seeing many low-income families, senior citizens, and disabled people who live on fixed incomes being preyed upon by unscrupulous mortgage companies, with a practice known as reverse redlining. These firms often target lower income families claiming to be able to assist them in paying for medical care, home repairs, and property taxes. The results, however, can lead to the misery and impoverishment of this population. Many of these homeowners are suffering great hardships because of the financial "solution" offered by mortgage companies, and it has increased the burden on limited community resources. Some people are actually being forced out of their homes.

Background

People living on fixed incomes are susceptible to abuse by mortgage companies because they have seen their expenses for vital items increase at a rate greater than their incomes. Many of our most vulnerable citizens; the elderly, the ill, the unemployed and the disadvantaged, are being targeted by unscrupulous lending institutions because they are homeowners with substantial equity in their homes. This population is experiencing difficulty paying for health care, home repairs, and basic sustenance, and they are forced to supplement their incomes with debt.

Finance companies are gauging and exploiting the most vulnerable Americans. In previous testimony before this committee on February 17, 1993, I gave specific examples of these abuses, so I will not take your time with them today. Rather, I will speak of my experiences with our regulatory agencies in dealing with the problems of reverse redlining and comment on the Home Ownership and Equity Protection Act of 1993.

The Federal Trade Commission has primary responsibility for enforcing Truth-In-Lending and Fair Credit Reporting laws as they apply to finance companies, mortgage brokers, and other non-bank lenders. Attorneys for the FTC's Credit Practices Division report that they only get involved in reverse redlining abuses "by responding to consumer complaints, information from competitors, and attention in the media."

The Federal Reserve maintains oversight of entities such as Fleet Finance that are part of a bank holding company. Though the Fed's primary concern is over safety and soundness, they have neglected to investigate charges of reverse redlining and have even approved mergers and acquisitions by lending institutions that are facing huge class action suits and racketeering charges for engaging in unscrupulous and unfair lending practices. Because the Community Reinvestment Act makes no distinction between originated or purchased loans, banks are allowed to fulfill their CRA obligations by purchasing high rate mortgages.

I attended meetings with the Board of Governor's of the Federal Reserve and at the FDIC. After a breakfast meeting with Governor Lawrence Lindsay and leadership of various organizations from across the country to discuss regional hearings to investigate the pervasiveness of reverse redlining, the Fed refuse a request for regional field hearings. However, Governor Lindsay did suggest that the print on Truth-In-Lending Disclosure could be made larger and darker in an attempt to help people understand mortgage papers. He had just been presented with court documents that told of a legally blind elderly woman who was about to lose her home of forty years from a mortgage foreclosure. She had signed for a mortgage for \$39,500 at 25 percent interest that had a three year balloon payment. Of that \$39,500 she only received \$4,066 as the remainder paid for discount point and origination fees. This woman could not even read the mortgage papers that were brought to her home to sign, so Governor Lindsay's solution would not have helped her.

I attended a meeting with the FDIC to speak with regulators about reverse redlining. Some of the participants were people who had actually lost their homes to companies that practice reverse redlining. An elderly woman, who was part of a delegation of people who had lost their homes to mortgage foreclosures that met with Senator's Riegle, Chaffey, and the staff of Senator Sarbanes, was tired and sat on a bench in front of a bank of elevators. FDIC personnel were upset because there were as many as twelve people in the lobby, so this poor and tired woman was threatened with arrest and forcibly removed from the bench. It is an affront to American justice and fairness when a woman who has had her life time home taken away from her through an unfair mortgage is threatened with arrest when she tries to share her experience with the people charged with investigating this activity.

Our regulatory agencies are out of touch with the plight of average Americans. These agencies are run and staffed by people who were appointed because they are products of the very culture and institutions that they are supposed to regulate. Their orientation is with the people who are perpetrating these mortgage abuses on the American people. They will not be part of the solution because they are part of the problem. They concentrate on what they should not do, will not do, and cannot do instead of insuring fair access to reasonable credit and protecting the national interests on the American people.

Over 90 percent of the victims of reverse redlining that I have seen are African-Americans. Those I have spoken with have a common profile. They come from working class backgrounds. They worked hard their entire lives and they have participated in part of the American Dream, home ownership. Many of them have paid off a first mortgage on their homes. They are usually elderly, and grew up before the Civil Rights Amendment to the Constitution. They do not feel that their interests are necessarily protected by government. They are a prideful group of people, and they want to find their own solutions to their problems, so they are reluctant to ask for help. But their pride is used against them because the mortgage brokers contact them in their homes, and sign the mortgage papers in their homes with high pressure tactics. This is an environment bereft of proper contemplation where there is no opportunity for consultation with an attorney, family members, or traditional lenders before documents are signed.

The victims of reverse redlining feel disenfranchised from our government, as if they are second class citizens, and they don't have the same rights as most Americans. This view is understandable when you see the treatment they have received by regulators, or just the newspaper. There are reports that African-Americans are three times more likely than whites to be denied credit with equal incomes and debts. Discrimination is re-enforced in the media. Last Wednesday Rush Limbaugh said on his nationally televised television show that "blacks have more rights than whites and we have to even the score card." He made this statement in reference to Leonard Davies, a department head at the City College of New York, who was reinstated to his position after a Federal Court found that he was improperly fired for making racist statements.

We must stop the alienation of our minority populations. Our government must protect their economic rights, their right to access fair and reasonable credit, as the economic rights of business people are upheld. Our regulatory agencies have failed to deal with the reverse redlining problem. After seeing the lack of interest our reg-

ulators have in the citizens of our country it is easy for me to understand how S&L Crisis was allowed to happen.

It is up to the Senate to deal with this problem. You represent the real America, and you have the power, the ability, and the desire to insure fair access to credit for all Americans, to make a stronger and fairer nation for us all. This committee is representative of America as few are, its make up, and the experiences of its Members lets us know that the voice of the American people will be heard, that we are represented by our government.

Senator Riegle and Senator D'Amato should be commended for their zeal and firm resolve in investigating the reverse redlining issue. They have broken gridlock, something the last three Presidents have been unable to achieve.

Comments on The Home Ownership and Equity Protection Act of 1993 and Recommendations

The Home Ownership and Equity Protection Act of 1993 is a great start to stem abuse in the non-conforming mortgage industry. It sends a clear message to the American people that our government cares about the American people, and lets them know that their interests will be protected.

The reverse redlining issue is a product of the Depository Institutions Deregulation and Monetary Control Act of 1980. As with many pieces of legislation, over time problems develop that were not intended by the original drafters. It is time to enact legislation that will stop the abuses that have developed since deregulation. We recommend the following for your consideration.

- Lower the trigger rate in the definition of high cost mortgages. The current 10 year Treasury rate would allow for loans as high as 15 percent (double of current market rates) without calling for closer scrutiny under the proposed act.
- Amend Truth-In-Lending Disclosures to require that lending institutions provide the name, address and phone number of a Local non-profit Legal Services Office. This is consistent with HUD guidelines for reverse mortgages, and not an onerous burden to lenders.
- Require judicial foreclosure of high risk mortgages.
- Establish an assignment program to refer troubled mortgages to the HUD mortgage assignment program.
- Strengthen and clarify the notice of foreclosure prevention services existing in current law.
- Amend the Community Reinvestment Act to allow more community oversight and input.
- Support the appointment of citizen advocates to regulatory agencies.

There are many abuses in the non-conforming mortgage market, and what was once considered usurious mortgages are now allowable under current law. Many lower income homeowners are being victimized. We are not against nonconforming mortgages, in fact, the Mayor and Administrator of Ann Arbor, along with City Council, are currently trying to develop a Loan Pool with local banks under the Ann Arbor Credit Enterprise initiative to write non-conforming mortgages to help low-income individuals obtain housing. However, we feel that there are consumer protections than can be put in place to help protect the low income, vulnerable, and disadvantaged, from an unchecked and under-regulated segment of the banking industry. The Home Ownership and Equity Protection Act of 1993 empowers people to pursue their own remedy in the courts, thereby eliminating reliance of lack luster regulators.

Summary

The problem of reverse redlining mortgages, along with the threat of tax foreclosures, is so severe in the City of Ann Arbor and the State of Michigan, that our Mayor, along with the City Administrator and City Council, has established a foreclosure fund to help our citizens with this terrible problem. But we have far too few dollars to meet the need, and many people are falling through the gaping holes in the small safety net that we can afford to throw out. We have less money to spend on the seemingly insurmountable problems facing our nation. Legislative action is needed to take care of this abusive mortgage system, which was largely created by the *Depository Institutions Deregulation and Monetary Control Act of 1980*. The practice of reverse redlining mortgages is threatening the sanctity of part of the American Dream, home ownership, for those who can least afford it. This activity is wrong, unfair, and unjust; it must be stopped. We support the Home Ownership and Equity Protection Act of 1993 as a way to end many of the abuses associated with reverse redlining.

STATEMENT OF DIANNE M. LOPEZ
ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION
THE CONSUMER BANKERS ASSOCIATION

Mr. Chairman and Members of the Committees, my name is Dianne Lopez. I am Senior Vice President and Compliance Division Manager for the First Interstate Bank of Texas. I am a member of the American Bankers Association's Compliance Executive Committee and am pleased to be here to testify on behalf of the American Bankers Association¹ and the Consumer Bankers Association² ("the Associations") regarding S. 924, The Home Ownership and Equity Protection Act of 1993. The bill amends the Truth-In-Lending Act to require additional disclosures and contract term restrictions for certain mortgage loans. The new provisions apply to closed-end home equity loans and mortgage refinancings imposing fees that exceed statutory limits and to borrowers with high debt to income ratios.

As stated in the May 7, 1993 *Congressional Record*, the purpose of S. 924 is to combat abusive mortgage lending practices. Such abuses are said to involve high rate, high fee mortgages to "cash poor homeowners" by nontraditional lenders. These loans are frequently made with promises of home improvements or debt consolidation. Apparently, disclosures about terms and costs are often not adequately made. Homeowners, unable to make the payments on these high cost loans, are forced into foreclosure. They end up losing their homes.

Mr. Chairman, clearly, there have been abuses in this mortgage lending area, and the Committee is right to be concerned. We share that concern and agree that such abuses should be stopped. Simply put, low-income consumers should not be subjected to these types of practices, and our associations want to make sure they are stopped. One way to stop these abuses is to provide clear disclosures regarding loan costs and the consequences if loan payments are not made. The Associations have always supported clear disclosures.

Furthermore, as you are aware, the banking industry is highly concerned about regulatory burden. Too often, well-intended legislation has resulted in unintended consequences. Simple concepts have been translated into complicated exercises. The unintended result has been time-consuming paperwork, complicated formulas, expensive new software and forms, micromanagement of the industry, and major resources spent ensuring and proving compliance to regulators. We need to make sure that the costs justify the benefits. Working together with your Committee, we believe this proper balance can be achieved in this case.

We believe that you and your staff have gone a long way in improving the bill to make the new requirements consistent and compatible with existing laws. Nevertheless, while the fundamental concept of the bill is sound, we have serious concerns about the bill. We believe that, largely because it may cover loans which are not of the type meant to be covered, it will unintentionally subject highly regulated lenders to significant new compliance burdens. Even banks not making "high cost mortgages" will still have to prove to bank examiners that they have not made such loans. They will still have to calculate debt to income ratios according to a regulatory formula.

The debt to income ratio element of the definition of high cost mortgage is particularly worrisome: whether intended or not, Congress will in effect be micromanaging how creditors analyze and use debt to income ratios. Pages of regulation will be needed to define what is included in "income," and "debt," and this will result in complexities as well as new burdens for loan applicants. In addition, the compliance and liability consequences of the bill may discourage beneficial and useful loans, loans not targeted by the legislation, such as home improvement Community Reinvestment loans and work-out loans, among others. Assignees acquiring mortgages subject to the bill could be subject to potentially costly liability for violations outside their control if the civil liability provision is not modified.

We do not believe that the bill is intended to create these additional compliance and liability burdens or discourage certain consumer lending. We would like to continue to work with you and your staff to target the bill more directly to ensure that

¹The American Bankers Association is the national trade and professional association for America's commercial banks, from the smallest to the largest. ABA members represent about 90 percent of the industry's total assets. Approximately 94 percent of ABA members are community banks with assets less than \$500 million.

²The Consumer Bankers Association was founded in 1919 to provide a progressive voice for the retail banking industry. CBA represents approximately 750 federally insured banks and thrift institutions. Its members hold more than 70 percent of all consumer credit held by federally insured depository institutions.

it effectively discourages abusive practices without imposing unnecessary and inadvertent compliance burdens and lending restrictions.

Summary of Bill

The bill defines "high cost mortgage" as a closed-end home equity loan or mortgage refinancing with one of the following characteristics:

- the annual percentage rate at time of origination will exceed by more than 10 percent the yield on Treasury securities having comparable maturities;
- based on information provided by the consumer, the consumer's total monthly debt payments will exceed 60 percent of the consumer's monthly gross income, immediately after the loan is consummated; or
- all points and fees payable at or before closing will exceed eight percent of the total loan amount.

Mortgages fitting this description are subject to special disclosure requirements and contract term restrictions. The disclosures include:

- a statement that failure to pay the loan may result in loss of the home and any equity;
- an initial annual percentage rate; information regarding the consumer's gross monthly cash income, monthly payment on the loan, and funds remaining after the loan payment;
- information regarding variable rate loans, if applicable;
- and a statement that the consumer is not required to complete the transaction merely because he or she has received disclosures or signed a loan application.

These disclosures must be provided no later than three business days prior to consummation of the transaction. Terms of the loan may not change after the lender provides the required disclosures.

High cost mortgage contracts are also prohibited from including certain terms: prepayment penalties, rebate computation methods less favorable than the actuarial method; balloon payments; negative amortization; and prepaid payments exceeding two periodic payments. In addition, an agreement to refinance a high cost mortgage by the same creditor may not require points, discount fees, or prepaid finance charges on the portion of the loan refinanced.

Definition of "high cost mortgage," if not refined, will discourage certain types of desirable loans.

The basic problem is that the definition of high cost mortgage will cover types of mortgages not intended to be covered. Many banks, to avoid the disclosure requirements and loan term restrictions, may choose not to make *any* loans falling within the definition. Banks may also choose not to make such loans because managing a system with two different contracts—one containing terms prohibited for high risk mortgages and another without—is complicated and risky from a liability standpoint. Other banks will avoid these loans because of the negative association and as a potential source of special regulatory scrutiny. Small banks, particularly, may decide that it is too costly and complicated to continue making any closed-end home equity loans or mortgage refinancings whether or not they fall within the bill's definition. Many small banks already choose not to make variable rate mortgage loans because of regulatory complexity and liability, and the situation under the pending bill may be even worse. The result may be less credit available for certain groups.

For example, the definition includes loans to people whose monthly debt to income ratio will exceed 60 percent. In some cases, loans to borrowers with such debt to income ratios may not be abusive. For instance, borrowers seeking work-out loans, by their very nature, will have high debt to income ratios: the reason they apply for a home equity loan or mortgage refinancing loan is that they are having trouble meeting credit obligations, and a home equity consolidation loan often reduces their effective monthly loan costs. Seasonal workers may be denied loans because in the off-season, their monthly income is low or nonexistent and the bill refers to *monthly* debt and income. High income individuals may prudently have high debt to income ratios because they have sufficient income after debt to accommodate normal living expenses. While the bill allows the Federal Reserve Board to establish a different debt to income ratio if it is in the public interest, it does not allow a different ratio for a particular class. Even if it did, determining which loans qualified for the designated exceptions would entail so much analysis and documentation as to render the exceptions difficult to implement. For example, defining a "work-out loan" would be as, if not more, subjective and difficult as defining the debt to income ratio.

The definition of high cost mortgage also includes loans with fees and points exceeding eight percent of the loan. Many small closed-end home equity loans used

for home improvement will exceed the eight percent limitation, but would not be considered abusive. Home improvement loans in the \$3,000 to \$7,000 range are not unusual. However, there are fixed costs associated with home equity loans, including many imposed by federal and local government regulations, e.g.:

- lending and mortgage taxes;
- title insurance,
- appraisals;
- flood insurance determination;
- lead paint determination;
- environmental analysis;
- pest inspection;
- credit reports;
- private mortgage and other insurance; and
- minimum loan fees.

The sum of these fixed costs, often paid to third parties, may push the points and fees percentage above eight percent for small loans. For example, \$400 in fees would not be unusual or costly for a \$4,000 loan. Yet, such a loan would be characterized as a high cost mortgage subject to the bill's disclosure requirements and the severe substantive restrictions and civil liability. Many banks would be compelled to not make small closed-end home equity loans, to the detriment of many credit applicants. Small home equity loans, for example, are a popular product under Community Reinvestment Act programs.

Small banks particularly may choose to avoid any closed-end home equity loans or mortgage refinancings because distinguishing between loans subject to the bill and those not will be too complex and costly. As stated previously, many small banks already shy away from adjustable rate mortgages for those reasons. Credit availability and competition will suffer.

Because it will result in overly broad coverage, we recommend that the definition exclude a debt to income ratio element. If the bill must retain a debt to income ratio reference, it should be in the form of a disclosure to consumers. The *disclosure statement* for high cost mortgages should contain the ratio. Furthermore, legislative language and history should make clear that banks may use any debt to income ratio method, so long as it is "reasonable." Because of the potential for inadvertent and harmless errors, the disclosed ratio should not be considered a "material" disclosure for purposes of the Truth-In-Lending Act. Equally, the ratio disclosure should not be subject to any additional civil liability imposed by the bill. However, even with these modifications, the debt to income test will cause severe problems.

In addition, the inclusion of "fees" in the cost calculation may render the definition over-broad. Because they are fixed costs and are often paid to third parties, they could inadvertently bring small loans into the definition, even though those loans may not in fact be excessively costly.

Unless the definition of high cost mortgage is narrowed and made less subjective, the bill will impose substantial new compliance burdens on all banks. Even banks not making "high-cost mortgages" will have to prove compliance to examiners.

The definition of high cost mortgage will compel banks to make new and complicated calculations and will further complicate the process and paperwork associated with closed-end home equity loans and mortgage refinancings. Regardless of whether a bank makes high cost mortgages, all refinancings and closed-end home equity loans will have to be evaluated to determine whether they meet the bill's definition. Moreover, highly regulated financial institutions such as banks will have to document to be able to *prove* to bank examiners that they are not making high cost mortgages.

The most problematic elements of the definition from a compliance standpoint are the debt to income ratio and incorporation of "fees" into a percentage reference. The annual percentage rate and points are easily identified and objective. The debt to income ratio, in contrast, is subjective and requires a complex analysis. Incorporating the fee's into a percentage figure also entails a new calculation and the potential for inadvertent violations.

Determining the debt to income ratio will require new calculations and documentation. For example, while there are many similarities, banks currently use their own tailored method to determine debt to income ratios based on their own experience. Determinations may also vary according to the individual applicant's characteristics. For instance, unused bank card lines are weighted differently depending on the credit line amount, the borrower's current outstanding balance and historic use of credit cards, among other factors. Retail credit cards may be treated differently from bank credit cards. Alimony may or may not be included, depending

on the applicant's preference. It is not clear the effect of using a single month's debt to income ratio as the bill does, as opposed to calculating it over a longer period to incorporate fluctuating incomes and debts.

The bill will in effect mandate that banks use a rigid formula to determine the debt to income ratio. It is impossible to anticipate now all the possible variables. However, if experience with other consumer banking regulations is a guide, the debt to income ratio formula promises to become a very complex and ever changing exercise. The result will be a new compliance nightmare and an expensive liability trap for even competent and well-intended lenders. It should be emphasized that there is currently no widely-accepted definition of either income or debt. Creating such definitions and covering all the many contingencies in individuals' economic profiles is likely to result in dozens more pages of regulations! These regulations will impose heavy costs on lenders and on consumers.

In addition, evidence of the debt to income ratios would have to be preserved for all loans subject to the bill because implementing-regulations will have to establish calculation standards. Currently, it is not unusual to do the calculation on a worksheet or computer program which is later-discarded. Thus, the ratio is not apparent on the face of the documents. Banks will have to document the calculation and basis for it to protect against later claims against the bank or assignee that the loan was subject to the statute on this basis and convey these papers to secondary purchasers. Creditors will need to obtain the customers' signature on one more document in an already paper intensive loan transaction.

Equally, the "fees" component of the eight percent reference of the definition will add yet another new calculation and requirement to document and preserve evidence of the computation. All creditors will have to make this calculation to determine whether the loan is a high cost mortgage. It is another opportunity for inadvertent errors and liability. Moreover, it is unnecessary since fees which are considered finance charges are already reflected in the annual percentage rate element of the bill's definition. If the fees are excessive, the annual percentage rate will exceed the bill's eight percent limitation. Accordingly, the definition should limit itself to points and exclude any reference to fees.

Simply providing the disclosures for all loans will not be a compliance safe harbor. Many bank loan contracts contain terms prohibited for high cost mortgages under the bill. These terms are generally legitimate and good business practices: balloon payments; prepayment penalties; and points and prepaid finance charges for refinancings. However, banks risk violations if loans which inadvertently fall within the definition contain a prohibited but commonly used term.

S. 924 also presents a new and additional disclosure obligation for loans which inadvertently fall within the definition of high cost mortgage. Such loans include small closed-end home equity loans and legitimate mortgage loans to people with high debt to income ratios. This means new forms and software, training for lending officers, new calculations, and possibly, new timing requirements.

To reduce unnecessary compliance burdens, we strongly urge that the high cost mortgage definition omit the debt to income ratio element and the "fees" as part of the percentage limitation. Refining the definition in this fashion will help to minimize unnecessary compliance burdens and narrow application of the bill to the intended target. We also suggest that the definition exclude refinancings of first mortgages. The section by section analysis refers to S.924 as the "second mortgage bill," but the definition includes many first mortgages other than purchase money mortgages. This creates an unnecessary compliance burden for first mortgage lenders, many of whom are not implicated in the loan abuse schemes.

Congress should not be micromanaging the business of banking by creating a debt to income ratio formula and restricting contract loan terms.

As already discussed, designating a loan category based on the borrower's debt to income ratio will, in effect, mandate a strict and complex federal debt to income ratio formula. All loans potentially subject to the bill will have to be evaluated on this basis. Accordingly, the statutory formula will tend to become the industry standard. The temptation will be for creditors, bank examiners, and legislators to apply the same formula in other areas unrelated to high cost mortgages.

We believe that establishing a federal debt to income formula is an unwise precedent. Lenders should have flexibility in evaluating debt to income ratios. Creditors use various factors and weight them differently, depending on the type of loan, their own experience, the credit history of the applicant, and other circumstances unique to the individual situation. A rigid federal formula invariably would have the unintended effect of denying loans to people who perhaps would otherwise qualify, and granting them to others who are not creditworthy. In addition, as experience with other standard calculations demonstrates, the formula will be constantly changing

as new issues, data, and information arise. Further, the bill refers to a ratio based on information "provided by the consumer." It is not clear whether the creditor may use information supplied from other sources such as credit reports. The strict federal formula will become an unfair trap for creditors whether applied to high cost mortgages or other unrelated situations.

For these reasons, in addition to the associated compliance burdens, we strongly recommend that the reference to debt to income ratio be deleted from the high cost mortgage definition. If it must be included, it should be limited to including the ratio in the special disclosure statement. Disclosing it would alert consumers that this was high risk borrowing. The ratio should be allowed to be based on the creditor's own method, so long as it is a reasonable one.

We are equally concerned about the proposed Congressional intervention into loan contract terms and believe it constitutes an unjustified interference with contracts. The terms prohibited for high cost mortgages generally reflect legitimate and accepted business practices: prepayment penalties; balloon payments; and points, prepaid finance charges, and discount fees on refinancings.

For example, for many small banks, balloon payment loans are the only viable alternative to adjustable rate mortgages. The disclosure and calculation requirements for adjustable rate mortgages have become so complex, so costly, and such a source of potential liability that these banks cannot offer them as a practical matter. The balloon payment structure is a comparable alternative. Prepayment penalties, while not widespread among banks, also have a legitimate purpose. Usually, up-front costs to process and administer a loan are not recovered until the loan has been outstanding for some time. A prepayment penalty may help to offset money lost if the borrower pays off early. Equally, points, discount fees, and prepaid finance charges are usually appropriate charges for mortgage refinancings.

To the degree that the definition of high cost mortgage encompasses proper and legitimate loans, such loans will not be allowed to use those commonly accepted terms. The danger of Congress labeling such terms as per se unacceptable for a particular class of loans is that it prohibits their use in instances when they are legitimate within that class. Moreover, the prohibition for one type of loans casts a negative pallor on such terms even when used for other types of loans.

Furthermore, it is unnecessary for Congress to engage in regulating specific contract terms: to the extent that such practices are used unfairly, they are already prohibited under general laws of conscionability and fairness. Therefore, we urge that the bill exclude restrictions against specific terms, particularly if the definition of high cost mortgages remains so broad.

The liability for assignees should be the same as it currently is for violations of the Truth-In-Lending Act: Under the Truth-In-Lending Act, actions are permitted against assignees for violations "apparent on the face of the disclosure statement."

The bill imposes liability on assignees for "all claims and defenses that the consumer could assert against the creditor." Thus, assignees may be liable for all finance charges and fees paid by the consumer, plus attorney fees, and statutory damages up to \$1,000 per violation, even if they cannot determine from the face of the documents that the original creditor has not complied with the regulation.

We believe that this imposes an unfair and onerous penalty on purchasers of mortgages. Assignees will have no means to protect themselves from potentially expensive liability. For example, there is no way to ascertain whether a creditor charged but did not disclose a fee, whether the disclosures were made in a timely fashion and as stated in the disclosures, or whether the debt to income ratio was based on the correct information and calculated properly.

While the agreement could include an indemnification clause to protect the buyer from the seller's violations, there is no recovery if the seller is no longer in business years later when the borrower makes the claim. Particularly problematic are mortgages bought from failed or failing depository institutions. Since borrowers may use Truth-In-Lending Act violations as a defense in a creditor's suit for default, the claim of a violation may not arise until years after the loan was originated. The assignee thus must forfeit years of interest and other income, in addition to other penalties, for the original creditor's violation—a violation which it could not have known about from the documents.

The potential liability for errors may severely chill the secondary mortgage market. The result may be less consumer credit. The mortgage portfolios of troubled depository institutions will be less marketable given the potential liability.

We believe that the current Truth-In-Lending Act liability for assignees is appropriate and fair. It imposes liability for violations "apparent on the face of the disclo-

sure statements." This standard protects the consumers rights without imposing an unfair and impossible standard of care on assignees.

The penalties for violations are unusually harsh, particularly if the definition of high cost mortgages is not narrowed, and will discourage some types of consumer lending.

S. 924's penalties for violations are "all finance charges and fees paid by the consumer." These penalties are in addition to actual damages, statutory damages up to \$1,000, and attorney fees already imposed under the Truth-In-Lending Act. Because consumers may use Truth-In-Lending Act violations as a defense in a suit for default, the penalty could be substantial, depending on the age of the loan. Class actions could also be extremely expensive and punitive.

While the penalties may not be unduly severe in truly abusive situations, they are for legitimate loans which may inadvertently be covered by the bill. In addition, some banks may choose to avoid all mortgage refinancings and closed-end home equity loans because of the complexity of the requirements and the expensive consequences of violations.

The potential liability and difficulty of compliance could discourage certain types of lending such as closed-end home equity loans and mortgage refinancings generally. As already discussed, many of these loans—work-out loans, loans to seasonal workers and to high income individuals—may be desirable, irrespective of their objective characteristics. The heavy penalties will also discourage loan purchases, particularly if assignees are liable for violations not apparent on the face of the documents.

Moreover, consumers are already protected from unfairly high rates and fees by the right of rescission. Under the Truth-In-Lending Act, consumers may generally rescind a non-purchase money mortgage up until three business days after settlement or after they have received correct disclosures (up to three years). If they choose to rescind, the creditor must refund all fees paid by the consumer. This includes application fees, appraisal fees, credit report fees, etc. which the creditor cannot recover. Thus, borrowers have three business days after the transaction to decide without consequence that the rates are too high, that the monthly payment is too high, or that they simply do not want the loan. If the disclosures are incorrect, the period is extended to three years. Two required copies of the right to rescind alert consumers to this right.

The timing for disclosures should be modified to allow that they be provided at the time of settlement. In the alternative, creditors should be permitted to estimate the annual percentage rate stated in the disclosure statement.

The special disclosures for high cost mortgages must be provided "no later than three business days prior to consummation of the transaction." Terms may not be changed after the disclosures have been provided.

The timing requirement of S. 924 is a significant improvement over earlier proposals to provide them at the time of the credit approval, but no later than three days prior to consummation of the transaction. That approach would have introduced a fourth disclosure time associated with mortgage lending. Existing disclosure times are: the time of application (e.g., home equity loans and adjustable rate mortgages), three days after application (e.g. Real Estate Settlement Procedures Act), and at the time of consummation (all loans). Adding a fourth disclosure time would have complicated compliance and confused lending officers, who must already discern among a myriad of various disclosures and timing requirements. Moreover, the earlier proposed disclosure time would have unnecessarily delayed the loan process.

It is critical for ease of compliance that creditors be permitted to supply the bill's disclosures at a time when other existing disclosures must already be provided. We believe that the best time to provide the proposed new disclosures is at the time of settlement, with the notice of the right to rescind: the lender has sufficient information to make accurate calculations, but the applicant may still choose to decline.

In fact, even if the applicant proceeds with the transaction, he or she may rescind the loan for three business days after settlement, for any reason, and receive a refund of all fees paid to the creditor. Two separate notices of this right ensure that the applicant is aware of this option. The right to rescind already protects consumers who determine after disclosure of actual loan terms, even if that time is the time of consummation, that the loan terms are too high.

In addition, the bill may inadvertently require borrowers to "lock-in" to an interest rate before they wish. Since the terms cannot change after the special disclosures are made, the applicant must decide at least three business days prior to settlement. It will be earlier if the creditor wishes to provide them at the time of appli-

cation or with the Real Estate Procedures Act disclosures. Forcing the consumer to lock-in earlier is clearly not in their best interest when interest rates are falling. The final annual percentage rate is often not determined until just before settlement. Either the bill should allow the annual percentage rate to be identified as an estimate or the disclosures should be permitted at the time of settlement.

Statement of the consumer's income, monthly payment, and difference between the two should be omitted from the disclosure statement.

The bill requires that the disclosures state the consumer's gross monthly cash income, as reported to the creditor by the consumer, the total initial monthly payment, and the amount of funds that will remain to meet other obligations of the consumer. We believe that this disclosure is unnecessary and will be a liability trap with potentially expensive consequences. The consumer is able to make the subtraction without the assistance of a lender.

The effective date should conform with existing Truth-In-Lending Act regulation change requirements.

Under the bill, the Act is effective 60 days after the promulgation of regulations. Regulations must be adopted no later than 180 days following the date of enactment. This provision is inconsistent with the existing Truth-In-Lending Act.

Under Section 105(d) of the Truth-In-Lending Act, creditors have at least six months advance notice of changes to the regulation: any changes must be effective on the October 1 which follows at least six months the date of promulgation. This provision was specifically enacted by Congress to avoid constant unscheduled rewriting of loan documents. It allows lenders to plan for the timing of changes. Not following this timetable makes this previous Congressional determination worthless. The bill should be modified to be consistent with this timing mechanism to ensure continuity in scheduled changes to the regulation and sufficient time for lenders to implement changes.

Conclusion.

We thank the Chairman and the Committee for the opportunity to testify on this issue and support and commend your efforts to combat abusive home equity lending schemes. While the fundamental conceit of S. 924 has merit, we nevertheless have grave concerns regarding its unintended consequences: the imposition of significant new and costly compliance obligations which may discourage certain consumer lending. It is imperative that any definition of high cost mortgage omit the subjective debt to income ratio element and the fees as a component of a percentage reference. This will help to reduce the compliance implications and ensure that loans not targeted are not unfairly constrained. Moreover; we do not believe that is appropriate for Congress to interfere and restrict commonly used and accepted loan contract terms. Finally, any bill should limit assignee liability to violations apparent on the face of the disclosure statement, and not impose new special liability for violations of the high cost mortgage requirements.

I appreciate the opportunity to be here and will be happy to answer any questions.

TESTIMONY BY MARGOT SAUNDERS AND KATHLEEN KEEST

NATIONAL CONSUMER LAW CENTER, INC.

Mr. Chairman and Members of the Committee, we very much appreciate your invitation to testify today on behalf of our low-income clients.

The National Consumer Law Center is a national support center for legal services attorneys and pro bono attorneys representing low-income consumers around the country. On a daily basis these attorneys request our assistance with the analysis of credit transactions to determine appropriate claims and defenses these clients

might have.¹ As a result, we have seen examples of predatory home equity loans from almost every state in the union.²

With the introduction of S. 924—The Home Ownership and Equity Protection Act—you have already recognized how the current status of the law in this country permits and encourages overreaching lending practices which have contributed to record high foreclosure rates and the heart wrenching loss of homes to the auction block throughout the country. As you have heard already details of many of these abuses in the hearing on February 17, 1993, we will not regale you with further examples of the desperate need for a federal remedy.

On behalf of our low-income clients, we heartily commend Chairman Riegle and Senators D'Amato, Bond, Dodd and Mosely-Braun, for the introduction of S. 924. The bill makes an excellent start at designing a means to address some of the worst abuses in the home equity lending market.

In our testimony today, we hope to accomplish two goals: 1) to set out some of the bases for the specific terms *which are currently* in S. 924, to encourage you to continue to include everything that is now in the bill; and 2) to explain why the bill, as written now, does not cast its net wide enough. Despite your excellent intentions, only a fraction of the evils this legislation seeks to address would in fact be stopped.

I. REASONS FOR CONTINUED INCLUSION OF PROHIBITIONS CURRENTLY IN S. 924.

A. Points and Fees Payable At Closing. We would also like to commend the sponsors for specifically including as a trigger for coverage by the Act subsection (v)(3) amending Sec. 103 of the Truth-In-Lending Act (page 3, line 1). This subsection would cause any non-purchase money home loan to be covered by the Act when the "points and fees payable at or before closing . . . exceed 8 percent of the total loan amount." This is necessary because of the extensive abuses in closing costs and points charged by lenders. However, it would be good if this language were clarified to ensure that it embraces *all* of the following:³

- points;
- loan fees;
- discount fees;
- finder's fees, or similar charges;
- appraisal, investigation and credit report fees;
- premiums or other charges for any guarantee or insurance protecting the creditor against the consumer's default or other credit loss;
- premiums or other charges for credit life, accident, health, or loss of income insurance written in connection with the loan;
- application fees;
- the following fees, whether or not they are paid to a bona fide third party:
 - (i) Fees for title examination, abstract of title, title insurance, property survey, and similar purposes.
 - (ii) Fees for preparing deeds, mortgages, and reconveyance, settlement, and similar documents.
 - (iii) Notary, appraisal, and credit report fees.

For those loans which fall under its coverage, S. 924 has four basic prohibitions:

B. No prepayment penalties. (Sec. 129(c), page 5, line 14). Prepayment penalties will generally apply when a borrower voluntarily prepays the loan; when there is a refinancing by the same or related lender, which is often encouraged by lenders because of the extra *kick* they receive from closing a loan, whenever a borrower is a bit behind (in the finance industry this is called flipping); and when a

¹The National Consumer Law Center, Inc. (NCLC) is a nonprofit Massachusetts corporation founded in 1969 at Boston College School of Law and dedicated to the interests of low-income consumers. NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government and private attorneys across the country. *Usury and Consumer Credit Regulation* (NCLC 1991) and *Unfair and Deceptive Acts and Practices* (NCLC 1991), two of eleven practice treatises published by NCLC, and our newsletter, *NCLC Reports Consumer Credit & Usury Ed.*, describe the law currently applicable to home equity loan transactions.

²Some examples of the types of outrageous practices we have seen may be found in NCLC publications, such as Hobbs, Keest, DeWaal, "Consumer Problems with Home Equity Scams, Second Mortgages, and Home Equity Lines of Credit," (AARP 1989); Keest, "Second Mortgage Lending: Abuses and Regulation," (NCLC, for Rockefeller Family Fund, 1991); "Nature Abhors a Vacuum: High-rate Lending in Redlined, Minority Neighborhoods in Boston," and "Principal Padding: The Prepaid Payment Pyramid," 9 NCLC Reports *Consumer Credit & Usury Ed.* (May/June 1991).

³Much of this list was taken from the Regulation Z, 12 C.F.R. §226.4, Finance Charge.

borrower defaults on a loan such that the acceleration of the note and resulting foreclosure works an effective *prepayment*.

There is little justification for prepayment penalties. Lenders recover all of their costs of closing the loan at consummation. There are always separately charged 1) points, sometimes as many as 10 to 20 points⁴—presumably to compensate the lender for making the loan; 2) attorneys fees and other charges paid to parties who performed services for the lender in searching the title, preparing the title certificate, appraising the property, etc.; and 3) commissions fanned on the sale of credit insurance (which often equal or exceed 50 percent of the credit insurance premiums charged to the borrower). In addition, there are often brokers fees paid to related parties.

Some creditors find a number of imaginative ways to charge borrowers who are forced into default by the high payments called for in the loan. In addition to accrued late charges (which are not addressed in S. 924), lenders charge default fees as well as "prepayment" fees. In the contract attached as Appendix I, the lender charged:

- a late charge of "1 percent of the unpaid principal and interest balance of the loan for each month that such default continues," plus
- interest in the event of default "on the entire balance due under the Note at the greater of (i) the rate then in effect under your note or (ii) the rate of three and one-half percent (3½ percent) per month until paid in full . . ." plus
- a prepayment penalty equal to 3 months interest.

S. 924 appropriately limits all prepayment penalties (except one month's interest is allowed as a penalty if the full principal is prepaid within 90 days of origination); and requires that any rebates of unearned interest be computed on the most advantageous terms for the borrower. To deal with the inherent inequities of a refinancing by the same or affiliated lender, the bill appropriately prohibits the charging of points or discount fees on the portion of the loan that is refinanced, allowing these up front fees only for *new money* lent to the borrower.

We recommend that the following language be added to the prepayment penalty subsection, to complete the circle on the prepayment evils that are addressed by the bill:

Prepayment Penalty Clarified—page 5, line 20, add at end:

"If maturity is accelerated for any reason, the debtor is entitled to the same rebate calculated under this section as if payment had been made on the date maturity was accelerated. No high cost mortgage shall provide for a default interest rate higher than the original note rate, or that permitted by state law, whichever is lower."

C. No balloon payments (Sec. 129(d), page 6, line 15). In high cost home equity loans that are made to low-income people who face no reasonable expectation of winning the lottery or inheriting a huge sum of money, balloon payments are simply an invitation to foreclosure. One example of the need for the prohibition which is appropriately included in S. 924 (from a multitude):

Client had a monthly income of approximately \$800. She was facing foreclosure on her mortgage, and her creditor gave her name to a mortgage broker. Although she resisted a long time, she finally gave in to the broker's sell job and signed a loan which called for payments of \$2,548.34 a month, with a one year balloon of \$141,548.34. The kindly broker took a \$10,000 broker's fee. The APR was 22.68 percent. The contract included a default interest rate of 42 percent.

There was also a late charge of 1 percent of the unpaid principal and interest.

D. No Negative Amortization Allowed. (Sec. 129(e), page 6, line 19). A negative amortization loan is a loan which requires payments which *fail* to cover the interest as it becomes due. These loans are especially heinous when they are combined with high interest rates as the borrower then struggles to meet high regular payments only to find that even after making thousands of dollars in monthly payments, *their debt has grown so that more is owed than was originally borrowed*. There might possibly be justification for a loan with a temporary negative amortization which is at market rates *when used to purchase a home*, and when the borrower reasonably anticipates a steady increase in income. However, there can be little reasonable justification for a loan with built in negative amortization which is not used

⁴As you know, each point is equal to 1 percent of the principal borrowed on the loan. So a \$10,000 loan which includes 15 points to be paid to the lender includes an *up front fee* of \$1,500 which the lender receives immediately. The points are *in addition to the interest earned by the lender*. This \$1,500 is then added to the principal of the loan, and interest is charged on the points.

to purchase a home and which is at a high interest rate. S. 924 appropriately prohibits negative amortization loans.

E. No Prepaid Payments. (Sec. 129, page 6, line 23). Prepaid payments is a feature of some loans which produces astronomical profits for lenders. Combining all the nicest features—for a lender—of a discount interest and points, the lender deducts from the proceeds of a loan at the time of consummation a sum equal to interest-only payments for some term (often the entire term) of the loan. The lender declares, by a clause in the contract, that all that interest is earned that day, and subject to no refund.⁵

In a loan like this, in order for the borrower to actually receive the use of the amount of money he wants, the face amount of the note can't be for the requested amount. It has to be padded sufficiently to cover both the deducted interest payments and what the borrower has asked for—otherwise, the borrower might actually suspect something and go elsewhere. In one real life example:

A borrower needed \$24,000. This lender turned it into a \$40,000, 24 percent, one year balloon note. The borrower was to pay no monthly installments, simply one \$40,000 payment 12 months later. The equivalent of 12 interest-only payments, however, was deducted from the face amount of the note, and declared "earned" as of the date of signing. That sum was nearly \$9,600.⁶

Just looking at the benefit the borrower received, repaying \$40,000 in a lump sum for the use of \$24,000 for one year works out to an effective 66.6667 percent APR.⁷

II. NECESSARY ADDITIONS TO S. 924

While S. 924 makes a good start at addressing the abuses created by the deregulation fervor of the 1980's it does not go far enough. It's like throwing three or four life preservers to dozens of drowning people; it is a step in the right direction, but it will not alone solve the problem. A few additions will considerably add to the protective net S. 924 will cast. By stressing these additions, we do not minimize the other suggestions we have made in our February 17 testimony to this committee on how to address these problems; we are simply focusing on the following four important recommendations:

A. Reduce the Annual Percentage Rate Trigger in Sec. 2. This trigger is one of three that determine which home equity loans are covered by the Act. The prohibitions applicable to high cost mortgages covered by the Act are not onerous, and these prohibitions actually do not disallow terms which are generally found in most market rate loans made to middle income people by mainstream lenders. So inclusion of a particular loan within the parameters of the Act will not have a detrimental affect on legitimate lenders, rather it will ensure that the prohibitions of the Act will apply to all loans to borrowers who need the protections of the Act.

Currently the Act will only cover loans which are 10 percent points over Treasury securities of comparable terms. The effect of this would be as follows: A ten year loan secured by a first mortgage would have to have a 16.75 percent rate to be covered by this bill.⁸ Current ten year rates by legitimate lenders for first mortgages are in the 7-8 percent range, with no points. Therefore a loan made in today's market with an interest which is twice the market rate would not be included in the protections of this bill. That is wrong. The spread over T-Bills of comparable term for first mortgage loans should be no more than 6 percent. A 6 percent-spread would mean, for example, that any ten year loan over 12.75 percent would be covered by the provisions of this Act; that leaves over 4 percentage points between market rates and coverage by this Act. That should be sufficient to allow a reasonable profit

⁵As to the latter clause, that simply means that the borrower has no right to prepay (to thereby reduce interest costs). The borrower would be paying a penalty of interest for the whole term, say one or two years, even if all was repaid two weeks after getting the loan. It also means, of course, that it would do the borrower no good to refinance with a market rate lender if the borrower realized in short order that this wasn't the deal of a lifetime. The borrower would just be paying market rate interest on the predatory interest, as well as the real proceeds of the earlier loan.

⁶The extra \$6,000 of padding came in various forms, including points, a 9 percent (\$3,600) brokers' fee, higher than usual attorneys fees, and some interesting little additions like "will preparation."

⁷Some might ask if the borrower wasn't getting some benefit from this, since he did not have to come up with monthly payments from other income every month. Think of it this way: a 24 percent, \$24,000, one year balloon note would have cost the borrower \$5,760, for a total repayment obligation at the end of the year of \$29,760. So that "favor" of not having to make payments for a year cost the borrower \$10,240.

⁸Currently 10-year Treasury securities are slightly over 6.5 percent.

for some lenders who may have legitimate reasons to charge borrowers more than market, without allowing abuses to continue.

Further, one of the worst problems which has resulted from the passage of the federal deregulation of interest rates⁹ is the encouragement implicitly provided to scam lenders to make their loans *first liens* on real property. State laws which have crafted to protect consumers from high rate mortgages do not apply to those secured by first liens, because of the preemption of their laws by DIDMCA and AMTPA.¹⁰ The result is that even though some states may have protective statutes for loans secured by second and junior liens, there are no protections for the same loan if the lender holds a first lien.¹¹ As a result lenders who want to charge exorbitant rates or unfair terms are encouraged to make their loan the *first lien* on the property so they can take advantage of the federal preemption. The result is too often that the high rate lender will cause the borrower to refinance a low rate first mortgage loan into a high cost mortgage. The additional principal thus included in the loan at the higher rates adds considerably to monthly payments and acts as a further catalyst for default and foreclosure. An example of the wrong-headed impetus created by DIDMGA is found in Appendix II, which includes a detailed account of the refinancing of a low-cost mortgage to a disabled couple with a high priced loan designed for foreclosure in the state of Washington.

S. 924 should reverse this incentive and allow higher rates to junior lienholders. We recommend that the bill be amended on page 2, line 9 by rewriting that subsection as follows:

"(1) "For a loan secured by a first lien on a borrower's dwelling, the annual percentage rate at the time the loan is originated will exceed by more than 6 10 percentage points the yield on Treasury securities having comparable maturities, as determined by the Board; or 2) for a loan secured by a junior lien on a borrower's dwelling the annual percentage rate at the time the loan is originated will exceed by more than 8 percentage points the yield on Treasury securities having comparable maturities, as determined by the Board. In the case of a variable rate loan with an initial interest rate that may be different than the rate or rates that will apply during subsequent period, the annual percentage rate shall be computed taking into account the subsequent rates."

Such an amendment would have the double-barrelled effect of including more high cost loans within the coverage of the Act and discouraging flipping low cost first mortgages into high cost first mortgages.

B. Add a Prohibition Against Unfair, Deceptive or Evasive Acts. The lenders who have created the problems this committee is trying to remedy are exceptionally ingenious and resourceful when it comes to designing ways to avoid the limitations of consumer protection laws. Although the bill appropriately prohibits some of the worst abuses identified to date, *there is no doubt other methods of charging unreasonable amounts from unwary homeowners will be devised.* Moreover, a number of known abuses have not been targeted by the bill, for example:

- 1) Entering into a home equity loan if there is no reasonable probability that the homeowner will be able to make payments according to the terms of the loan;
- 2) Taking advantage of the borrower's infirmities, lack of education or sophistication, or language skills, necessary to understand fully the terms of the transaction;
- 3) Charging unreasonable premiums for credit insurance, or charging premiums for unreasonable amounts or kinds of credit insurance, or failing to supply a contract of insurance at the time of closing;
- 4) Refinancing other loans owed by the homeowner which had not been accelerated by reason of default of the homeowner prior to the application for the home

⁹ Congress' contribution to this problem can be traced to the passage of 1) the Depository Institutions Deregulation and Monetary Control Act of 1980, §501 (hereinafter referred to as "DIDMCA"), codified at 12 U.S.C. § 1735f-7a, which preempted state usury ceilings on mortgage lending secured by first liens (whether purchase money or not); and 2) the passage of the Alternative Mortgage Transaction Parity Act of 1982 (hereinafter referred to as "AMTPA"), 12 U.S.C. § 3800, *et seq.*, which preempted state limitations on risky "creative financing" options, such as negative amortization loans, or balloon notes.

¹⁰ Sixteen states did "opt out" of the effects of the preemption in DIDMCA, so this sentence would not apply to those states. However, generally the laws even in the states which did opt out track the provisions of the federal preemption and virtually deregulate interest rates and terms for first mortgage loans.

¹¹ The absurdity of this is apparent when one realizes that a first lienholder has virtually a risk-free loan because the loan is completely secured by real estate valued in excess of the amount owed, and no one has a prior right to the proceeds from a sale of that real estate. There is thus considerably less justification for a first mortgage loan to have higher interest rates than a loan secured by a junior lien.

equity loan, unless the new loan is at a lower interest rate or has lower monthly payments;

5) Financing a mortgage broker's commission unless the borrower entered into a separate written contract with the broker prior to the date of application for the home equity loan;

6) Taking action or interfering with any other consumer protection laws or regulation designed to protect the homeowner;

7) Assisting in the falsification of information on the application for a home equity loan;

8) Disbursing to a home improvement contractor more than 80 percent of funds due under a home improvement contract which exceeds \$10,000, before the completion of the work due under the home improvement contract. Loan disbursements for a home improvement contract shall not be made in a form other than an instrument jointly payable to the primary borrower and the contractor;

9) Engaging in any other unfair, deceptive or unconscionable conduct which creates a likelihood of confusion or misunderstanding.

Further, the current bill leaves a number of loopholes through which an inventive lender may avoid the application of this Act altogether.¹² The best way to prohibit each and every evasive activity would be to identify each activity in the bill and prohibit them. A second best way would be as follows:

Adding the following language to the bill, as a new subsection (g) to Sec. 129 (page 7, line 3):

"(g) UNFAIR, DECEPTIVE OR EVASIVE ACTS PROHIBITED.—Creditors of contracts governed by this section shall not commit, in the making, servicing, or collecting of a home equity loan, any act or practice which is unfair or deceptive. An attempt to evade the provisions of this section by any devise, subterfuge, or pretense whatsoever shall be considered a unfair act under this section."

C. Amend the federal laws which prohibits states from setting interest rate caps and limitations on terms and conditions of loans for non-purchase money first mortgages. As mentioned above, Congress' passage of the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA)¹³ and the Alternative Mortgage Transaction Parity Act of 1982 (AMTPA)¹⁴ prohibited states from limiting interest rates and terms and conditions of first mortgage loans. The purpose of this deregulation was to stimulate the sale of homes by ensuring that purchase money first mortgage loans were not unduly restricted by state interest rates, and to strengthen a national market of home lenders.

These federal preemptive laws went too far: not only did they remove limits on the interest rates charged for loans used to purchase homes, they also prohibited the imposition of interest rate ceilings on loans which were also secured by first mortgages and were not used to purchase the home—non-purchase money loans. Just as serious, the federal deregulation set the stage for many states to remove rate caps and other limitations on lending including second mortgage lending. Whatever the overall merits of economic deregulation, it undeniably unleashed the greedy instincts of unscrupulous operators all over the country.

With the passage of DIDMCA and AMTPA Congress threw the baby out with the bath water. Rate caps and other limitations on lending have been employed by regulators since biblical times. It has long been recognized that such protections are needed to guard the trusting, the unsophisticated, the unwary, and the necessitous consumer from the "oppression of usurers and monied men who are eager to take advantage of the distress of others."¹⁵

A federal usury ceiling would be the best remedy to assure that the abuses identified by this committee do not continue. The 1970's problem of a mismatch between a statutory cap and the market rate could be easily resolved by the imposition of a statutory ceiling which can float with a specified market-related index.

Failing a federal usury ceiling on non-purchase home loans, the next best step would be to allow states to impose state specific protections on these loans. To accomplish this end, we recommend that S. 924 be amended to allow states to impose limits on the interest, fees and other terms of non-purchase money first mortgages. Such a change in federal policy would have the additional benefits of reestablishing

¹² One example of a comparatively simple method a lender could use to avoid this Act would be to make the loan look like a *purchase money loan*. The borrower need never know; the lender would simply need to add a couple of pieces of paper to the multitude that is already provided to the borrower to confuse: a deed for transfer of the home from the borrower to the lender, and then a deed for the purchase of the home by the borrower back from the lender.

¹³ 12 U.S.C. § 1735f-7a.

¹⁴ 13 U.S.C. § 3800, *et seq.*

¹⁵ *Whitworth & Yancy v. Adams*, 5 Rand 333, 335, 26 Va. 333 (Va. 1827).

Congressional approval for interest rate protections when appropriate. *Specifically, the following addition to S. 924 would accomplish this:*

On page 6, line 16, making the following Sec. 3, and renumbering the remaining sections accordingly:

"Sec. 3. STATES' RIGHTS TO REGULATE HIGH RATE MORTGAGE LOANS.

"Notwithstanding the provisions of 12 U.S.C. § 1735f-7a, and 12 U.S.C. § 3800 *et seq.* the limitations imposed by the states on the interest, fees and other terms on first mortgages shall not be preempted for loans secured by first liens of residential real property which were not used for the purchase of the property."

D. Eliminate Holder-In-Due Course Status for Assignees of Home Equity Loans. One of the difficulties borrowers face is the complete insulation afforded to assignees and other holders of their loans by the Holder-In-Due Course rule that exists in every state's Uniform Commercial Code. This rule works as a bar to the borrower's attempt to raise claims and defenses which exist against the original lender when the note is held by another party. Fraud claims, usury claims, unfair and deceptive trade practice claims, etc., can rarely be raised against the holder of the note, *even if the cumulative effect of such claims and defenses would work as a complete defense to a foreclosure action.*

The Federal Trade Commission has recognized the inequities in this rule, and has eliminated its effect for the purchase of consumer goods or services, in its Preservation of Consumer Claims and Defenses Rule.¹⁶ (There is thus no holder insulation for home improvement credit sales, while there is still such protections for straight mortgage loans.¹⁷) Congress also limited the holder rule somewhat for certain credit card purchases.¹⁸

No doubt lenders will vigorously argue that limiting the holder rule on home loans will dry up the credit market for legitimate home equity market. This argument holds no water. Although the credit industry vigorously opposed the FTC Rule, making hair-raising predictions about how the auto financing market would disappear. The auto financing market is stronger than ever, and its very health should prove that the only creditors the elimination of the holder rule would drive out of business are the crooked ones.

Elimination of the holder rule will force the industry to do more self-policing. If assignees of high cost mortgages will be clearly liable for the claims the borrowers have against the originators, the holders will more carefully screen those with whom they do business. That will dry up the financial lifeline that has enabled the predatory mortgage companies to operate.

Therefore, we recommend the following change in S. 924 on page 8, line 6, by rewriting that section to read:

"(d) HIGH COST MORTGAGES—Any assignee of the original creditor of a *high cost mortgage governed by section 129*, shall be subject to all claims and defenses that the consumer could assert against the original. Recovery under this subsection shall be limited to the total amount paid by the consumer in connection with the transaction."

III. ADDITIONAL TECHNICAL FIXES NECESSARY TO ACCOMPLISH GOALS OF THE BILL

1) Violation of Prohibitions Additional Ground for Rescission—Add in the appropriate place:

VIOLATION OF REQUIREMENTS OF SECTION 129 GROUND FOR RESCISSION.—Section 125 of the Truth-In-Lending Act (15 U.S.C. 1635) is amended by rewriting the first sentence of subsection (a) as follows:

"(a) Except as otherwise provided in this section, in the case of any consumer credit transaction (including opening or increasing the credit limit for an open end credit plan) in which a security interest, including any such interest arising by operation of law, is or will be retained or acquired in any property which is used as the principal dwelling of the person to whom credit is extended, the obligor shall have the right to rescind the transaction until midnight of the third business day following the consummation of the transaction or the deliv-

¹⁶ 16 C.F.R. § 433.

¹⁷ However, lenders for home improvement credit sales generally do their best to avoid the application of the FTC rule by making their loans look like original loans. They are sometimes successful because they will extend additional credit to the borrower, over and above what is required to pay for the credit sale which engendered the home loan in the first place.

¹⁸ 15 U.S.C. § 1666i.

ery of the information and rescission forms required under this section together with a statement containing the material disclosures required under this title, *and in the case of a transaction governed by the provisions of section 129, full compliance with the requirements of that part*, whichever is later, by notifying the creditor, in accordance with regulations of the Board, of his intention to do so.

OR

Amend page 3, line 14, by adding at the end:

“Any contract with provisions prohibited by section 129 (c) through (g) shall be deemed to fail to include the material disclosures required under this title, for purposes of section 125.”

2) Prepayment Penalty Clarified—page 5, line 20, add at end:

“If maturity is accelerated for any reason, the debtor is entitled to the same rebate calculated under this section as if payment had been made on the date maturity was accelerated. No high cost mortgaged shall provide for a default interest rate higher than the original note rate, or that permitted by state law, whichever is lower.”

3) Disclosure of Income Must be Verified by Creditor—page 2, line 18, rewrite as follows:

“(2) Based on information provided by the consumer, *and verified by the creditor*, the consumers total monthly debt payments will exceed 60 percent of the consumers monthly gross income, immediately after the loan is consummated. The Board may establish a different debt to income ratio if the Board determines that such a ratio is in the public interest and is consistent with the purposes of this Act.”

4) Prohibited Terms Unenforceable—page 7, line 16, by rewriting that subsection to read as follows:

“(4) in case of a failure to comply with any requirement under section 129, all finance charges and fees paid by the consumer. *Any provision included in the contract in violation of section 129 (c) through (f) shall not be enforceable.*”

APPENDIX I

DISCLOSURE STATEMENT

Creditor: Resource Mortgage Corp.
62 Eastern Avenue
Dedham, MA 02026

Borrower: _____

AMOUNT FINANCED \$139,000.00

The amount of credit provided to you or on your behalf.

You have the right to receive a written itemization of the amount financed.

I do X do not _____ want a written itemization: _____
(Borrower)

FINANCE CHARGE * \$30,580.00

The dollar amount the credit will cost you for the term of the loan if all payments are made as scheduled.

PAYMENT SCHEDULE *

Eleven consecutive monthly payments of interest (estimated to be in the amount of \$ 2,548.34 each month) payable on the fourth day of each month commencing September 4, 1987, then with a final balloon payment of the full unpaid principal balance and all unpaid interest (estimated to be in the amount of \$ 141,548.34 due and payable on August 4, 1988.

TOTAL OF PAYMENTS (*estimate) 169,580.00.

The amount you will have paid when all payments have been made as scheduled.

ANNUAL PERCENTAGE RATE (*estimate) 22.68041% *

The cost of your credit as a yearly rate.

* The interest rate on your loan is a variable interest rate. Interest shall accrue at the aggregate per annum rate of _____ percent () and the rate of interest charged by Bank of Boston known as the Prime Rate ("Prime"), with changes in Prime rate effective on the same date as said changes are determined by the Bank, but the interest rate shall in no event be less than _____ per annum. The Annual Percentage Rate, Finance Charge, Total of Payments, and other disclosures made herein are estimates based upon a Prime Rate of _____ effective on the date of this loan. Therefore, the interest rate has been assumed to be _____ per annum.

~~The Annual Percentage Rate, Finance Charge, and Total of Payments will increase each time Prime increases above _____ percent per annum. Any increase will take the form of higher payments. If the interest rate were 1% per year higher on the date of this loan, the monthly payments of interest would be \$ _____. The Final Payment would be \$ _____.~~

PREPAYMENT

If you prepay the Note in whole or in part during the term of this loan, you will pay a prepayment penalty equal to three (3) monthly interest payments, said prepayment penalty to be calculated as of the date of the prepayment.

LATE CHARGE

Upon the occurrence of any event of default under your loan arrangement, you shall pay a late charge of one percent (1%) of the unpaid principal and interest balance of the loan for each month that such default continues (or such lesser amount as the Lender deems appropriate, but in no event to exceed one percent (1%) per month).

ADDITIONAL INTEREST UPON DEFAULT

Upon any event of default under your loan arrangement, you will pay interest on the entire balance due under the Note at the greater of (i) the rate then in effect under your Note or (ii) the rate of three and one-half percent (3½%) per month until paid in full (or such lesser rate as the Lender deems appropriate, but in no event to exceed 3½% per month).

SECURITY INTEREST

As collateral for this loan you have given us a mortgage in the following real property: _____, Massachusetts and in certain other property as more fully described in a mortgage of even date. The mortgage/security agreement grants to the Creditor a security interest in presently owned and after-acquired property and secures other and future indebtedness of the Borrower.

Creditor's right of set-off secures the Note.

FILING FEES

See your note, mortgage, and other contract documents for additional information about nonpayment, default, the right of set off, the right to accelerate the maturity of the Note, prepayment, and any security interest.

Borrower acknowledges receipt of a copy of this Disclosure Statement and the Note on August 4, 1987.

ITEMIZATION OF AMOUNT FINANCED

The following disclosures, containing an itemization of the Amount Financed, are furnished in connection with a loan arrangement between [REDACTED] (as "Borrower") and Resource Mortgage Corp. (as "Lender") and are made pursuant to Massachusetts General Laws Chapter 140D, Section 12:

THE AMOUNT FINANCED includes:

(a) the amount that is or shall be paid directly to the Borrower	\$ <u>439.80</u>
(b) the following items that shall be paid to third persons by the Lender on behalf of the Borrower:	
(i) TO DEAN ASSOCIATES (payoff 2nd mortgage) to JERICO TRUST (payoff 1st mtg)	\$ 109,476.72
(ii) Recording Fees (Mortgage, 2 discharges and MLC)	\$ 11,233.00
(iii)	\$ 52.00
a) Document Preparation	\$ 1,000.00
b) Title Examination	\$ 250.00
c) Miscellaneous costs and expenses Municipal Lien	\$ 15.00
(iv) Title Insurance	\$ 164.00
(v) Manhattan Financial	\$ 10,000.00 <i>E Baker</i>
(vi) Inspection Fee	\$ 350.00
(c) Origination Fee	\$ <u>4,170.00</u>
RECORDED	
(d) Town of Norwood - taxes	\$ 1,849.48
L16.33 THE AMOUNT FINANCED IS	\$ 139,000.00

APPENDIX 11

STATEMENT OF EMILIO VIGIL

I live in Seattle, Washington with my wife, Beverly Vigil. I am 64 years old and I am blind. I receive Social Security benefits of \$590 per month. My unemployment security benefits I received after I was laid off at the Lighthouse for the Blind have expired and it does not appear that I will be rehired. My wife, Beverly, is disabled and receives SSI benefits of \$270 per month.

We bought our house over 20 years ago and last year only owed \$11,000 on our mortgage. It was a HUD Section 235 mortgage with a very low interest rate. We fell behind in our payments because a caregiver living in our basement was mishandling our money without ~~our~~ our knowledge. After we got a notice that our mortgage was in foreclosure, we went to a mortgage broker to help us get a loan to solve our financial problem.

The mortgage broker arranged for us to get a loan with Investors Mortgage Company. Our attorney recently explained to us that we will have to begin paying \$650 per month beginning in September of this year and we will have to pay the entire loan amount of over \$52,000 in two and a half years. We cannot pay monthly mortgage payments of \$650 per month on our income of \$860 per month. There is no way we will have \$52,000 in the next two and a half years.

We still don't understand all of the terms of our agreement with Investors Mortgage Company but we do understand that we made a big mistake. Our mortgage broker and Investors Mortgage never discussed with us how we would make the monthly payments or the balloon payment and we did not go to anyone else for advice before we signed the papers.

Dated: April 19, 1993.



EMILIO VIGIL

STATEMENT OF BARBARA ISENHOUR

I am an attorney with Evergreen Legal Services and represent Emilio and Beverly Vigil. In 1992 the Vigils only owed \$11,000 on their Section 235 HUD insured mortgage. Their interest rate was 3% and their monthly payments, which included taxes and insurance, came to \$242 per month.

Because of Mr. Vigil's blindness and Mrs. Vigil's disability, they are dependent upon caregivers to assist them with their finances. In 1992 the Vigils had a caregiver living in their basement who misappropriated their money and used it for his own purposes. The Vigils were unaware of the fact that many bills were not paid, including their mortgage payments. After discovering the problem, the Vigils went to a loan broker to get a loan of approximately \$2,000 to cure the delinquent mortgage payments and the fees incurred in starting a foreclosure.

The mortgage broker placed the loan with Investors Mortgage Company, a partnership of private investors. Neither the broker nor the lender advised the Vigils that the HUD Section 235 mortgage program provided for assistance for mortgagees who defaulted on their loans because of circumstances beyond their control. The total amount of the loan made by IMC to the Vigils was \$52,010. The Vigils received no cash disbursement. In addition to paying off the first mortgage, the lender paid off two old judgment liens and a lien from the state welfare department (DSHS). The state does not enforce its welfare liens against a recipient's home until the AFDC recipient dies or sells the home. The amount of the loan proceeds applied to the Vigil's lien creditors came to \$28,577. The balance of the loan proceeds of \$23,433 was applied to fees, prepaid interest and a lender required repair fund. The mortgage broker charged a fee of \$3,345 and the lender charged a 7% loan fee of \$3,640.

The interest rate for the loan is 18.5 percent. The lender claims that Washington's usury rate, which is currently 12%, does not apply to IMC because it put itself in a first lien position and does over a million dollars in residential lending annually. It is relying upon the federal preemption in 12 U.S.C. § 1735f-7 to claim that Washington's usury law does not apply. The lender charged 18.5 percent interest on the \$7,800 held back for the first year's payments under the loan and on the \$6,000 holdback repair fund.

The monthly payments for the Vigil's loan are \$650 per month. These payments are less than the accruing monthly interest on the loan so their will be a negative amortization when the loan is due. There is a balloon payment due at the end of the three year loan term of \$52,650. The monthly payments represent 76% of the Vigils SSI and social security income and these payments do not include insurance and property taxes.

There is a complicated prepayment penalty for the loan. That portion of the loan agreement is attached to this statement. Under the loan terms, if the Vigils sold their home to pay off the loan in the first six months of the loan, they would owe a penalty that could be as high as \$3,900.

Dated: April 22, 1993.

Barbara Isenhour

 BARBARA A. ISENHOUR

FIXED RATE
PROMISSORY NOTE
SECURED BY DEED OF TRUST

\$52,000.00

Seattle, Washington
September 26, 1992

For prepayment made in the first six months, the prepayment premium will be the greater of three percent (3%) of the total prepaid payment or the remainder of six months interest owing from inception and calculated against the entire principal owing at the inception of this Note.

For prepayment made between the 7th and 18th months, three percent (3%) of the total prepaid payment.

For prepayment made between the 19th and 24th months, two percent (2%) of the total prepaid payment.

For prepayment made between the 25th and 30th months, one percent (1%) of the total prepaid payment.

For prepayment made between the 31st and 36th months, no premium.

The prepayment charge shall also be payable if this Note is repaid at any time after default and acceleration.

Notwithstanding the foregoing, the entire principal balance and all unpaid interest plus prepayment charges shall be paid in full on the earlier of conveyance, transfer or encumbrance, including by real estate contract or lease, of all or any portion of the property subject to the Deed of Trust securing this Note.

APPENDIX III

SUMMARY OF PROPOSED AMENDMENTS TO S. 924.

A. Fixing the Trigger—page 2, line 9 rewrite as follows:

"(1) The annual percentage rate at the time the loan is originated will exceed by more than 6 10 percentage points the yield on Treasury securities having comparable maturities, as determined by the Board. In the case of a variable rate loan with an initial interest rate that may be different than the rate or rates that will apply during subsequent period, the annual percentage rate shall be computed taking into account the subsequent rates."

OR

"(1) *"For a loan secured by a first lien on a borrower's dwelling, the annual percentage rate at the time the loan is originated will exceed by more than 6 10 percentage points the yield on Treasury securities having comparable maturities, as determined by the Board; or 2) for a loan secured by a junior lien on a borrower's dwelling the annual percentage rate at the time the loan is originated will exceed by more than 8 percentage points the yield on Treasury securities having comparable maturities, as determined by the Board. In the case of a variable rate loan with an initial interest rate that may be different than the rate or rates that will apply during subsequent period, the annual percentage rate shall be computed taking into account the subsequent rates."*

B. Unfair, deceptive or evasive acts prohibited—page 7, line 3, by adding the following subsection to section 129:

"UNFAIR, DECEPTIVE OR EVASIVE ACTS PROHIBITED.—Creditors of contracts governed by this section shall not commit, in the making, servicing, or collecting of a home equity loan, any act or practice which is unfair or deceptive. An attempt to evade the provisions of this section by any devise, subterfuge, or pretense whatsoever shall be considered a unfair act under this section."

C. DIDMCA and AMPTA Amendments—page 6, line 16, by making the following Sec. 3, and renumbering the remaining sections accordingly:**"Sec. 3. STATES' RIGHTS TO REGULATE HIGH RATE MORTGAGE LOANS.**

"Notwithstanding the provisions of 12 U.S.C. § 1735f-7a, and 12 U.S.C. § 3800 *et seq.* the limitations imposed by the states on the interest, fees and other terms on first mortgages shall not be preempted for loans secured by first liens of residential real property which were not used for the purchase of the property."

D. Elimination of Holder-In-Due Course—page 8, line 6, by rewriting that section to read:

"(d) HIGH COST MORTGAGES—*Any assignee of the original creditor of a high cost mortgage governed by section 129, shall be subject to all claims and defenses that the consumer could assert against the original. Recovery under this subsection shall be limited to the total amount paid by the consumer in connection with the transaction.*"

TECHNICAL FIXES

A) Violation of Prohibitions Additional Ground for Rescission—Add in the appropriate place:

VIOLATION OF REQUIREMENTS OF SECTION 129 GROUND FOR RESCISSION.—Section 125 of the Truth-In-Lending Act (15 U.S.C. 1635) is amended by rewriting the first sentence of subsection (a) as follows:

"(a) Except as otherwise provided in this section, in the case of any consumer credit transaction (including opening or increasing the credit limit for an open end credit plan) in which a security interest, including any such interest arising by operation of law, is or will be retained or acquired in any property which is used as the principal dwelling of the person to whom credit is extended, the obligor shall have the right to rescind the transaction until midnight of the third business day following the consummation of the transaction or the delivery of the information and rescission forms required under this section together with a statement containing the material disclosures required under this title, and in the case of a contract governed by the provisions of section 129, a document in full compliance with the requirements of that part, whichever is later,

by notifying the creditor, in accordance with regulations of the Board, of his intention to do so.

OR

Amend page 3, line 14, by adding at the end:

"Any contract with provisions prohibited by section 129 (c) through (g) shall be deemed to fail to include the material disclosures required under this title, for purposes of section 125."

B) Prepayment Penalty Clarified—page 5, line 20, add at end:

"If maturity is accelerated for any reason, the debtor is entitled to the same rebate calculated under this section as if payment had been made on the date maturity was accelerated. No high cost mortgage shall provide for a default interest rate higher than the original note rate, or that permitted by state law, whichever is lower."

C) Disclosure of Income Must be Verified by Creditor—page 2, line 18, rewrite as follows:

"(2) Based on information provided by the consumer, and verified by the creditor, the consumer's total monthly debt payments will exceed 60 percent of the consumer's monthly gross income, immediately after the loan is consummated. The Board may establish a different debt to income ration of the Board determines that such a ration is in the public interest and is consistent with the purposes of this Act."

D) Prohibited Terms Unenforceable—page 7, line 16, by rewriting that subsection to read as follows:

"(4) in case of a failure to comply with any requirement under section 129, all finance charges and fees paid by the consumer. Any provision included in the contract in violation of section 129 (c) through (f) shall not be enforceable."

STATEMENT OF ROBERT F. ELLIOTT

OFFICE OF THE PRESIDENT, GROUP EXECUTIVE—U.S. CONSUMER FINANCE

ON BEHALF OF HOUSEHOLD INTERNATIONAL, INC.

Mr. Chairman and Members of the Committee, I am Robert F. Elliott. I appreciate the Committee's invitation to testify today in support of the enhanced disclosure features of S. 924, the "Home Ownership and Equity Protection Act of 1993." I am testifying on behalf of Household Finance Corporation ("HFC"), which is one of several finance and banking business units operating within our parent holding company, Household International, Inc. ("HI"). I joined Household in 1964 and I have been involved in the consumer finance business for my entire career in various capacities.

So that you might understand the importance of home equity loan legislation to my company, please allow me to provide you with some background information. HI is a publicly-owned financial services company with assets of \$32.5 billion that offers a broad range of financial services and products to consumers and small businesses. Our company employs more than 15,000 people and we serve approximately 13.3 million customers in the United States, Canada, the United Kingdom and Australia. On an owned and/or managed basis we currently service \$38.6 billion of consumer loan receivables.

HFC is HI's core business, as well as its oldest, tracing its origins to a personal loan office established in Minneapolis in 1878. In the intervening years, HFC was an innovator in the consumer finance industry. HFC:

- Developed the monthly payment plan;
- Created the Money Management Institute to help consumers make informed financial decisions;
- Developed, in concert with the Russell Sage Foundation, the first regulation of the industry; and
- Offered revolving lines of credit so consumers could borrow money in the amounts and at the times that best fit their needs.

Today, 115 years later, HFC continues its commitment to providing our customers with value, innovation and leadership in the consumer finance industry.

HFC offers a variety of secured and unsecured products to our customers through a network of approximately 470 branch offices located in 35 states throughout the country. While our business is conducted primarily through state-licensed compa-

nies, our consumer lending products are subject to extensive federal laws and regulations relating to discrimination in credit extensions, use of credit reports, disclosure of credit terms, and correction of billing errors.

Household International is a major player in the home equity market. The total amount of home equity loans HFC managed at the end of 1992 was \$6.7 billion, while the gross receivables of Household Bank for its second mortgage portfolio were \$1.4 billion.

At the Committee's previous hearing on February 17th, testimony was heard about the credit practices of certain second-mortgage lenders and third-party originators who targeted poor and working class-consumers and who charged above-market interest rates and/or add-on loan fees.

There was also testimony about other types of questionable business practices that take advantage of individuals who are inexperienced in credit matters. I regret to say that for many reasons, some consumers are indeed victimized in their credit decisions by credit grantors. The unfortunate consequences are that, in extreme cases, consumers lose their homes and ethical, consumer-oriented finance companies like HFC and most of its competitors become tarnished with a public perception that the consumer finance business does not act responsibly.

I am testifying today not to deny that there is a problem, but because I would like you to know that HFC and, we believe, the great majority of our competitors, operate responsibly and with sensitivity to the human and social needs of our customers and society as a whole.

Speaking for HFC, the focus of our Company is on providing our customers with compliant, needs-based service, which recognizes that our customer is somewhat vulnerable and in need of assistance through difficult times.

Our franchise grew for 115 years because we served people who were largely denied credit from traditional lenders. Our focus today continues to be on providing credit services to borrowers whose needs are not fully or even adequately served by other financial institutions.

Further, customers come to us because they believe we offer something besides money. In this regard, open, candid, plain English disclosure of credit terms and conditions is not a burden. Rather, it is our competitive advantage. Our strategic intention is to be a company viewed by our customers as the market leader in service quality, integrity, and thus value. Compliant, needs-based service, delivered in an open, candid manner, is what our customer values; it is what he or she is willing to pay for. We hope it is why he or she selects Household.

We are working in many ways to be the industry leader in integrity. We have developed systems and technology so that our loan documents are electronically stored and printed only as needed. This allows us to continually stay in compliance with changing regulations and ensures we provide our customers with accurate information.

To help educate the thousands of consumers who we hope to make our customers, we have available in our sales offices a 'Understanding Money and Credit' booklet, which I have appended to my testimony, to answer questions and assist customers in making educated financial decisions. We are also in the process of developing additional literature to explain specific credit terms and loan features.

To reach out to new customers who are underserved by traditional depository lenders, HFC has underway an extensive Hispanic marketing effort. We have bilingual offices in operation today in San Antonio, Texas and San Jose, California, and an office opening on Chicago's north side in the middle of June.

Consistent with our commitment to educate consumers on money management and handling credit, all our sales literature and documents are produced in Spanish as well as English, and we have produced TV and radio public service announcements on the importance of managing credit, with the noted Hispanic educator Jamie Escalante as our spokesman. Nora Fierros, who heads this initiative for HFC, recently appeared before the Congressional Hispanic Caucus in Washington, DC, to discuss this initiative.

Our company operates with a philosophy of commitment to being a contributive corporate citizen in the communities we serve. Our employees are actively encouraged to voluntarily participate in public service activities. Through the HFC program, "Help for Communities," HFC provides funding for more than 270 local programs.

We are pleased to be one of six major contributors to the San Antonio Educational Partnership, a program created by Henry Cisneros to assist in the education of inner-city children.

As a business organization that engages in the highly competitive financial services industry, we would prefer to see group members police their own lending activities. The consumer credit industry is highly fragmented, with thousands of banks,

thrifts, credit unions, and other financial institutions competing for the consumer's lending business. We believe that consumers, if given the proper information, will opt for doing business with those companies that provide the best value to them and that treat them honestly and fairly at all times.

However, from your perspective as legislators, we appreciate your concern that the practices of a few lenders have caused harm to real individuals, and that society's commitment to equal housing and equity credit opportunities propels you in the direction of additional federal regulation of the home equity loan market.

As I said earlier, at HI we view service quality and integrity as ways to distinguish ourselves. We take very seriously our responsibility to conduct our business affairs in accordance with the highest legal and ethical standards. We have a Statement of Business Principles, adopted by our Board of Directors, which sets forth the principles by which we manage the businesses of the Corporation. When we discover issues of compliance to these principles, we act quickly and forcefully to correct them. With respect to the abhorrent practice of redlining and reverse-redlining, our Statement of Business Principles states:

"In dealing with employees, customers and suppliers, the Corporation makes decisions without regard to race, color, religion, national origin, sex, age or handicap. . . ."

"In dealing with customers, Household is dedicated to offering top quality products and services and to supplying only honest information about them. Household will offer its products and services on a competitive basis and will not tolerate the use or attempted use of improper incentives to obtain business."

A copy of our Statement of Principles is appended to my statement.

Your Bill focuses on the need to set out the consumer's right to have disclosed to him or her in clear, simple, straightforward language, all of the terms, conditions, costs and potential penalties peculiar to the credit transaction. That focus is the appropriate one.

The Bill also calls for elimination of clearly egregious practices, and with that we do not argue.

I am pleased that your Bill does not attempt to impose underwriting standards, nor to limit rates. Such efforts invariably are counterproductive and serve only to restrict and limit 'credit' availability for those whom such initiatives seek to protect.

In short, although we regret the need which led your Committee to act, we support the product of your work.

TESTIMONY OF MICHELLE MEIER

COUNSEL FOR GOVERNMENT AFFAIRS ON BEHALF OF CONSUMERS UNION—CONSUMER FEDERATION OF AMERICA

Consumers Union¹ appreciates the opportunity to testify on S.924, the Home Ownership and Equity Protection Act of 1993. We are testifying on behalf of our own organization and Consumer Federation of America,² Public Citizen³ and U.S. PIRG.⁴

We commend the sponsors of the bill for moving expeditiously to try to address the scourge of home equity scams. The bill is a good first step toward developing the kind of legislative remedy that is needed to end the predatory practices that cost consumers their homes and their life savings.

¹Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the State of New York to provide consumers with information, education and counsel about goods, services, health, and personal finance; and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. Consumers Union's income is solely derived from the sale of *Consumer Reports*, its other publications and from non-commercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, *Consumer Reports* with approximately 5 million paid circulation, regularly, carries articles on health, product safety, marketplace economics and legislative, judicial and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

²Consumer Federation of America is a non-profit consumer advocacy organization representing more than 250 local, state and national consumer groups with a combined membership of more than 50 million Americans.

³Public Citizen is a nonprofit research and advocacy organization founded by Ralph Nader in 1971, which works on behalf of its over 60 thousand members and all consumers. Congress Watch is the legislative advocacy arm of Public Citizen.

⁴U.S. Public Interest Research Group is a national nonprofit, nonpartisan, research and advocacy organization. The group serves as the Washington, DC lobbying office for state PIRG's across the country.

The home equity scam problem can only be solved with a variety of legislative remedies.

- A multi-faceted approach is necessary because the problem comes in many shapes and sizes and arises because of numerous breakdowns in the rules of fair play in the credit market.
- A broad approach—one that generally prohibits unfair and deceptive practices in the home equity market—is necessary because there is no end to the inventiveness of scam artists. Without broad prohibitions against predatory equity loan practices, prohibiting today's unconscionable deeds will only spur the creation of new ones tomorrow.

The best solutions will be those that are systemic. Systemic reforms, as we use the term, are those that reduce or eliminate the incentives that produce the problems in the first place.

- Systemic reforms include giving back to states their traditional authority to set usury ceilings and other consumer protections. If Congress isn't going to set basic rules to eliminate extreme price gouging and other abuses, then it should at least not stand in the way of states who want to protect their own citizens.
- Systemic reforms include basic changes in the legal rules under which foreclosed property is sold in this country. The current rules that allow secured lenders to buy the property for a song create powerful incentives for unscrupulous lenders to coerce consumers into equity loans they can't afford.
- Systemic reforms also include extending the rules of fair play to those who, in a very real and practical sense, stand in the original lender's shoes by purchasing a loan. We will be wasting our time if the primary lender can ignore rules of fair play by selling the loan to the secondary market with no questions asked. The reforms will only stick if the law catches up with the real world by putting the secondary lender in the primary lender's shoes as a matter of law.

The Bill Will Eliminate Some Of The Most Harmful Practices

On the positive side, S.924 will prohibit some of the specific abuses that are evident in the marketplace today. Specifically, the bill makes it illegal for the highest priced loans to contain balloon payment, negative amortization and prepayment penalty clauses.

The bill's prepayment penalty prohibition clause is broadly written to include penalties that may not be labelled as such. For example, some scam artists severely penalize pre-paying consumers by using unfair accounting rules under which monthly payments in the first part of the loan term only go toward paying interest. At the point of prepayment the consumer's monthly payments may already have been credited to interest that will only be earned months into the future. The bill requires the lender to rebate this "unearned interest."

The prepayment penalty prohibition clause also applies to penalties that often arise in the context of a refinancing, during which the original loan is prepaid with the proceeds of the new one. These penalties come in the form of excessive points and fees, which are often required as a condition of refinancing. These fees severely penalize the refinancing consumer because they add thousands to the balance of the loan. They are another way for lenders to reap windfall profits by siphoning the home equity of vulnerable consumers in desperate financial straits.

The "Triggers" in the Bill Will Leave Some Scams Untouched by the New Reforms

The reforms described above only apply to home equity loans that meet the bill's threshold test, or "trigger." To trigger the bill's disclosure requirements and substantive prohibitions, a loan must have one of the following characteristics:

- an annual percentage rate (APR) that is more than 10 points above treasury securities of comparable maturity;
- upfront costs to the consumer that exceed 8 percent of the loan amount;
- a high debt to income ratio on the part of the borrower, as established by the Board.

We have serious concerns about restricting all reforms in this marketplace to loans that fall above a prescribed cost level or other "trigger." This is not to say that we believe the trigger concept should be abandoned altogether. However, some of the most fundamental reforms, including a general prohibition against unfair and deceptive practices, should apply across the board to all home equity loans except those used to purchase the home.

Unless this broader approach is taken, some of the worst abuses will continue because they will evade the trigger. For example, one of the biggest problems in the home equity market involves lenders qualifying distressed consumers for loans that

the borrowers have no resources to repay. Lenders engage in this type of asset-based underwriting because they know they can recover the debt, and possibly the entire property, upon foreclosure. Reforms to address this fundamental problem should not depend on a price-based trigger because the fundamental problem is not the price of the product but the practice of underwriting for an inevitable foreclosure.

A trigger based on a borrower's debt to income level is also not adequate to address this fundamental abuse because no single test can capture the quality of a lender's underwriting decision. Consequently, many loans underwritten for inevitable default will never be captured by a single debt to income test.

The best way to address this serious underwriting problem is to generally prohibit unfair and deceptive practices in the home equity marketplace. The bill should specifically identify as "unfair and deceptive" the practice of underwriting for inevitable default.

Similarly, some home equity scams involve fraud or deception in the inducement of the loan. For example, some home improvement loans secured by the borrower's equity are based on false promises about the work to be performed. According to the testimony in February of the Attorney General of Massachusetts, some scams are based on false promises of employment to make the loan affordable, or false promises that onerous terms will be deleted several months into the repayment term.

Again, a price-based trigger won't necessarily capture these loans because excessive fees or interest charges are not their fundamental characteristic. Their fundamental characteristic is the deception on which they are based and the risk of default they place on the borrower. The legislation should include reforms to deter against these types of scams regardless of the interest rates the loans carry.

Beyond these fundamental problems with relying *exclusively* on a trigger approach to reform, we must stress the fact that any price-based trigger invites evasion. The market will naturally price its product just below whatever trigger is established by law. That is why the trigger level is a critical issue with any trigger-based reform.

Given the critical importance of the trigger, we believe the interest rate (APR) trigger in S.924 is too high. A survey conducted by the University of Virginia under contract with the Consumer Bankers Association indicates that the average spread in 1992 on closed-end equity loans using treasury bill indices was 4.5 points. (The median was 4.36 points.) The spread on open-end equity loans using the same indices was even lower—roughly 4.29 points. (The median was 4.00 points.)

Yet the bill sets the rate-based trigger at 10 points above treasury bills of comparable maturity. This means that high-priced loans that are roughly 5 to 7 points above the competitive marketplace could escape the bill's reforms altogether!

We believe the trigger should be set no higher than 2 or 3 points above the competitive marketplace. Further research is necessary to know exactly how this goal can be achieved with indices of securities of varying maturities. Since indices of securities with lower maturities will tend to have lower values, the margin in the rate-trigger formula should vary according to the index used.

We have similar concerns with the trigger based on a loan's closing costs. Further research is necessary for us to assess whether the 8 points established by the bill is too high, too low, or just right.

The Reforms Could Miss Their Target Unless the Bill Covers Open-end Loans, Too

Aside from our concerns about the trigger level, we have concerns about the bill's failure to cover all non-purchase money mortgage loans. Army non-purchase money mortgage loan—i.e., one secured by the home but not used to purchase the home in the first place—can be used to prey on distressed and vulnerable consumers. If the bill's reforms only apply to closed-end loans—i.e., where the consumer receives the loan proceeds in one lump-sum at the beginning of the loan term—abusive lenders will simply restructure their products to make them open-ended—i.e., where the consumer can borrow repeatedly against a pre-approved line of credit. We strongly urge the bill's sponsors to extend the reforms to cover all non-purchase money mortgage loans.

But More Reforms Are Needed To Correct The Fundamental Problem

Again, we applaud the bill's sponsors for taking concrete steps to wrestle with the serious home equity scam problem. Although the bill is a good beginning in drafting reform legislation, we believe the bill omits some of the basic reforms that are necessary to end the abuses.

Additional reforms are critical. Aside from the coverage issues already discussed above, below we list some of the additional reforms we feel are necessary to get to

the heart of the problems with systemic solutions. Most of these reforms should apply as a supplement to the reforms activated by the bill's triggers. They should apply to all home equity loans except those used to purchase the home in the first place. This way we ensure that today's problems don't reappear in different form tomorrow.

- Congress should attack the heart of the price gouging problem by setting a national usury ceiling and other comprehensive protections or returning to states their traditional authority to set interest rate ceilings and other consumer protection restrictions.
- Congress should broadly prohibit any "unfair and deceptive" practice in the home equity marketplace and specify as "unfair and deceptive" the practice of approving a loan when it is clear a homeowner won't be able to repay it.
- Congress should bring some basic reform to the foreclosure laws, which are often grossly unfair to consumers. These reforms will reduce the incentive for unscrupulous lenders to prey on equity-rich but income-poor consumers. For example, consumers should have 90 days to "cure" their delinquency by making all their past-due payments. Currently, many states allow consumers to "cure" their delinquency on loans secured by their car or TV set and thereby avoid getting that item repossessed. Except in bankruptcy, the same rights generally do not apply when a loan is secured by a consumer's home.

Foreclosure sales should also be conducted in a more competitive environment. Currently, these homes are often sold in what amounts to a virtually unadvertised sale at a price way below market value. The price may not even cover the balance on the equity loan. This leaves the homeowner without a home, with no equity and a huge debt.

- Congress should make all secondary lenders, who buy these loans as an investment, abide by all the same rules as the primary lender; this would be accomplished by totally banning the "holder in due course rule," which currently absolves these investors from any responsibility to the homeowner.

The bill eliminates the holder in due course rule only in connection with the bill's own limited reforms. In other words, secondary lenders are subject to the bill's prepayment penalty prohibition. They are not subject to claims and defenses that arise under common law or state law, such as claims of fraud or usury ceiling violations.

In conclusion, we appreciate the opportunity to comment on a bill that addresses one of the most serious consumer problems that has come before this Committee. We look forward to working with the Members of this distinguished Committee and their staff as the reform legislation evolves and moves forward. Thank you.

103D CONGRESS
1ST SESSION

S. 924

To protect home ownership and equity through enhanced disclosure of the risks associated with certain mortgages, and for other purposes.

IN THE SENATE OF THE UNITED STATES

MAY 7 (legislative day, APRIL 19), 1993

Mr. RIEGLE (for himself, Mr. D'AMATO, Mr. BOND, Mrs. BOXER, Mr. DODD, and Ms. MOSELEY-BRAUN) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

A BILL

To protect home ownership and equity through enhanced disclosure of the risks associated with certain mortgages, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. SHORT TITLE.**

4 This Act may be cited as the "Home Ownership and
5 Equity Protection Act of 1993".

6 **SEC. 2. CONSUMER PROTECTIONS FOR HIGH COST MORT-**
7 **GAGES.**

8 (a) DEFINITION.—Section 103 of the Truth in Lend-
9 ing Act (15 U.S.C. 1602) is amended—

1 (1) by inserting after subsection (u) the follow-
2 ing new subsection:

3 “(v) The term ‘high cost mortgage’ means a
4 consumer credit transaction, other than a residential
5 mortgage transaction or a transaction under an open-end
6 credit plan, that is secured by a consumer’s principal
7 dwelling and that satisfies at least 1 of the following condi-
8 tions:

9 “(1) The annual percentage rate at the time
10 the loan is originated will exceed by more than 10
11 percentage points the yield on Treasury securities
12 having comparable maturities, as determined by the
13 Board. In the case of a variable rate loan with an
14 initial interest rate that may be different than the
15 rate or rates that will apply during subsequent peri-
16 ods, the annual percentage rate shall be computed
17 taking into account the subsequent rates.

18 “(2) Based on information provided by the
19 consumer, the consumer’s total monthly debt pay-
20 ments will exceed 60 percent of the consumer’s
21 monthly gross income, immediately after the loan is
22 consummated. The Board may establish a different
23 debt to income ratio if the Board determines that
24 such a ratio is in the public interest and is consist-
25 ent with the purposes of this Act.

1 “(3) All points and fees payable at or before
2 closing will exceed 8 percent of the total loan
3 amount.”; and

4 (2) by redesignating subsections (v), (w), (x),
5 (y), and (z) as (w), (x), (y), (z), and (aa), respec-
6 tively.

7 (b) MATERIAL DISCLOSURES.—Section 103(u) of the
8 Truth in Lending Act (15 U.S.C. 1602(u)) is amended
9 by striking “and the due dates or periods of payments
10 scheduled to repay the indebtedness.” and inserting “the
11 due dates or periods of payments scheduled to repay the
12 indebtedness, and the disclosures for high cost mortgages
13 required by paragraphs (1) through (6) of section
14 129(a).”.

15 (c) DEFINITION OF CREDITOR CLARIFIED.—Section
16 103(f) of the Truth in Lending Act (15 U.S.C. 1602(f))
17 is amended by adding at the end: “Notwithstanding the
18 above, any person who originates 2 or more high cost
19 mortgages a year, or who originates a high cost mortgage
20 through a loan broker, is a creditor for the purposes of
21 section 129.”.

22 (d) DISCLOSURES REQUIRED AND CERTAIN TERMS
23 PROHIBITED.—The Truth in Lending Act (15 U.S.C.
24 1601 et seq.) is amended by adding after section 128 the
25 following new section:

1 **“SEC. 129. REQUIREMENTS FOR HIGH COST MORTGAGES.**

2 “(a) DISCLOSURES.—In addition to any other dislo-
3 sures required under this title, for each high cost mort-
4 gage, the creditor shall provide the following written dis-
5 closures in clear language and in conspicuous type size
6 and format, segregated from other information as a sepa-
7 rate document:

8 “(1) The following statement: ‘If you obtain
9 this loan, the lender will have a mortgage on your
10 home. You could lose your home, and any money you
11 have put into it, if you do not meet your obligations
12 under the loan.’

13 “(2) The initial annual percentage rate.

14 “(3) The consumer’s gross monthly cash in-
15 come, as reported to the creditor by the consumer,
16 the total initial monthly payment, and the amount of
17 funds that will remain to meet other obligations of
18 the consumer.

19 “(4) In the case of a variable rate loan, a state-
20 ment that the annual percentage rate and the
21 monthly payment could increase, and the maximum
22 interest rate and payment.

23 “(5) In the case of a variable rate loan with an
24 initial annual percentage rate that is different than
25 the one which would be applied using the contract
26 index after the initial period, a statement of the pe-

1 riod of time the initial rate will be in effect, and the
2 rate or rates that will go into effect after the initial
3 period is over, assuming that current interest rates
4 prevail.

5 “(6) A statement that the consumer is not re-
6 quired to complete the transaction merely because he
7 or she has received disclosures or signed a loan ap-
8 plication.

9 “(b) TIME OF DISCLOSURES.—The disclosures re-
10 quired by this section shall be given no later than 3 busi-
11 ness days prior to consummation of the transaction. A
12 creditor may not change the terms of the loan after pro-
13 viding the disclosures required by this section.

14 “(c) NO PREPAYMENT PENALTY.—

15 “(1) IN GENERAL.—Except as provided in para-
16 graph (4), a high cost mortgage may not contain
17 terms under which a consumer must pay a prepay-
18 ment penalty for paying all or part of the principal
19 of a high cost mortgage prior to the date on which
20 such balance is due.

21 “(2) REBATE COMPUTATION.—For the pur-
22 poses of this subsection, any method of computing
23 rebates of interest less advantageous to the
24 consumer than the actuarial method using simple in-
25 terest is deemed a prepayment penalty.

1 “(3) CERTAIN OTHER FEES PROHIBITED.—An
2 agreement to refinance a high cost mortgage by the
3 same creditor or an affiliate of the creditor may not
4 require the consumer to pay points, discount fees, or
5 prepaid finance charges on the portion of the loan
6 refinanced. For the purpose of this paragraph, the
7 term ‘affiliate’ has the same meaning as it does in
8 section 2(k) of the Bank Holding Company Act of
9 1956.

10 “(4) EXCEPTION.—A high cost mortgage may
11 include terms under which a consumer is required to
12 pay not more than 1 month’s interest as a penalty
13 if the consumer prepays the full principal of the loan
14 within 90 days of origination.

15 “(d) NO BALLOON PAYMENTS.—A high cost mort-
16 gage may not include terms under which the aggregate
17 amount of the regular periodic payments would not fully
18 amortize the outstanding principal balance.

19 “(e) NO NEGATIVE AMORTIZATION.—A high cost
20 mortgage may not include terms under which the out-
21 standing principal balance will increase over the course of
22 the loan.

23 “(f) NO PREPAID PAYMENTS.—A high cost mortgage
24 may not include terms under which more than 2 periodic
25 payments required under the loan are consolidated and

1 paid in advance from the loan proceeds provided to the
2 consumer.”.

3 (e) CONFORMING AMENDMENT.—The table of sec-
4 tions at the beginning of chapter 2 of the Truth in Lend-
5 ing Act is amended by striking the item relating to section
6 129 and inserting the following:

“129. Disclosure requirements for high cost mortgages.”.

7 **SEC. 3. CIVIL LIABILITY.**

8 (a) DAMAGES.—Section 130(a) of the Truth in Lend-
9 ing Act (15 U.S.C. 1640(a)) is amended—

10 (1) by striking “and” at the end of paragraph

11 (2)(B);

12 (2) by striking the period at the end of para-
13 graph (3) and inserting “; and”; and

14 (3) by inserting after paragraph (3) the follow-
15 ing new paragraph:

16 “(4) in case of a failure to comply with any re-
17 quirement under section 129, all finance charges and
18 fees paid by the consumer.”.

19 (b) STATE ATTORNEY GENERAL ENFORCEMENT.—
20 Section 130(e) of the Truth in Lending Act (15 U.S.C.
21 1640(e)) is amended by adding at the end the following:
22 “An action to enforce a violation of section 129 may also
23 be brought by the appropriate State attorney general in
24 any appropriate United States district court, or any other

1 court of competent jurisdiction, within 5 years from the
2 date on which the violation occurs.”.

3 (c) ASSIGNEE LIABILITY.—Section 131 of the Truth
4 in Lending Act is amended by adding at the end the fol-
5 lowing new subsection:

6 “(d) HIGH COST MORTGAGES.—If a creditor fails to
7 comply with any of the requirements of section 129 in con-
8 nection with any high cost mortgage, any assignee shall
9 be subject to all claims and defenses that the consumer
10 could assert against the creditor. Recovery under this sub-
11 section shall be limited to the total amount paid by the
12 consumer in connection with the transaction.”.

13 **SEC. 4. EFFECTIVE DATE.**

14 This Act shall be effective 60 days after the promul-
15 gation of regulations by the Board of Governors of the
16 Federal Reserve System, which shall occur not later than
17 180 days following the date of enactment of this Act.

○

STATEMENT OF JOHN P. HAMILL
PRESIDENT, FLEET BANK OF MASSACHUSETTS

Mr. Chairman and Members of the Committee, I appreciate the opportunity to submit these written comments to the Committee on behalf of Fleet Financial Group (Fleet) regarding your legislation dealing with the second mortgage market, the Home Ownership and Equity Protection Act of 1993 (S. 924), and I respectfully request that they be made part of the hearing record for this legislation.

Based upon our preliminary analysis, we believe that S. 924 is a constructive attempt to protect both consumers and lenders against potentially abusive practices in the second mortgage industry. We support clear and effective disclosures to assure that consumers are fully informed about credit transactions, and the disclosure requirements included in S. 924 will help give borrowers a better understanding of the potential risks associated with taking out a second mortgage on their homes.

However, there are some technical problems that should be addressed by the Committee, particularly in the compliance area, as this legislation moves forward. It is my understanding that the American Bankers Association will be submitting a statement to you identifying these problems and suggesting ways to alleviate them, and I hope that you will continue to work with us on this.

There is also a great deal that the private sector can do to help, and Fleet has embarked on an aggressive effort to expand its consumer service and education programs. For instance, Fleet Finance has developed a new program, in conjunction with the National Consumers League, to help provide consumers with straightforward information about first and second mortgages. With the League's help, we will be conducting one- and two-day seminars this Fall, first in Georgia and Florida, and later in all states in which Fleet Finance conducts business, where consumers will learn about borrowing money, loan documentation, credit ratings and issues that affect family budgets and credit history.

Mr. Chairman, we congratulate you, and Senators D'Amato, Dodd, Bond, Moseley-Braun and Boxer for sponsoring this legislation, and we look forward to working with you as S. 924 is given further consideration by this Committee and the Congress.

STATEMENT OF THE AMERICAN FINANCIAL SERVICES ASSOCIATION

The American Financial Services Association appreciates this opportunity to express our views on S. 924, "The Home Ownership and Equity Protection Act of 1993."

The American Financial Services Association (AFSA) is the trade association for a wide variety of non-traditional providers of financial services to consumers and small businesses. Members fit into four basic categories:

(1) Diversified Financial Services Companies—these are companies that offer a broad range of financial services and products to middle income consumers nationwide. Many of these members are affiliated with banks or savings and loans. Examples of these members include Dean Witter, Discover & Co., Household International, and Beneficial Corporation.

(2) Automotive Finance Companies—frequently referred to as "captive finance companies," they provide financing for customers that purchase the manufacturer's products. In addition, many of the companies or their parents have branched out into a range of other financial services, such as credit cards or mortgage lending. Members representative of this category include General Motors Acceptance Corporation, Ford Motor Credit Company, Deere & Co., and Chrysler Financial Corporation.

(3) Consumer Finance Companies—the core business of this membership segment includes: unsecured personal loans, home equity loans, and sales financing (for retailers' credit customers). This segment includes companies of all sizes. Some representative companies include Norwest Financial, Chemical Financial Services Corp., and Commercial Credit.

(4) Credit Card Issuers—this membership segment offers bank cards, charge cards, credit cards or private label cards. AFSA members include some of the largest credit card issuers in the U.S.: Advanta Corporation, American Express Company, AT&T Universal Card, G.E. Capital, Dean Witter, Discover & Co., General Motors, and Household International.

Some consumer finance companies are owned by, own, or are affiliated with depository institutions, such as savings & loans, consumer banks (limited-purpose banks), or credit card banks. These institutions are fully regulated institutions, sub-

ject to all of the laws and regulations applying to banking institutions. They are regularly examined by state and federal banking authorities.

In addition, non-banking consumer lenders must comply with federal regulations relating to consumer credit—the Equal Credit Opportunity Act, the Truth-In-Lending Act, the Real Estate Settlement Procedures Act, the Truth-in-Leasing Act, the Fair Credit Billing Act, the Fair Credit Reporting Act, and the Federal Trade Commission's Credit Practices Rule are among the most important.

Non-banking consumer lenders are generally licensed and regulated by the state banking department or the department of corporations in every state in which they operate. They are subject to state usury laws governing the interest they can charge on consumer loans, as well as state consumer protection laws.

As the above demonstrates, AFSA members are important providers of credit to the American consumer. AFSA members are highly innovative and compete at all levels in the financial services markets. Our members have charged AFSA with promoting a free and open financial services market that rewards the highest level of competitiveness.

Summary of AFSA's Position

AFSA strongly supports the goals of S.924. It should go without saying that AFSA members are strongly opposed to any credit practices directed at particularly vulnerable consumers which are intended from the outset to deprive those consumers of their homes. It is highly appropriate that Congress move to eliminate this type of abuse, no matter how limited the class of lender or consumer. These types of practices have a negative impact on legitimate lenders as well as consumers. AFSA members have a strong interest in ending such abuses.

While supporting the goals of the bill, AFSA believes that the current provisions in the bill need to be narrowed and focused on specific abuses. Instead, many of the provisions seem only to duplicate already extensive disclosures required under the Truth-In-Lending Act and unnecessarily impose costly substantive restrictions on legitimate home equity lenders that may restrict the flow of credit.

Finally, the recent extension of the Real Estate Settlement Procedures Act to "subordinate" mortgages by Congress last year should ameliorate many of the problems which S.924 seeks to resolve. The effect of this major regulatory development on the entire second mortgage industry should be examined before imposing new obligations and restrictions on home equity lenders.

S. 924 and Alleged Second Mortgage Abuses

As we understand it, the genesis of the bill lies in certain alleged lending practices that were first publicized on the television program "60 Minutes" and reviewed in hearings before this committee and its counterpart on the House side. The testimony alleged that low- and moderate-income consumers were the targets of home improvement contractors who fraudulently induced them to sign a contract for extremely overpriced home repairs.

Characteristics of the finance contracts for the home repairs appear to have been high rates of interest, high prepaid finance charges, high prepayment charges, high broker fees, and balloon payments designed to trigger foreclosure. According to the victims who publicized their predicaments, only a relatively small amount of the proceeds of the loan would go to the borrower. In order for this practice to be profitable, customers must either pay the inflated or "padded" loans, or the house in question must have high equity enabling it to be sold in foreclosure for a profit.

It was alleged that these mortgages were financed by a so-called intermediary lender and then the mortgages were "assigned," frequently on a "preapproved" basis, to another lender.

New RESPA Requirement Should Be Considered Before Imposing New Disclosure and Substantive Requirements

Before making any specific comments on S.924, it is necessary to discuss new regulatory developments in the second mortgage area. On May 13, 1993, the Department of Housing and Urban Development (HUD) published its proposed rule to extend coverage of the Real Estate Settlement Procedures Act (RESPA) to second and other subordinate mortgages, including most home equity loans and lines of credit and home improvement loans. This proposal reflects amendments to RESPA contained in Sections 908 and 951 of the Housing and Community Development Act of 1992.

The extensive disclosure requirements and substantive nature of RESPA promise to change the character of the second mortgage industry in the United States. Fur-

ther, HUD's recent decision to extend RESPA coverage to refinancings as of December 2, 1992, means that all of the loan transactions meeting the definition of "high cost mortgage" in S.924 are already under the comprehensive and rigid regime of RESPA, which constitutes a substantial new compliance burden.

The impact of these changes is so significant that AFSA submits that the current scrutiny of the second mortgage industry would not now be taking place if these RESPA changes had been in place during the past few years.

This important development should be examined carefully before imposing even more new disclosure and substantive requirements on subordinate mortgages.

Among the requirements that subordinate mortgage lenders will now follow to comply with RESPA are:

(1) **Good Faith Estimate:** Lender must provide good faith estimate of settlement costs to all applicants within three business days after application is received or prepared. If application is received by a mortgage broker who is not an exclusive agent of the lender, the mortgage broker must provide a good faith estimate within three business days, in addition to that provided by the lender.

(2) **Special Information Booklet:** RESPA requires lenders to provide a special information booklet to borrowers within three days of application. However, since the current booklet has no information about non-purchase transactions, HUD is proposing to waive this requirement "until and unless" HUD issues a revised or separate booklet, or until the Agency has endorsed forms or information booklets of other Federal Agencies.

(3) **Settlement agents** are required to use a HUD-1 settlement statement (an alternative HUD form has been proposed for refinancing and junior lien settlements). This form itemizes each and every charge associated with the transaction in a manner that enables the borrower to examine the true details of the loan. Mortgage brokerage fees must now be disclosed in the HUD form and good faith estimate if the broker is not the exclusive agent of the lender. This would include any fees paid by the broker who is not the exclusive agent of the lender. This would include any fees paid by the lender as well as in "borrower-pay" transactions. Regulation X (which implements RESPA) also now requires disclosure of broker's fees in "table-funding" transactions.

(4) **Loan Servicing.** As a result of 1990 amendments to RESPA, lenders must disclose at the time of application (1) whether the servicing of the loan may be assigned, sold or transferred at any time; and (2) a historical disclosure that includes the percentage of loans they have made in recent years that have experienced service transfers.

(5) **Prohibition Against Kickbacks and Unearned Fees:** Under RESPA, no person shall give and no person shall accept any fee, kickback, or other thing of value pursuant to any agreement or understanding for the referral of a real estate "settlement service" in connection with a covered loan. Section 8(b) of RESPA prohibits any person from giving or receiving any part of a charge for a real estate "settlement service" in connection with a covered loan, except for services actually performed. Violations of these provisions can trigger both criminal and civil liability.

RESPA will have a significant impact on how mortgage brokers are compensated. The prohibitions of RESPA's Section 8 and the requirements to itemize and disclose all fees will prove to be very significant consumer protections. In the future, fees attributable to the use of mortgage brokers are likely to be lower—the consumer will benefit.

(6) **Escrow Accounts:** RESPA limits the amount that a lender may require the borrower to pay into tax and insurance escrows.

* * *

The extension of RESPA to all refinancings and subordinate loans (including all those which would be "high cost mortgages" under S.924) is far from a trivial, legalistic development. These requirements and prohibitions will have a profound effect on the second mortgage industry—mostly in ways that should benefit the consumer. Consumers will receive even more disclosures, and will likely see some cost reductions due to the stringent prohibitions of Section 8. Broker compensation is likely to decline to reflect the actual services rendered by the broker.

As stated by the National Consumer Law Center, the new RESPA requirements will probably go a long way in curbing the type of second mortgage abuses cited in your hearings:

[M]any of the second mortgage scams involve 'loan padding,' in which the loan includes exorbitant fees for the full array of closing costs—even when unnecessary. Reg X gives a bow in that direction by giving HUD the authority to investigate high prices to see if they are caused by kickbacks or referral fees. While

high prices standing alone are not proof of a RESPA violation, if there is no reasonable relationship to the market value of the goods or services provided, it may be considered that the excess is unearned and therefore a RESPA violation." (NCLC Reports, Consumer Credit and Usury Edition, Jan/Feb. 1993)

The report goes on to say:

"As with Truth-In-Lending, RESPA provides consumers with important information. The settlement statement, in fact, helps close one of TIL's loop holes. Since TIL does not mandate that consumers be given an itemization of the amount financed, some of the overreaching second mortgage lenders were able to conceal exorbitant costs and other forms of loan padding by providing simply a total amount financed. They should no longer be able to do that.

"Moreover, the limitation on unearned charges and kickbacks, which carries the possibility of a maximum \$10,000 fine as well as the treble-damages private remedy, gives advocates a handle on at least some of the loan padding techniques used by these lenders." (NCLC Reports, Consumer Credit and Usury Edition, Jan/Feb. 1993)

While AFSA believes that some modifications must be made to HUD's recent RESPA proposal to reflect the realities of the second mortgage industry, all of our members are aware of the new RESPA requirements which will take effect upon issuance of the final rule.

Some of them have already made efforts to comply, even though not required as of yet (HUD's Proposed Rule to implement the changes was just issued on May 13, 1993). Implementation of just the RESPA provisions will pose a major compliance burden on all subordinate mortgage lenders. Increasing them further through the enactment of S. 924 would pose an extraordinary burden on this one industry. AFSA urges that full consideration be given to the compliance burden placed on the industry by the new RESPA requirements and that the requirements of S. 924 be weighed carefully against the new RESPA regulations.

Characteristics of the Modern Finance Company

AFSA is concerned that there is not a clear understanding of the structure of the modern finance industry and how it operates, especially vis a vis insured depository institutions. The finance industry has many unique characteristics which AFSA believes that the Committee should consider if it moves forward with S. 924. While AFSA represents primarily the consumer finance industry, it is necessary to look at the finance industry as a whole. *The Federal Reserve Bank of New York Quarterly Review* published a useful paper on the finance industry, which is summarized below and attached in its entirety to the testimony.

The modern finance industry consists of a varied group of non-depository financial institutions. Ownership is especially diverse, including: industrial and other non-financial companies, banks, nonbank financial companies as well as independent finance companies. Many companies engage in both commercial and consumer finance. In 1990 the combined assets of the twenty largest firms totaled \$426 billion or 82 percent of the industry's overall assets. Of the top twenty companies, twelve do both commercial and consumer finance.

In virtually all cases, finance companies carry significantly heavier capital burdens and do not have deposit insurance (see Table 7, p. 36 of Appendix C). In 1990, capital ratios for the top 20 companies ranged from a low of 8.4 percent to a high of 27.7 percent. Seventeen of the companies had capital in excess of the highest recent capital level for an insured institution of comparable size, which is 12.3 percent. Capitalization for finance companies is at least partially dependent upon asset quality and size.

Finance companies traditionally concentrate on loans secured by tangible assets and have the greatest success in niche markets where they are well established and have specialized expertise, whether it is in commercial aircraft leasing or second mortgage lending to consumers who would not meet insured institution underwriting standards.

This is why finance companies are generally not in head to head competition with banks, but instead compete by offering services that substitute for bank credit in markets not served by banks. Banks do not serve these markets not because they are somehow evil or uncaring but because they are federally insured institutions with a regulatory environment that tries to protect the deposit insurance funds by tightly controlling risks, and hence controlling types of lending.

This is as true for an activity such as equipment leasing as it is for second mortgage loans to higher risk individuals. These specialized niche markets place a premium on specialized information and practical experience which place new lenders

at a disadvantage short of acquiring a finance company engaged in a particular niche. For an insured institution it is particularly difficult to overcome this lack of knowledge and experience. Federal bank examiners will not tolerate the rate of losses and attendant demands on capital that it frequently takes to enter one of these niche markets. Additionally, once in the market, lenders are still exposed to higher risks than regulators of insured depository institutions would deem prudent, especially in light of Congressional pressures in recent years.

While banks have a significant cost of funds advantage, finance companies are able to charge overall higher interest rates which *reflect the greater risks in their niche markets*. Overall, finance companies earn higher returns than banks, but not by a huge amount (see Table 5 on p. 31 of Appendix C). In order to fund themselves competitively in the commercial paper market, these are the rates of returns that are required. This is also reflected in Chart 1 which shows the cost structure of a typical finance company second mortgage loan.

AFSA Members and the Home Equity Market

There are approximately 15,000 home equity lenders of all types. This includes banks, thrifts, credit unions and finance companies. In dollar terms, the total home equity market stands at about \$272 billion with finance companies holding about 20 percent or \$54.3 billion of the total (See Chart 2). Of that \$54 billion, approximately 70 percent is distributed among 11 large finance companies and roughly 80 or more percent is distributed among the 20 largest finance companies.

AFSA second mortgage lenders tend to lend to individuals who cannot or prefer not to obtain credit from insured institutions. Accordingly, the cost structure for this type of lending is higher. Attached are two charts which demonstrate the cost and profit structure of a typical home equity loan as well as the practical impact of the higher rate of losses on a lender's portfolio. The cost of funds, which are obtained in the commercial paper market, are significantly higher than for bank deposits or T-bills. While higher than banks, return on assets for these types of loans average only about 1.5 percent (See Chart 1). This is hardly egregious. Additionally, this category of loans experiences a higher rate of losses, and, as the example points out for a \$5,000 loan with a term of 36 months and a rate of 15 percent, it takes ten performing loans to make up for the loss of one loan. So while a loss rate of 3 or 4 percent may seem low, it has great impact on profitability. Using the example, it would take 30 percent of a portfolio to make up for a loss rate of 3 percent.

In terms of consumer awareness of the possible consequences of nonpayment, a study by the University of Michigan Survey Research Center indicated that 84 percent of all home equity borrowers cited foreclosure as a possible action that a creditor might take, with another 7 percent listing some other type of legal action. This is an extremely high level of consumer awareness. This is not to say that we should not concern ourselves with the other 9 percent, but it does give us some idea of the smaller scope of the problem to be addressed by the additional disclosures and substantive prohibitions. A recent GAO report (Appendix B) indicated that overall delinquency rates for home equity loans were no higher than for other significant forms of credit and in recent years have been significantly lower.

Specific Comments on S. 924

S. 924 contains a number of substantive prohibitions—most of them in areas which have traditionally been the province of state legislatures or regulators. Prepayment penalties, rebate computations, and refinancing costs are all price-related areas that have been considered by most states within the context of their consumer credit regulatory structures.

Prepayment penalties are not inherently abusive; to the contrary, they compensate the lender for costs incurred in originating the loan. Lenders do not make a profit on loans during the first year, based on the reality of proper accounting. The lender has fixed costs associated with every transaction, whether it closed or not. The earned interest in approximately the first year does not equal those costs, including the accounting practice of booking the entire loan loss reserve at the time you put the loan on the books. Each lender identifies a percentage which represents its average loss for loans with similar risk characteristics, and charges itself that full amount when the transaction is booked. Lenders often protect against losing money by including a reasonable prepayment penalty for usually just the first year. High rate loans are high risk loans. The rate charged to the consumer reflects the risk, so the loss reserve is greater. Therefore, to reflect these concerns, AFSA would recommend eliminating the prepayment prohibition or, at the very least, allow prepayment penalties during the first 18 months of the loan.

Rebate computations are also a traditional area of state purview. By restricting rebates to the actuarial method using simple interest, S. 924 would effectively outlaw the Rule of 78's on so-called high cost mortgages. This is an area in which Congress legislated just last year by reaching a compromise in banning the Rule of 78's for loans with maturities of over 61 months. (Section 933 of the Housing and Community Development Act of 1992.) AFSA believes that the impact of last year's compromise should be observed before implementing further restrictions.

Finally, AFSA urges reconsideration of the bill's ban on balloon payments and negative amortization. Neither of these features is inherently abusive and both are found in all types of mortgages. The borrower should be thoroughly aware of these terms if they are part of the loan agreement, and any substantive provisions should be targeted at abuses. A disclosure approach is certainly more appropriate for the balloon payment and negative amortization situations. There may be times when such features may be appropriate and desirable for a particular borrower—why outlaw them altogether?

We have listed additional specific concerns in Appendix A.

Expansion of the Truth-In-Lending Act to Include Definitional "Triggers" for High Cost Mortgages

We are concerned over the precedent set by Section 2 of the legislation which amends the Truth-In-Lending Act (TILA) by adding a definition of the term "high cost mortgage" predicated on the existence of one of three "triggers" dealing with interest rates, debt to income ratio, and points. Once a mortgage is deemed to be high cost, a series of largely duplicative disclosures are required three days prior to consummation of the transaction.

TILA is intended to provide meaningful disclosure of credit terms to consumers. It was never intended to provide a means for the government to prescribe or limit private sector lending programs and policies. Also disturbing is the subject matter of the triggers. In essence, the Congress is making a pricing decision for consumers by triggering the disclosures based on a statutory rate index. Additionally, for the first time, Congress would be codifying, in the debt to income ratio trigger, what amounts to an "improvident lender standard" to be enforced by the lender.

This is a significant expansion of TILA and provides a troublesome precedent, especially when used to get at problems that, however egregious and inexcusable, have not been demonstrated to affect large numbers of consumers.

In AFSA's view, if existing disclosures are not doing the job, then the disclosures should be made more meaningful without regard to the class of mortgage. We feel that second mortgage abuses can be addressed from the disclosure side by improvements to just one of the disclosures required by S. 924. AFSA feels that if the gross income disclosure on page 4, line 16 of S. 924 were modified and expanded to become a *cash flow work sheet* for the consumer, preferably located just above the signature line on the loan agreement, this would provide meaningful disclosure protections for consumers unaware that they could lose their house. We would envision the disclosure worksheet listing both gross monthly income and all obligations, including the new loan, to provide an accurate picture of just how much income the consumer would need to meet all obligations.

We feel that this disclosure prior to consultation would be an excellent replacement for the triggers and other disclosures as it would set out the reality of the consumer's situation prior to consummation.

If the Committee is unwilling to adopt such an approach, then we would suggest a second alternative as a substitute for the triggers—that the Federal Reserve Board be charged with developing a regulation requiring disclosures for certain classes of mortgages based on the factors the Congress feels are relevant. This approach would target the class of mortgages with which the bill is concerned without setting undesirable precedents. Additionally, it would almost certainly result in a better technical product than setting purely statutory requirements.

If the Committee retains the trigger approach, we strongly feel that the bill should require that two of the three trigger conditions be present (rather than the one presently required). This is because it is possible for a loan to meet one of the triggers and still be cheaper than a loan that does not meet any of the criteria to be labeled a high cost mortgage.

Additionally, we would in any event recommend that some de minimis criteria be established to exempt smaller loans that could not reasonably be expected to place a consumer's dwelling at risk. We would be happy to work with the Committee in establishing the criteria and characteristics for this type of loan.

Conclusion

The closed-end second mortgage industry is far from an under-regulated business. Numerous federal and state laws and regulations exist to protect consumers and to rein in unscrupulous lenders.

With the pending application of RESPA to the second mortgage industry, AFSA feels that the alleged abuses publicized on "60 Minutes" would not have been possible.

We urge the Committee to narrow the focus of the bill and will make every effort to cooperate in achieving the best result. We have made a number of constructive recommendations to focus the bill on particular areas of concern for consumers, and we hope to work with the committee to achieve its goals.

Composite Figures on Closed End Home Equity Loans Among AFSA Member Companies *

Typical closed end Home Equity Loan
A.P.R. 14.12%

Yield*	<u>14.85 %</u>
(-) Operating Expenses	<u>4.48 %</u>
(-) Losses	<u>1.09 %</u>
(-) Cost of Funds	<u>7.27 %</u>
= Pretax	<u>2.73 %</u>
= Net ROA	<u>1.44 %</u>

The following is a simplified example to illustrate the impact of losses on a lender's portfolio of closed end home equity loans. The example does not take into account numerous real world considerations such as disposition of the real property when a borrower defaults or the cost of money to the lender, etc.

A borrower defaults on a 36 month, \$5000 home equity loan with a 15% interest rate. Assume the lender loses all principle (\$5000) and interest (\$1239.76) on the loan.

Under these circumstances, the lender would have to make five performing loans (totaling \$31,198.80) with comparable terms just to break even on the losses from the one bad loan.

If you further assume that half of the earned interest goes to expenses, then the lender would have to make ten performing loans (totaling \$62,397.60) with comparable terms just to break even on the losses from the one bad loan.

- * Based on a sample survey of the largest AFSA home equity lenders

Chart 1

**DATA FROM AFSA'S RESEARCH REPORT & SECOND MORTGAGE
LENDING REPORT 1989**

o	Total <u>Number</u> of Second Mortgages Outstanding at Reporting Finance Companies, Year-End 1989	1,024,717
o	Total <u>Amount</u> of Second Mortgages Outstanding at Reporting Finance Companies, Year-End 1989	\$24.7 billion
o	Average Size of Second Mortgages Outstanding	\$24,149
o	Contract Maturity of Second Mortgages Made in 1989	60%--less than 121 months 40%--121 months +
o	Income of Borrowers	Over 1/4 of Seconds Made to Borrowers with Income of Over \$3000/month
o	Ages of Borrowers	56% of Seconds Made to Borrowers Between the Ages of 35 and 54 Years

Chart 2

APPENDIX AAPPENDIX TO AFSA STATEMENT ON S.924

In addition to our comments on S.924 in the main statement, AFSA wishes to make the following observations and suggest the following changes to the bill:

THE BILL SHOULD NOT COVER FIRST-LIEN REFINANCINGS: In order to limit the coverage of the "high cost mortgage" requirements, Section 103(v) should be amended to read as follows:

"(v) The term "high cost mortgage" means a consumer credit transaction, other than a transaction under an open-end credit plan, that is secured by a subordinate lien against the consumer's principal dwelling and that satisfies at least [2]* of the following conditions:"

*In accordance with recommendation found in text of statement.

LONG OR SHORT TERM DEBT?: Criteria No.2 as stated in Section 103(v)(2) does not indicate whether the lender is to take into account only short term debts or long term debts. Frequently, in determining lending ratios, lenders will not take into account debt obligations which will be paid off within a 12 month period.

In addition, since the section reads: "Based on information provided by the consumer...", is the creditor limited to information provided by the consumer or can the creditor make this determination based on verified information? In the event of a joint credit application, is the creditor permitted to make the determination (for purposes of the 60% threshold) based on the joint incomes and debt obligations of the credit applicants?

WHAT FEES SHOULD BE INCLUDED?: Criteria No.3 as stated in Section 103(v)(3) needs to be clarified as to "points and fees payable at or before closing...." Is this limited to lender related fees and charges or does it include third party fees and charges such as: title insurance, hazard insurance premiums, appraisal fee, credit report fee, tax/insurance escrows, property taxes, survey, recording fees, etc.?

AFSA believes the criteria should be limited to points charged by the lender. Fees will vary considerably by region and other variables, but do not vary greatly from lender to lender.

APR Disclosure: The requirements of Section 129 concern the creditor's obligation to provide additional disclosures to the consumer no later than 3 business days prior to the consummation of the transaction. This information includes the "annual percentage rate." Not only is this disclosure requirement duplicative with other TIL disclosures, the APR may not yet be determined at the time specified. Therefore, the lender should be able to give a good faith estimate of the APR and note that it is subject to change. This should also be the case for providing the disclosure of the maximum interest rate.

LIABILITY: The penalties for violations are exceedingly harsh, particularly if the infraction is slight, immaterial, or inadvertent. The general TILA liability provisions should be sufficient. Additionally, if the lender fails to make correct disclosures, the borrower may rescind the loan up until the time proper disclosures are made and receive a refund of all interest and fees paid.

LIABILITY OF ASSIGNEES: Section 131 would extend liability to assignees regardless of whether they had knowledge of the violation. This provision would present a major problem to any secondary market which exists for these types of loans. To remain consistent with TILA, liability to assignees should be limited to a "violation which is apparent on the face of the document," and the penalty should be the current statutory damages available under the Act.

EFFECTIVE DATE: The bill's effective date should be consistent with the TILA's requirement that requires that new regulations have an effective date of October 1 which follows by at least six months the date of promulgation.

OTHER CONCERNS: The bill contains many ambiguities which will result in litigation because of the incentive to obtain penalties and attorney fees. Some of the ambiguities are as follows:

- a. How is the "yield" calculated, i.e., based on the last sale or the average of a certain number of sales of the Treasury bills, and on what day is the yield determined since the disclosure must be given no later than 3 business days prior to the consummation of the loan?

- b. What is a "comparable maturity?" "Comparable" is defined by Webster's New Collegiate Dictionary as "capable of or suitable for comparison." This should be clarified.
- c. The provision regarding "variable rate loan(s)" doesn't really work for a variable rate loan where the variation is related to future fluctuations which are unknown at the time of the disclosure. Under such circumstances, it would be impossible for the creditor to compute the APR as contemplated by the bill.
- d. The phrase, "Based upon the information provided by the customer" is too broad to determine the customer's monthly debt payments. For example, the name of a creditor is "information." In this example, it would be very difficult for the prospective creditor to ascertain the monthly debt payment from that "information." The creditor could refuse to provide the monthly payment. What about revolving loans where the monthly payment could vary from month to month? What are "debts"? Do they include utility and other monthly bills?
- e. Pursuant to the bill, the monthly debt load must be determined "immediately after the loan is consummated"; however, this must be determined at least 3 days before the loan is consummated in order to determine whether the mortgage is one on which the disclosure must be made. If so, the disclosure must be made at least 3 days before the loan is consummated.
- f. What constitutes "income"? What about pension and social security benefits or food stamps?
- g. Which month's interest can be charged as a prepayment penalty, i.e., interest is much larger in the first than in the last month of a loan.

Problems With Home Equity Financing for Lenders

While thus far there has been little indication of lender or homeowner hardship from using home equity financing, the evidence available is sketchy and lender experience is limited. Studies show that delinquency rates and the number of foreclosures on this type of borrowing have been low. However, we do not know if this will continue to be true. In addition, lenders and bank regulatory agencies have raised some concerns about the risks associated with home equity financing. Both are working on approaches for guarding against future problems.

Low Delinquency Rates to Date for Home Equity Financing

The Federal Reserve's Surveys of Consumer Attitudes in 1990 and 1991 indicated that among the various types of consumer debt, "other mortgages," particularly home equity financing, had the best payment performance by borrowers.

Table V.1 shows delinquency rate data from ABA for 1987 through 1991. During this period, delinquency rates¹ for home equity financing were low, and the difference in the delinquency rates for home equity loans and home equity lines of credit was significant. The rates for home equity lines of credit, thus far, have been much lower than those for home equity loans and other types of credit, which have been similar to one another.

Table V.1: Delinquency Rates as a Percentage of the Number of Loans Outstanding for 1987-1991

Year	Delinquency rates by credit type				
	Home equity financing		Auto loans (direct)	Revolving credit loans	Bank card loans
	Loans	Lines of credit			
1987	2.01%	.74%	1.73%	2.39%	2.47%
1988	1.96	.68	2.08	2.82	2.34
1989	1.85	.78	2.25	2.91	2.35
1990	1.45	.85	2.51	3.15	3.02
1991	2.06	.88	2.45	2.91	3.36

Source: American Bankers Association

The rates for the lines of credit may be lower for several reasons, including the following.

- Most lines are not very old.

¹ABA defines delinquency as loans past due 30 days or more.

Finance Companies, Bank Competition, and Niche Markets

by *Eli M. Remolona and Kurt C. Wulfekuhler*

During the 1980s, U.S. commercial banks faced increased competition in their lending activity from other financial intermediaries. Large finance companies were an especially vigorous competitor of banks. Because finance companies enjoyed their success despite carrying apparently heavier capital burdens and lacking the advantage of deposit insurance, concerns arose that commercial banks were being hampered by the structure of their regulation and ownership.

This study seeks to explain the differential performance of banks and finance companies in common lending markets. We find that while regulatory and ownership factors were important, they were not the primary determinants of success in individual markets. Had these institutional factors been decisive, finance companies would have outperformed banks in both consumer and business credit markets. But in the consumer credit markets generally, finance companies lost market share to banks and their affiliates. Finance companies fared better than banks overall because they benefited from surging demand in sectors where they were well established and highly experienced, notably in the equipment leasing segment of the middle market for business credit. Even as banks with excess lending capacity became more willing to take risks in commercial real estate and highly leveraged transactions, they mounted little direct challenge to the finance companies in important segments of the middle market.

Why was this so? The evidence shows that much of the growth in the leasing market took place in niches, market segments of relatively risky credit where command of specialized information was critical to lenders.

In niches such as commercial aircraft leases and medical equipment leases, finance companies enjoyed dynamic scale economies in information because of their early entry and accumulated experience in the business. Since banks could not develop their own expertise at once, such learning-curve economies served as a substantial barrier to entry.

Nonetheless, the niche barrier was not insurmountable: indeed a few banks did break into the equipment leasing market. Banks could have overcome the niche barrier either by expanding rapidly to accelerate their learning or by acquiring an existing leasing operation. These strategies entail entry costs, however, and banks would have needed a sufficient cost-of-funds advantage to earn the high future returns that would make up for the initial costs. We argue that most large banks lacked this funding advantage and thus chose to bypass good opportunities in the fast-growing leasing markets.

In the following sections, we first analyze the growth of finance companies and the importance of good credit ratings. Then we examine how finance companies took advantage of niches in their traditional markets. Finally, we discuss the factors inhibiting bank entry into the finance companies' leasing niches.

Growth of finance companies

Nature of the industry

Finance companies are a diverse group of non-depository financial institutions. Like commercial banks, these institutions extend credit to both consumers and businesses, although they traditionally concentrate on loans secured by tangible assets.

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Large companies have long dominated the finance company industry. In 1990 the combined assets of the twenty largest firms totaled \$426 billion, or 82 percent of the industry's overall assets (Table 1). These large companies tend to be wholly owned subsidiaries of nonfinancial firms, and the very largest are most often "captives" that finance principally the sales and leases of their parents. Of the twenty largest finance companies, seven are captives, five are noncaptives owned by nonfinancial parents, three are owned by nonbank financial parents, three are affiliated with banks, and two are independent.

The largest finance companies tend to be those that diversified from consumer credit into business credit. The convention in the literature is to consider a finance company diversified if it holds at least 35 percent of its receivables in the form of commercial and industrial credit; otherwise it is considered a consumer finance company.¹ Of the top twenty, twelve are diversified finance companies, and by 1990 they held over four-fifths of the assets of this group.

Growth and excess capacity

For most of the 1980s, finance companies grew faster than commercial banks (Chart 1). From 1980 to 1990,

accounts receivable for the finance company industry grew an average of 11.4 percent a year; in contrast, commercial bank loans grew 8.4 percent a year. Yet finance companies enjoyed equity returns well above those of commercial banks (Chart 2). The banks' poor returns reflected excess lending capacity, specifically their having more resources in the short run than they needed to meet the demand for credit in their traditional markets.² We argue below that finance companies faced no such problem: the strong demand for credit in some of their traditional markets allowed them to utilize their resources fully.

Composition of credit growth

Finance companies set themselves apart from commercial banks by sustaining impressive growth in business credit through the second half of the decade. Initially, consumer and business credit contributed fairly evenly to the growth of finance companies, as they did to the growth of commercial banks. The major divergences in growth showed up mainly in the second half of the decade. For finance companies, consumer credit slowed and grew only 4.0 percent a year during this period, while business credit picked up the slack by growing 13.1 percent a year (Chart 3). Much of the business credit growth was in leasing, which grew 17.8

¹The classification scheme follows that used by the First National Bank of Chicago. The bank's annual review of finance companies appears in the *Journal of Commercial Bank Lending*.

²These resources included the services of loan officers and the credit relationships they had developed.

Table 1
The Twenty Largest Finance Companies
Assets in Million of Dollars, End-1990

Rank	Assets	Parent Relationship/ Type of Parent	Concentration of Business
1	105,103	Captive	Diversified
2	70,385	Nonfinancial firm	Diversified
3	58,969	Captive	Diversified
4	24,702	Captive	Diversified
5	16,898	Independent	Consumer
6	16,595	Nonfinancial firm	Diversified
7	15,373	Captive	Consumer
8	14,222	Captive	Consumer
9	11,665	Nonfinancial firm	Diversified
10	11,374	Bank holding company	Diversified
11	11,132	Captive	Diversified
12	10,336	Nonfinancial firm	Diversified
13	9,928	Bank holding company	Diversified
14	9,270	Independent	Consumer
15	8,501	Financial nonbank	Diversified
16	7,512	Bank holding company	Diversified
17	7,138	Financial nonbank	Consumer
18	5,933	Financial nonbank	Consumer
19	5,579	Captive	Consumer
20	5,084	Nonfinancial firm	Consumer

Sources: *American Banker*, December 11, 1991; First National Bank of Chicago; annual reports.

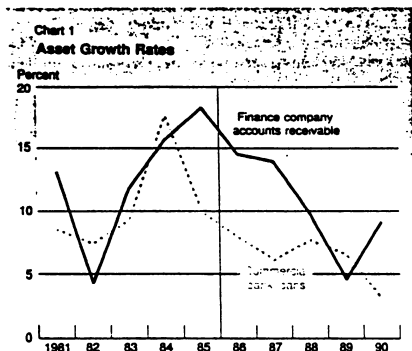
percent a year during the period. Banks and finance companies had opposite patterns of consumer and business credit growth: individual loans by banks still grew 5.1 percent a year, while their commercial and

industrial loans grew barely 2.8 percent a year.³ Thus, while finance company receivables altogether rose nearly 10.4 percent a year from 1985 to 1990, commercial bank loans increased only 6.3 percent a year.

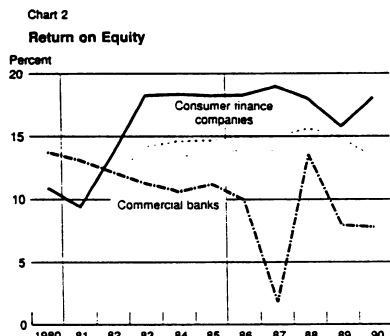
Liabilities growth

The growth of finance company assets was financed largely with funds from the burgeoning securities markets (Chart 4). Unable to issue deposits, finance companies raised funds largely in the commercial paper (CP) and corporate bond markets. At first, the CP market was the primary source of funds, with money market mutual funds allocating major portions of their portfolios to highly rated commercial paper. Finance companies became by far the largest issuers in the CP market. The outstanding amount of CP by finance companies grew an average of 12 percent a year from 1980 to 1990 and stood at \$153 billion by the end of the period. In the second half of the decade, total liabilities grew more slowly, but corporate bond issuance surged 14 percent a year and assumed considerable importance as a

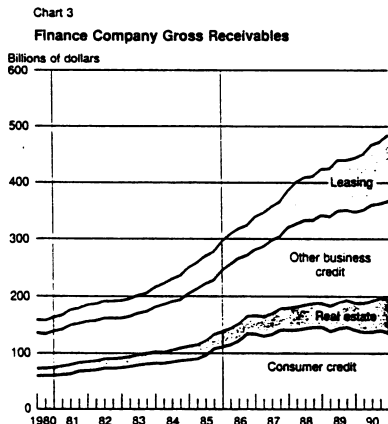
³Although real estate lending escalated throughout the decade for both commercial banks and finance companies, it grew from a small base and, in the case of finance companies, still represented only 12 percent of receivables at the end of 1990.



Source: Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin*.



Sources: Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin*; First National Bank of Chicago.



Source: Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin*.

source of funds. By 1990, long-term debt, at \$184 billion, had become the largest component of finance company liabilities. A significant part of this debt took the form of subordinated debt from parents.

Importance of credit ratings

The finance companies' reliance on securities markets for financing made credit ratings a key determinant of their growth. Table 2 reports credit ratings for large finance companies' senior debt and CP in 1985 and 1990. The table divides the companies into the fast growing (those that exceeded the industry growth average) and the slow growing, and ranks the individual companies by growth rates within each category. The table shows that fast-growing companies had generally better credit ratings than did the slow-growing companies.

A more systematic statistical analysis confirms the importance of credit ratings. Using data from 1985 to 1990, Table 3 reports econometric estimates of the effect of senior debt ratings on asset growth when the effects of capital ratios, parent relationships, and demand conditions are taken into account. Year dummies proxy for demand conditions. Credit standings are

represented by bond ratings because these are not as tightly clustered as the CP ratings.⁴ The regression shows that of the supply-side variables, only the finance company's own credit rating significantly explains asset growth.

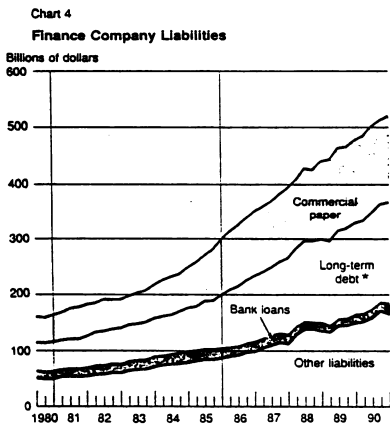
In the 1980s, a prime credit rating afforded easy access to low-cost funds from the securities markets.⁵ It was evidently the ticket to expanding in the business credit market, which required tighter lending margins than did the consumer credit market. Indeed, the diversified finance companies generally maintained higher credit ratings than did the consumer finance companies.

Importance of parents

A finance company's credit rating depends not so much on its own capitalization as on the existence of a parent and the perceived capital strength of that parent. Some of the strongest parents are commercial or industrial firms. Financial ties to such parents often help raise a finance company's credit ratings and thus lower its borrowing costs, a benefit of ownership that is not institutionally available to commercial banks.

Chart 5 plots credit ratings against stand-alone book capitalization for a number of large finance companies, distinguishing companies with well-rated parents from the others.⁶ The apparent negative relationship between credit ratings and capital ratios is striking. At the same time, the chart shows that the companies with strong parents had better credit ratings in spite of lower stand-alone ratios.

Econometric analysis confirms the central role of parents in finance companies' credit ratings. Table 4 presents estimates of the effect of capital ratios, asset size, parent relationships, and parents' senior debt ratings on a company's senior debt rating. When the parents' ratings are left out, asset size is the only significant variable. This finding may suggest that size leads to risk-reducing diversification or that size proxies for such unobservable factors as efficient management. For the companies with parents, however, the parent's credit rating is clearly the dominant factor explaining a subsidiary's rating.



Sources: Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin* and Flow of Funds data.

* *Federal Reserve Bulletin* data for long-term debt end in 1987. Data after 1987 are based on Flow of Funds data for corporate bonds.

⁴To estimate the regression, the bond ratings are assigned numerical values ranging from a value of 1 for AAA to a value of 10 for BBB-

⁵A good credit rating is important to finance companies not simply because it keeps the explicit cost of funds low but also because it eases access to the securities market for large debt issues. The average rate for A2/P2 paper from 1980 to 1990, for example, was only 31 basis points more than for A1/P1 paper. More important, money market mutual funds shunned paper that was less than prime. Under tight restrictions recently imposed by the Securities and Exchange Commission, this practice has become a rule.

⁶Capital is measured to include both equity and subordinated debt. Some studies include only equity when comparing the capital ratios of financial institutions. See, for example, U.S. Department of the Treasury, "Modernizing the Financial System: Recommendations for Safer, More Competitive Banks," February 1991, chap. 2, Table 1.

Table 2
Finance Company Credit Ratings and Growth

	1985 Credit Ratings		1990 Credit Ratings		1985-90 Growth Rate
	Senior Debt	Commercial Paper	Senior Debt	Commercial Paper	
Fast-growing companies					
Toyota Motor Credit	AAA	A-1+	AAA	A-1+	69.5
Transamerica Finance	A+	A-1	A+	A-1	31.0
General Electric Capital Corp.	AAA	A-1+	AAA	A-1+	25.6
Security Pacific Financial Services	N.A.	N.A.	N.A.	N.A.	19.9
American General Finance	A+	A-1+	A+	A-1+	18.7
Heller Financial	A+	A-1+	A+	A-1+	17.8
L.B.M. Credit	AAA	A-1+	AAA	A-1+	17.3
Associates Corp.	AA-	A-1+	AA-	A-1+	16.6
American Express Credit	AA	A-1+	AA	A-1+	16.2
Westinghouse Credit	A+	A-1	A	A-1	15.6
Ford Motor Credit	A	A-1	AA-	A-1+	13.5
ITT Financial Corp.	A+	A-1	A	A-1	13.2
Household Financial	AA-	A-1+	A+	A-1	13.2
Slow-growing companies					
Chrysler Financial	BBB	A-2	BBB-	A-3	9.3
Sears Roebuck Acceptance Corp.	AA-	A-1+	N.A.	A-1	9.2
CIT Group	AA	A-1+	A+	A-1	7.3
General Motors Acceptance Corp.	AA+	A-1+	AA-	A-1+	6.9
Commercial Credit	BBB+	A-2	A+	A-1+	2.4
Beneficial Corp	A	A-1	A	A-1	1.3
Avco Financial	A	A-1	A	A-1	-3.2

Source: Standard and Poor's Corporation, *Commercial Paper Guide*.

Table 3
Asset Growth of Finance Companies
(Dependent Variable is Growth Rate of Assets in a Year)

	Coefficient	
Constant	8.193	(0.767)
Capital ratio (lagged)	-0.001	(-1.014)
Senior debt rating (lagged)	-1.963	(-2.885**)
1986 Dummy	1.539	(0.266)
1987 Dummy	12.869	(2.202**)
1988 Dummy	10.390	(1.847*)
1989 Dummy	5.011	(0.893)
Dummy for captives	10.522	(1.091)
Dummy for noncaptives with parents	12.116	(1.307)
R-squared	0.144	
Adjusted R-squared	0.083	
Sample size	122	
F-statistic	2.372	

Note: T-statistics are in parentheses.

* Significant at the 10 percent level.

** Significant at the 5 percent level.

By assigning the credit ratings, the rating agencies in effect set capital adequacy guidelines for finance companies. In these guidelines, the agencies take impor-

tant account of the parents' strength and the financial ties between parents and subsidiaries. When the parent is rated higher than the finance company, rating agencies consider the capital support the parent has provided in the past and its capacity for future support. When the finance company is rated higher than the parent, rating agencies look for mechanisms that protect the subsidiary in the event of parent stress. These mechanisms may include attorney's letters and debt covenants limiting the capital a parent may take out of a subsidiary. On average, a subsidiary receives a somewhat higher rating than its parent because the financial ties are designed to enhance the finance company's rating rather than its parent's.

Niche markets of finance companies

Finance companies of all sizes focus their business strategy on "niches," market segments in which the companies claim special expertise.⁷ These niches tend

⁷One of the biggest companies, for example, states, "GE Financial Services has been built on the premise that highly focused, individually led, niche businesses enable us to penetrate specific markets quickly, efficiently, and profitably. Thus, the 22 businesses that make up GEFS are discrete organizations staffed by employees who are experts in their market" (GE Financial Services, 1990 *Annual Report*, p. 1). In our interviews with senior officials of several large finance companies, the importance of niche markets was repeatedly emphasized.

to be segments of the consumer credit market and the middle market for business credit. In the consumer credit market in the 1980s, banks and their affiliates gained market share at the expense of finance companies. In the middle market, banks kept their dominance in lending against accounts receivable, while finance companies held sway over the leasing markets.

The niche strategy meant that, for the most part, finance companies avoided head-to-head competition with banks; instead, the finance companies found their own special segments within markets, competing only by offering services that were imperfect substitutes for bank credit. Some finance companies may have found niches by lending to buyers of their parents' products, others by locating market segments barred to banks by regulatory restrictions.

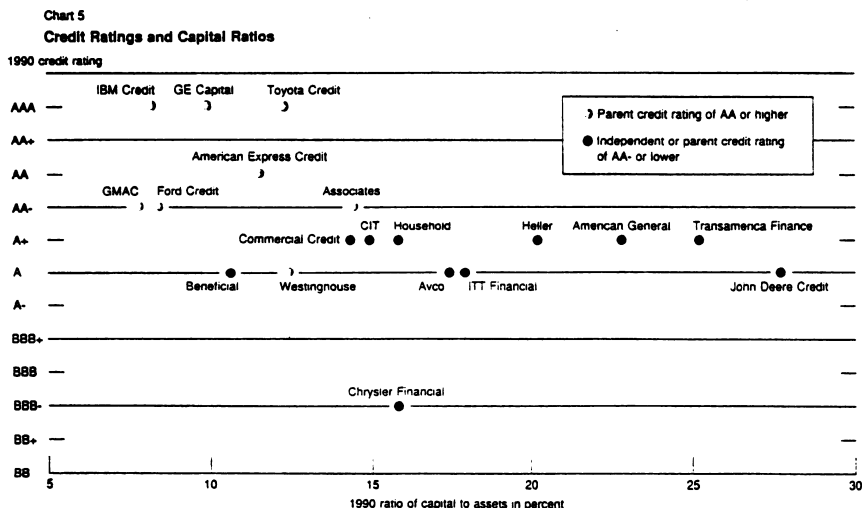
Dynamic economies of scale

In the credit market niches favored by finance companies, credit risks make specialized information critically

important. This special information is acquired through practical experience in the market segment—a form of learning-by-doing. Thus a new lender will face risks greater than those confronting lenders already established in the niche. Such dynamic economies of scale in information cause unit costs to decline with *cumulative* output, unlike static economies of scale, which cause unit costs to fall with *current* output levels. The unit cost curve of a financial service in a niche market is represented in Chart 6. The cost curve is intended to incorporate expected loan losses, operating expenses, and an assumed constant cost of funds. In providing credit services, the lender reduces its noninterest expenses as it learns more about the market, borrower characteristics, and ways to control credit risk.

Structure of income and expenses

The income and expenses of finance companies form a structure that appears consistent with an emphasis on niche markets. Table 5 compares the structure of income and expenses for large finance companies and



Sources: *American Banker*; Standard and Poor's Corporation.

Note: Capital includes equity and subordinated debt.

Table 4
Factors Affecting Credit Ratings of Finance Companies
(Dependent Variable is Rating of Senior Debt)

	All Companies	Companies with Parents
Constant	5.518 (4.550**)	1.723 (5.273**)
Capital ratio (lagged)	0.039 (1.704)	-0.012 (-1.051)
Asset size (lagged)	-0.493 (-3.964**)	-0.130 (-2.877**)
Dummy for captives	1.460 (1.141)	
Dummy for noncaptives with parents	-0.522 (-0.430)	
Rating of captive's parent		0.609 (18.490**)
Rating of noncaptive's parent		0.580 (14.484**)
R-squared	0.260	0.626
Adjusted R-squared	0.235	0.618
Sample size	125	92
F-statistic	10.517	103.258

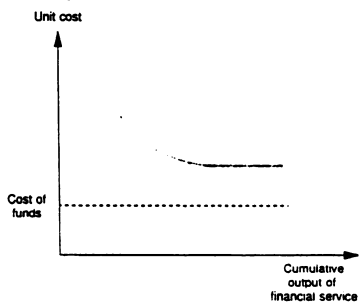
Note: T-statistics are in parentheses.

* Significant at the 10 percent level.

** Significant at the 5 percent level.

Chart 6

Unit Cost of Financial Service with Dynamic Economies of Scale



insured commercial banks.⁸ Average interest expenses are a smaller fraction of assets for banks than for finance

⁸The comparison should be treated with caution because it sets only nine large finance companies against all insured commercial banks. A similar comparison by Richard Mead and Kathleen O'Neil uses data for 1980-84. See "The Performance of Banks' Competitors," *Recent Trends in Commercial Bank Profitability, A Staff Study*, Federal Reserve Bank of New York, September 1986, pp. 269-366.

companies because banks can issue low-rate insured deposits. Nonetheless, finance companies earn higher spreads by charging their borrowers higher interest rates. Their higher lending rates reflect the greater risks in their niche markets as compared with the credit markets served by banks. In addition, dynamic economies of scale in information allow the finance companies to control their losses and keep their noninterest expenses nearly as low as banks'. As a result, finance companies are able to earn higher returns than banks earn.

Consumer installment credit

As consumer installment credit grew in the 1980s, finance companies lost market share to banks. In this market, banks may have found an edge in the ordinary economies of scale achieved through data processing technologies and may then have built on that edge in the course of the decade. By the second half of the decade, consumer installment credit extended by banks was growing 7.2 percent a year, while that extended by finance companies was growing 4.2 percent. The finance companies' share of the market fell from 34 percent to 28 percent (Chart 7).

In the auto loan market, the finance company captives of domestic auto manufacturers used subsidized incentives to increase their market share in the middle years of the decade, but subsequent declines in the

Table 5

Analysis of Income for Finance Companies and Banks, 1988-90 Average

Percent of Assets

	Finance Company Sample	All Insured Commercial Banks
Interest revenues	11.36	9.48
Interest expenses	7.21	5.99
Interest spread	4.15	3.49
Other revenues	2.12	1.57
Other expenses	4.54	4.18
Income before taxes and extraordinary items	1.72	0.88
Income taxes and extraordinary items	0.55	0.27
Net income	1.17	0.62

Sources: Annual reports for finance companies; "Recent Developments Affecting the Profitability and Practices of Commercial Banks," *Federal Reserve Bulletin*, July 1991, p. 507.

Note: The finance company sample comprises American Express Credit, Associates Corp., Chrysler Financial, CIT Group, Ford Motor Credit, General Motors Acceptance Corp., Household Finance, ITT Financial Corp., and Sears Roebuck Acceptance Corp.

sales of the parents allowed banks to get their share back quickly.

Secular trends are clearer in the nonauto consumer credit market. Whatever niche advantage finance companies may have had in personal cash loans was overwhelmed by the advantages banks realized from the development of credit-card technologies, including large-scale credit information services and servicing systems for huge numbers of small accounts.⁸ Banks' experience in servicing retail deposits may have given them a better appreciation of the new technology, so that they were quicker than finance companies to offer card-based revolving credit. The technology allowed the extension of credit to be linked to purchases of a wide range of goods and services, an arrangement customers evidently found more convenient than the traditional personal loans from finance companies.

Factoring

Factoring is the business of making loans against accounts receivable, the financing arrangement most widely used in the apparel and textile industries. In

practice, the factor purchases a client's accounts receivable without recourse, thus assuming all credit risks as well as collection and bookkeeping responsibilities.¹⁰ This arrangement differs from ordinary accounts receivable financing, in which the client merely pledges its accounts receivable as collateral for a loan.

Bank-related factors have long dominated the factoring industry. Table 6 shows factoring volume in 1985 and 1990 for the fifteen largest factors. Bank-related factors accounted for 94 percent of the total volume in both years. Although volume for the non-bank-related factors grew faster than volume for the bank-related factors, the banks maintained their dominance of the business. Note that a growth rate of 8.4 percent a year in bank-related factoring is impressive compared with the 2.8 percent growth in commercial and industrial lending by banks in the same period.

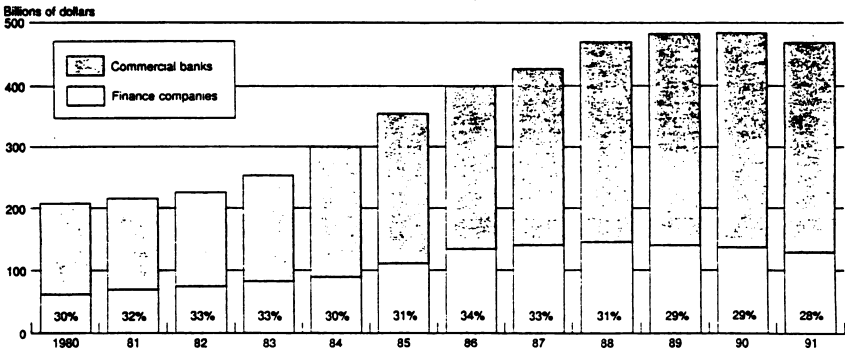
A probable reason for the banks' success in factoring is that the credit review process for the business is similar to that for other forms of revolving credit extended by banks. Factoring, unlike certain forms of lease financing, does not give the creditor clear posses-

⁸See Sangkyun Park, "The Credit Card Industry: Profitability and Efficiency," Federal Reserve Bank of New York, May 1992, unpublished paper.

¹⁰See Charles Rumble, "Factoring by Commercial Banks," *Journal of Commercial Bank Lending*, February 1969, pp. 2-5.

Chart 7

Consumer Installment Credit



Source: Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin*.

Note: Percentages appearing in the bars indicate finance company share of total consumer installment credit extended by banks and finance companies.

sion of an asset, but banks have found effective ways to secure their interest in the underlying collateral.

Lease financing

Finance companies found the leasing market to be much more hospitable territory than the consumer installment credit market. Finance companies started out with a market share twice that of banks and ended up with a share perhaps three times the share of banks (Chart 8).¹¹ Most of the banks' share took the form of nonoperating leases because until late in the period, Federal Reserve Regulation Y limited banks to leases that were economically equivalent to loans.¹² During the decade, finance company leasing receivables grew 18 percent a year. Most of the increase in absolute terms was in equipment leasing, although auto leasing receivables grew at a faster rate.

¹¹More precise comparisons are difficult because the data are gross receivables for finance companies and net receivables for banks. However, an adjustment for the difference between gross and net would not change the figures by more than 20 percent.

¹²Under Section 225.25 (b) 5 for permissible nonbanking activities, the leases must be structured to transfer ultimate ownership of the asset to the lessee or to expose the lessee to most of the asset risk. Regulation Y stipulated that the residual value of the leased asset not exceed 20 percent of the acquisition cost.

Table 6
Factoring Volume
Millions of Dollars

	1985	1990	Annualized Percentage Change
Bank-related factors			
CIT Group/Factoring	5,800	6,751	3.1
BNY Financial Co.	4,664	6,200	5.9
Citizens & Southern Commercial	4,449	5,800	5.4
Heller Financial	3,300	6,501	14.5
BancBoston Financial	2,967	3,444	3.0
Barclays/American Commercial	2,582	3,843	8.3
Congress-Talcott Factors	2,269	4,110	12.6
Republic Factors	1,750	4,200	19.1
Trust Co. Bank	1,543	2,906	13.5
Ambassador Factors	475	760	9.9
Midlantic Commercial	445	843	12.6
Standard Factors	143	151	1.1
Total	30,387	45,509	8.4
Non-bank-related factors			
Rosenthal & Rosenthal	730	1,160	9.7
Mitberg Factors	675	860	5.0
Century Business Credit Corp.	460	901	14.4
Total	1,865	2,921	9.4

Source: Daily News Record, February 13, 1991, p. 9.

Notes: Volume is the cumulative dollar value of accounts factored during the year. The volume numbers in 1985 are adjusted for subsequent mergers.

The strong demand for equipment leasing in the 1980s stemmed from tax incentives. The Economic Recovery Tax Act of 1981 provided for a faster write-off of capital expenditures under simplified and standardized rules. The leases offered by finance companies were a way to shift the tax benefits of accelerated depreciation to the companies that had the income to shelter. Banks, however, could offer only nonoperating leases and thus could not shelter their own income.

Later in the decade, the corporate leveraging trend probably added to the demand for equipment leasing. The banks themselves contributed to this demand by their participation in highly leveraged transactions. Debt-burdened firms strapped for cash could turn to sale leasebacks to raise funds at a lower cost than that demanded in other debt markets. Unless the sale of equipment was prohibited by existing loan covenants, the sale leaseback enabled a lessee to borrow more cheaply by effectively offering the lessor seniority with respect to the leased asset. The cheaper cost of borrowing would come at the expense of other creditors, who would lose their seniority with respect to the asset.

In the main equipment leasing niches of finance companies—commercial aircraft, construction equipment, machine tools, and medical equipment—dynamic economies of scale in information are indeed important. Information about the value of the equipment over its economic life is crucial for assessing contracts. Most of the gains and losses in the business turn on having the proper estimates of residual value. In the event of default on an operating lease, the lessor already owns the asset and can easily repossess it, but knowing how to manage a repossessed asset becomes essential.

Finance companies arrived in these niches well ahead of banks and over time accumulated valuable information and developed the expertise necessary to operate effectively in the market. The importance of such information and the difficulty of acquiring the requisite expertise quickly may have given finance companies their most effective defense against bank competition. The experience banks had in securing their interest in financial forms of collateral provided no advantage in a market where repossession was so easy; at the same time the banks were short of experience in the critical area of managing repossessed physical assets.

Economies of scope

A few finance companies may have had an informational advantage in the equipment leasing market because they were owned by the equipment manufacturers. If the residual value of a type of equipment depended critically on the development of new models, it would obviously help a lessor to know what was on the drawing boards. IBM Credit offers a prime example

of such economies of scope in its ties with its parent.¹³ These economies, however, appear to be less significant for other major leasing companies. GE Capital, for example, found it advantageous to acquire an existing aircraft leasing finance company, Polaris, even though its parent manufactured aircraft engines.

Breaking through the niche barrier
Bank strategies

Two basic strategies were available to commercial banks wishing to expand into the leasing niches of finance companies. First, banks could have hastened to develop their own expertise through rapid expansion in the niche markets. Second, banks could have purchased the necessary expertise by acquiring existing finance company operations. To succeed, either strategy would have required a cost-of-funds advantage to offset the costs of entry. The first strategy entails the costs of learning from experience, the second strategy the cost of a takeover premium. Moreover, even a signif-

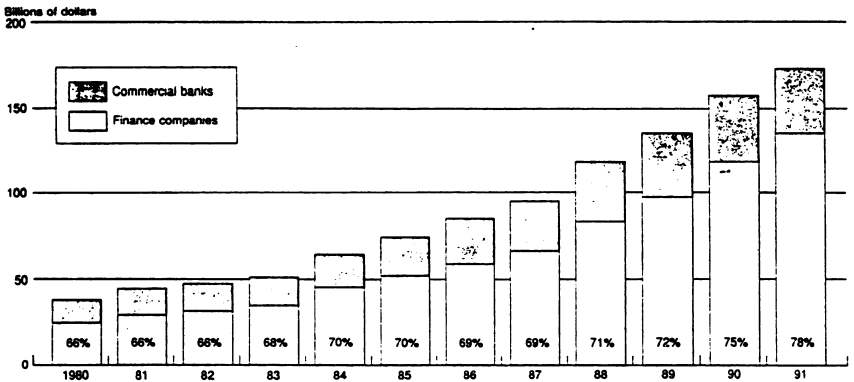
icant cost-of-funds advantage would not have ensured the banks' success. The restrictions imposed by Regulation Y and the difficulties of integrating two different operating cultures presented additional hurdles to entry into the leasing niches.

The strategy of rapid expansion

If banks had had a sufficient cost-of-funds advantage, they could have tried to catch up on the learning curves in the leasing markets by expanding rapidly on their own. Chart 9 depicts a lower cost of funds for banks by placing their dynamic cost curve below that for finance companies. Thus the banks may start at a unit cost of c_1 , which is higher than c_2 , the unit cost faced by finance companies. A sufficiently rapid expansion from q_1 to q_3 would bring the banks to a point on their curve that gave them the unit cost c_3 , which is now lower than the finance companies' c_2 . The higher returns the banks would then get would make up for the losses they incurred in pushing their way into the market. In a fast-growing market, this strategy would have a better chance of success if finance companies were already in the flat part of their learning curves, because the banks would not be chasing a moving

¹³The company's 1991 annual report states, "IBM Credit manages residual value risk by developing realistic projections of future values based on carefully monitoring IBM product plans, competitive announcements, and actual remarketing results" (p. 15).

Chart 8
Leasing Receivables



Source: Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin*.

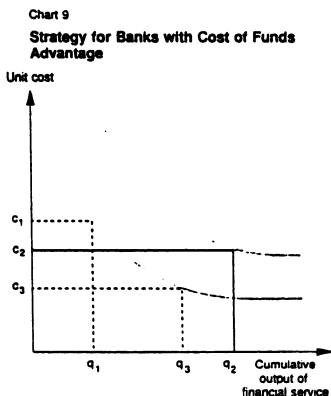
Notes: Because leasing data for commercial banks are reported on a net basis, the data are increased by 20 percent to approximate gross amounts. Percentages appearing in the bars indicate finance company share of total leasing activities by banks and finance companies.

cost target.

Banks do report much lower average interest expenses and operate on much narrower average capital ratios than do finance companies. These differentials, however, represent an intramarginal cost advantage for banks, arising partly from the banks' ability to issue low-rate insured deposits. The relevant cost for competing in new markets is the cost of funds *at the margin*, and here it is less obvious that banks have had a significant advantage.

Borrowing costs

The marginal cost of debt in the 1980s appears to have been very similar for finance companies and banks. Finance companies funded themselves at the margin largely by issuing CP and corporate bonds, while banks funded themselves by issuing large certificates of deposit (CDs). In the middle business credit market, the banks' main rivals would have been the prime CP issuers, many of which enjoyed the ratings support of industrial parents. For most of the decade, prime CP rates and bank CD rates moved virtually together (Chart 10). In addition to paying the CP interest rate, finance companies would have paid commitment fees for backup credit lines and placement fees. For their part, banks would have paid deposit insurance premiums and the cost of required reserves. These borrowing costs would not have given banks a cost-of-funds differential to offset any noninterest cost advantage finance companies may have had in their niche markets.

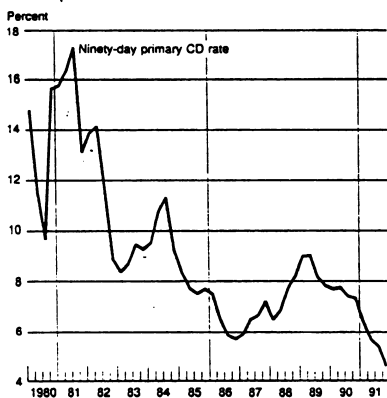


To illustrate, the average interest rate on prime CP from 1986 to 1990 was 7.23 percent. In addition, finance companies would pay perhaps 20 basis points in fees to banks providing the backup credit lines and 5 more basis points to place the paper, resulting in an all-in cost of 7.48 percent. For their part, commercial banks issued their large CDs at an average interest rate of 7.27 percent. In addition they would pay about 8 basis points for deposit insurance and 24 basis points for the cost of the 3 percent reserve requirement on large CDs (the requirement was reduced to zero at the end of 1990). Thus banks incurred an all-in cost of 7.58 percent. This calculation gives finance companies a 10 basis point advantage in borrowing costs; actual costs may have been slightly different, but they are not likely to have given banks a substantial advantage.

Capital and leverage

The cost of funds also depends on leverage and the cost of equity. The true amount of capital held by finance companies that are wholly owned subsidiaries is difficult to calculate because much of a subsidiary's capital tends to be in the form of an option on the parent's capital. Nonetheless, a superficial analysis of the finance companies' booked capital in the second

Chart 10
Rates for Commercial Paper and Bank Certificates of Deposit



Source: Data Resources International.

half of the 1980s suggests that the more successful finance companies did not necessarily suffer a disadvantage relative to banks in terms of leverage and the cost of capital. Although banks operated on narrower average capital ratios, finance companies were able to raise their leverage and thus operate at the margin on capital ratios not far from those of banks.

For most of the large finance companies, growth was accompanied by a decline in capital-to-asset ratios without corresponding downgrades in credit ratings. The fast-growing firms that sharply leveraged up were thus able to expand on relatively narrow marginal capital ratios (Table 7). Five firms—Toyota Motor Credit, IBM Credit, American Express Credit, Westinghouse Credit, and Ford Motor Credit—increased their leverage to the point of placing their capital ratios at or below the median for the group of fast-growing firms. Their marginal capital ratios from 1985 to 1990 ranged from 4.9 percent for IBM Credit to 11.6 percent for Toyota Motor Credit, and as a group their ratio was a mere 6.5 percent. Of the five, only Westinghouse Credit suffered a credit rating downgrade; indeed, Ford Motor Credit managed to obtain upgrades for its senior debt and

commercial paper. The largest fast-growing firm, GE Capital, did not expand by increasing its leverage, but it had a low capital ratio of 10 percent from the start and it maintained this ratio as it grew. Its size and asset quality apparently allowed it to keep the highest ratings for its debt.

Financial ties to industrial parents evidently allowed some of the finance companies to raise leverage without sacrificing their credit ratings. These companies, however, cannot increase their leverage indefinitely, and beyond a leverage limit, they will lose the concomitant benefit in marginal funding costs.

These marginal capital ratios were sufficiently close to those of banks to give finance companies with access to cheap equity financing a cost of funds about on par with that of banks, particularly at a time when these banks were facing loan quality and capital adequacy problems.¹⁴ Relatively cheap equity capital was often available to the subsidiaries of industrial firms because in the 1980s, U.S. industrial firms enjoyed higher price-earnings ratios than did commercial banks

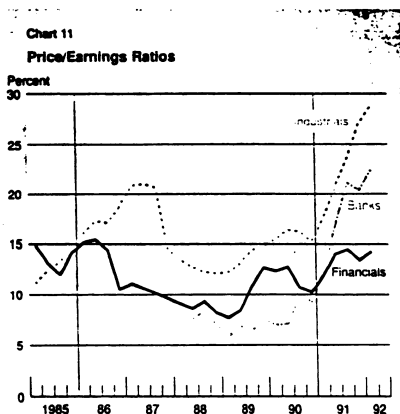
¹⁴In 1986, for example, the large U.S. banks started provisioning heavily for their less developed country (LDC) loans.

Table 7
Finance Company Leverage

	Capital/Asset Ratio (In Percent) 1985	Capital/Asset Ratio (In Percent) 1990	Change in capital/ Change in assets (In Percent) 1985-90
Fast-growing companies			
General Electric Capital Corp.	10.0	9.9	9.9
Ford Motor Credit	10.4	8.4	6.1
Household Financial Associates Corp.	15.1	15.8	16.7
American Express Credit	17.8	14.4	11.5
ITT Financial Corp.	15.1	11.5	8.3
I.B.M. Credit	20.3	17.9	15.4
Westinghouse Credit	12.2	8.2	4.9
Security Pacific Financial Service	18.1	12.4	7.1
Transamerica Finance	13.3	13.7	13.9
Heller Financial	26.6	25.2	24.9
American General Finance	22.5	20.2	18.3
Toyota Motor Credit	22.1	22.8	22.9
Median	23.3	12.3	11.6
	17.8	13.7	11.6
Slow-growing companies			
General Motors Acceptance Corp.	8.7	7.8	5.4
Chrysler Financial	17.7	15.8	12.4
Sears Roebuck Acceptance Corp.	22.2	18.7	12.6
CIT Group	13.7	14.9	3.2
Commercial Credit	14.5	14.3	11.9
Beneficial Corp.	12.6	10.6	-19.4
Avco Financial	19.5	17.4	30.0
John Deere Credit	22.0	27.7	50.9
Median	16.1	15.3	12.2

Source: *American Banker*.

Note: In each growth category, finance companies are ranked by size.



Source: Standard and Poor's Corporation.

(Chart 11). In particular, GE Capital, IBM Credit, and Toyota Motor Credit seem to have combined access to low-cost equity through industrial parents with relatively narrow marginal capital ratios to at least match the cost of capital for most large U.S. banks.¹⁵

Operating culture

Some bank holding companies would have had difficulty integrating a leasing operation's activities with the whole organization's credit review process. In making credit decisions, commercial banks rely on information about the borrower's financial condition, while finance companies offer a lease based simply on the value of the collateral and the equity stake of the lessee in the equipment. The banks' credit process seems to work effectively in the factoring market, where banks continue to dominate, but not so well in leasing, where a

¹⁵An example will clarify how the cost of funds is calculated for banks and finance companies. In the case of banks, a marginal capital ratio of 0.07, a cost of debt of 7.5 percent, and a cost of equity of 18 percent would give a weighted cost of funds of 8.24 percent. In the case of finance companies, a marginal capital ratio of 0.10, a cost of debt of 7.5 percent, and a cost of equity of 15 percent would give a cost of funds of 8.25 percent, virtually the same as that of banks.

Table 8

Twenty-Five Largest Acquisitions of Finance Company Assets, 1980-91

Target	Target's Main Activity	Acquiring Company	Date	Value (Millions of Dollars)
Associates Corp.	Consumer credit	Ford Motor Co.	10/89	3,350
Ford Motor Credit (real estate receivables)	Real estate	Associates Corp.	1/91	2,200
CIT Group	Factoring	Manufacturers Hanover Corp.	4/84	1,510
Macy	Credit cards	General Electric Capital Corp.	5/91	1,400
Barclays American/Financial	Consumer credit	Primerica Corp.	3/90	1,350
Meritor	Consumer credit	Ford Motor Co.	3/89	1,300
CIT Group	Factoring	Dai-ichi Kangyo Bank	12/89	1,280
Henley Group	Leasing	Itel Corp.	9/88	1,194
Chase Manhattan	Leasing	General Electric Capital Corp.	1991	1,024
Bank of New England	Communications lending	Canadian Imperial Bank	4/90	1,000
Itel Corp. (leasing receivables)	Leasing	General Electric Capital Corp.	1991	917
Bank of New England	Credit cards	Citicorp	2/90	828
Commercial Credit	Commercial finance	Security Pacific Corp.	6/85	800
Chase Manhattan Leasing Co.	Leasing	Associates Corp.	9/91	800
BWAC	Commercial finance	Transamerica Corp.	11/87	793
Manufacturers Hanover Consumer Services	Consumer finance	American General Corp.	5/88	685
Signal Capital Corp.	Equipment finance	Fleet/Norstar Financial Group	8/89	674
C. T. Bowring & Co.	Consumer credit	Marsh & McLennan Cos. Inc.	7/80	569
Shawmut (credit card receivables)	Credit card receivables	Norwest Corp.	1/91	568
Fidelicor Business Credit Corp.	Commercial finance	CIT Group	2/91	502
Lomas Bankers Corp.	Consumer credit	LBC Acquisition Corp.	8/89	500
PacificCorp Credit Inc.	Leasing and financing	AT&T	1/90	460
McCullagh Leasing Inc.	Leasing and commercial finance	General Electric Co.	2/90	450
Walter E. Heiler International	Factoring	Fuji Bank Ltd.	1/84	425
BankAmerica Corp. (Finance America subsidiary)	Consumer credit	Chrysler Corp.	11/85	405

Sources: Automatic Data Processing; annual reports.

physical asset is involved. Most banks have not been set up for the active management of physical assets. If a lessee defaults, a finance company lessor would typically be better prepared than a bank lessor to take the asset back and to find the use for it that best allowed recovery of the investment.

Regulation Y

Until the latter part of the 1980s, Federal Reserve Regulation Y would have made it difficult for banks to expand into operating leases. This regulation limited nonbank subsidiaries of bank holding companies to providing only nonoperating leases, a restriction that deprived banks of the tax advantage of operating leases. National banks were subject to restrictions imposed by the Office of the Comptroller of the Currency (OCC). During the latter half of the decade, the OCC restrictions were less stringent than those of Regulation Y. Bank holding companies, however, could apply to engage in operating leases. By 1989, Regulation Y had been sufficiently relaxed so that it no longer served as a binding constraint on banks' leasing activities.¹⁸ By then, however, new capital standards under the Basle Accord, problems with loan portfolios, and a cost of equity disadvantage placed large banks at a serious disadvantage in expanding into the leasing market.

The acquisition strategy

Efforts by banks and other firms in the 1980s to acquire existing finance company operations provide indirect evidence of the difficulties of penetrating the leasing niches of finance companies. The acquisition strategy, like the strategy of self expansion, faced hurdles of funding costs, operating cultures, and Regulation Y.

The decade saw a total of perhaps \$30 billion in deals that resulted in acquisitions of finance company assets. Of the twenty-five largest acquisitions since 1980, seven were of leasing operations (Table 8). Of these, only one—the acquisition in 1989 of Signal Capital's equipment leasing business by Fleet Norstar—was an acquisition of a leasing business by a bank holding company. Indeed two other acquisitions took the opposite direction: Chase Manhattan sold one leasing operation to GE Capital and another operation to Associates, two acquirors with industrial parents. The banks' large acquisitions were most often factoring and consumer businesses. Industrial firms tended to acquire leasing and other business credit operations.

Fleet Norstar's acquisition of a leasing business,

though unusual, suggests that this bank, at least, perceived itself as having a cost-of-funds advantage. In addition, Fleet Norstar may have escaped the difficulties posed by differences in operating culture because at the time of the acquisition, it already had a substantial leasing operation of its own. Finally, the takeover shows that by 1989 Regulation Y was not an absolute barrier to expansion in the equipment leasing market.

Conclusion

Many observers interpret the apparent success of large finance companies in competition with banks as evidence of the advantages enjoyed by unregulated financial intermediaries with ties to industrial parents. Any such advantages, however, would not readily explain why finance companies would outperform banks in some credit markets but not in others: in the 1980s, finance companies gained in the middle market for business credit, while banks gained on finance companies in the consumer credit market. This article suggests that this differential performance was driven largely by structural features of specific markets rather than institutional differences between banks and finance companies.

Finance companies saw their most impressive gains in their leasing niches, where their long involvement gave them important advantages in market information. Success in credit market segments that were among the fastest growing in the United States allowed finance companies to outstrip banks overall. While niche information was the source of the finance companies' advantage in leasing markets, large-scale data processing technologies provided banks with their own advantage in the consumer installment credit market.

Institutional factors of regulation and ownership do help explain why banks were so slow to take advantage of opportunities in the fast-growing leasing markets. In the 1980s, Regulation Y and an alien operating culture served to inhibit bank entry into these markets. These impediments, however, did not prevent some banks from penetrating these markets successfully. It appears that the critical barrier for most banks was their lack of a cost-of-funds advantage. In the 1980s, the importance of funding costs was heightened by the ability of potential finance company rivals to increase leverage and raise cheap capital, often by exploiting financial ties to industrial parents. At the same time, many large banks saw their own cost of capital rise because of loan quality problems and tightened capital adequacy standards. Had the banks maintained a stronger capital base, they would have been in a better position to compete in the niche markets of other financial intermediaries.

¹⁸In May 1992 the leasing restrictions of Regulation Y were made comparable with the OCC's rules.

STATEMENT OF MR. RONALD R. BIEBER

PRESIDENT, CALIFORNIA INDEPENDENT MORTGAGE BROKERS ASSOCIATION

Mr. Chairman, Members of the Committee on Banking, Housing, and Urban Affairs, I am Ronald R. Bieber, President of the California Independent Mortgage Brokers Association, most usually known as CIMBA.

I thank you, Mr. Chairman, for the opportunity to testify today on behalf of the Members of my Association concerning the "Home Ownership and Equity Protection Act of 1993" now under consideration by this body.

I have provided copies of my testimony to the Committee Staff and at the conclusion of the prepared testimony I will be happy to respond to your questions.

The California Independent Mortgage Brokers Association is a non-profit, professional society comprised of individuals and firms licensed as real estate brokers and engaging, primarily, in the specialty of arranging junior lien real property equity loans.

According to the California Department of Real Estate's Composite Report of Mortgage Loan/Trust Deed Annual Reports, we and our peers have performed this specialty at a success rate of 98.7 percent for the most recent year the Department has surveyed our industry, 1991. This report shows that of 129,081 loans arranged or made that only 1,699 resulted in foreclosure.

CIMBA believes this is an admirable record. Only 1.3 percent of the nearly 130,000 loans went to foreclosure. That is not to say we ever want to see any foreclosures because foreclosures are the bane of the mortgage brokers' business existence.

As an organization of professional, licensed real estate brokers we are convinced that this 98.7 percent success, ratio is the direct result of the professionalism of the California loan brokerage community and the extensive system of regulation, disclosure and reporting required of our industry and codified in our State's Real Estate Law and Department Regulations.

Our experience demonstrates where consumers are given detailed disclosure of the material facts of a transaction for which they have contacted one of our Members, the system of home equity loans in California works for the private citizen borrower and the private citizen lender.

I think I should explain here that in most all instances the home equity loans sought by borrowers of all economic conditions, races, religions or creeds are ultimately funded by other private California citizens seeking to supplement their incomes. It is the private lender who most usually receives the interest.

I am founder and President of Spartan Home Loans and Red Shield Servicing and Real Estate and Spartan Home Loans in Sacramento and can tell you from my own experience that a significant percentage of these private lenders are working people and middle class retirees.

These are real people who count on the income from their equity loan investments to maintain a decent standard of living. People like Neil and Maybelle Rosko. Neil is a retired operating engineer, a typical American blue collar skilled worker. Then there is Mabel Steele, a widow, and James W. Brewer a retired financial consultant who holds a Ph.D. in Economics. These are only a few examples of the hundreds of the Spartan Home Loan lenders for whom the interest on the trust deeds they have funded represents an important part of their income.

In this current economy these people would most likely be forced to take the three or four percent interest on a bank deposit while the bank would in turn lend that money and the money of other depositors on real estate loans returning the bank seven to nine percent and even greater returns on other types of loans.

By making real estate loans themselves, the California home equity private lenders receive those higher rates rather than settling for the three or four percent the banks will give them.

The Composite Report that I referred to earlier as evidence of our 98.7 percent success rate in arranging loans also discloses that sixteen billion dollars were infused into California's economy in 1991 through the loans surveyed in the Report.

Before proceeding to specifically address the provisions of the "Home Ownership and Equity Protection Act of 1993" let me make a few general points.

- The equity in real property, earned by and owned by an individual, is an asset and although not as liquid as a savings account it is an asset nonetheless.
- I believe all citizens should have the right to utilize their assets as they see fit as long as they respect the rights of others.
- Private lenders cannot be required to lend. They must be shown that lending their money will be beneficial to them and the return on their investment warrants the risks they take.

- Borrowers and lenders must be given detailed disclosure to insure they have received correct, material facts on which to make informed judgments.

The "Home Ownership and Equity Protection Act of 1993" calls for disclosure and CIMBA enthusiastically supports that objective. I hold here in my hand the package of documents Members of our Association are provided to use in processing a home equity junior lien loan.

There are 24 of these forms and CIMBA would respectfully invite the U.S. Senate Committee on Banking, Housing, and Urban Affairs to consider making these the disclosure documents for all home equity loans under provisions of the "Home Ownership and Equity Protection Act of 1993."

Our concerns with the non-disclosure provisions of the Act center on whether or not they assist or deter the primary goals of home equity loans as we know it and as practiced in our State.

Will the Act, if passed, facilitate and encourage the flow of funds from private lenders to private borrowers with equity in real property or will it inhibit and discourage the system so that two years from now the DRE will find only twelve billion or ten billion dollars were invested because the private lenders shied away from "high cost" transactions.

The answer, for my State is in the negative.

To understand the basis for my assessment one must know a little California history.

In 1979 the equity loan business was just that, a business puttering along at a growth rate about equal to the increase in population and then on November 6, 1979 the California electorate voted for the free market in real estate loans by abolishing the Constitutional usury limit on all loans made or arranged by a licensed real estate broker where real property was used as even partial security.

What had been a business exploded into an industry, an industry that infused SIXTEEN BILLION DOLLARS into our sagging 1991 economy.

Not only did the California voters endorse the free enterprise system in the real estate equity loan industry they have continued to support it with their dollars which is why what was slightly less than one billion in loans in 1979 became sixteen billion dollars in 1991.

Now, the "Home Ownership and Equity Protection Act of 1993," if passed, would subvert the will of the California electorates by creating an artificial "ceiling" through the establishment of the "ten percent over the Treasury instrument yield" that would trigger a mechanism assigning those loans the label of "high cost."

The instigation of unrealistic prohibitions in areas such as balloon payments and prepayment costs caused by the label "high cost" mortgages could make the junior equity loan unmarketable in California thus shutting out borrowers and eliminating a source of revenue for private lenders.

Senators, let us allow the public to do the labeling. If they determine a particular item is too dear they will avoid it and that product or service will be removed from the marketplace.

I am afraid if this provision and the others I will address next are enacted more and more investors would be dissuaded from using the conduit of home equity lending and thousands of potential borrowers would be denied access to the billions now available.

Many of those borrowers may be in danger of losing their homes as a result of a foreclosure action properly instigated by a senior lien holder.

That is why the next "trigger" mechanism that activates the "high cost" label when the potential borrower's debt payment exceeds 60 percent of his or her monthly income is so devastating.

Members of the Committee. *These* are exactly the people who most need the money from a real estate equity loan.

Consider, if you please, that these borrowers have an immediate and pressing need for the junior lien equity loan. Very few persons enter into such a transaction on a whim. They have reasons. You and I may not always agree the reason is sound but in far more cases we see that the emergency is real and the clear and present requirement for funds does exist.

Again, like the private lenders I spoke of, these are real people with real, critical problems that require real time action.

People like two who were helped out of what seemed to be an insoluble bind by one of CIMBA's Member Firms Aames Home Loan.

For instance, there is a 46 year old gentleman residing in West Hills, California who had been employed as a lab technician for 23 years only to be thrown into the ranks of the unemployed when the company went out of business. He could not qualify for a conventional loan due to lack of income but did have sufficient value

in his home to obtain an Aames home equity loan. The loan number was 2560589. Naturally, we are not going to use the names of these people here today.

Another example is the 60 year old receptionist with a poor credit rating and income below what the banks would use to qualify her. She received an Aames loan number 2560216. The funds were used to pay off a delinquent first mortgage thus preventing foreclosure as well as satisfying a second trust deed and also paying off IRS and California State tax bills, an automobile loan and educational expenses for her daughter.

There are hundreds of cases like this Senators.

It should be noted that brokers arrange loans for people from all strata of society not just those with low incomes.

The activator of the "high cost" label that establishes the "Eight Percent Fee Rule" strikes at the very hearth of the competitive structure of the real estate loan industry by attacking the compensation which allows brokers to remain viable and a service to their community. Since brokers do not generally earn the loan interest the brokerage fee is the broker's source of income.

To best appreciate the process it is necessary to know that the men and women who comprise the California Independent Mortgage Brokers Association and arrange, and sometimes fund, junior lien loans for their communities are not only in competition with each other and non-association brokers but with the large financial institutions as well.

While the financial institutions make such loans with depositors' funds most always insured by the U.S. government, the California mortgage broker has a more arduous task.

Both the financial institution and the broker advertise for borrowers with real property seeking loans but once the applicant finds either one or the other the process changes.

Almost always the financial institution is offering an interest rate miraculously similar, if not the same, as all other institutions are offering.

If the applicant fails to qualify under the institution's set of requirements they are denied the loan. It is perhaps the existence of these rigid requirements that for decades has created a situation in California's economically disadvantaged neighborhoods where the mortgage broker is the only source of financing because the "conventional" institutions have been, at best, reluctant to lend in these areas.

For the mortgage broker the application is only the beginning.

After analyzing the borrower's equity and gathering additional pertinent information, the broker packages the loan for presentation to a private lender. Remember, the broker is not using "deposited" funds but must match the borrower with an individual lender usually unknown at the time the loan application is made—for whom the transaction may be of interest.

Three important facts must be kept in mind when evaluating the service and its value to borrowers and lenders.

1. As stated earlier, private citizens cannot be made to lend. They must be shown that a particular investment is acceptable and the profit acquired through the interest to be paid is commensurate with the risk.

2. The broker does not get paid unless the transaction is consummated and many loan applications are not consummated.

3. The broker has a fiduciary relationship with both borrower and lender. Honoring these fiduciary duties creates not only professional obligations but added costs which must be figured into the broker's overhead.

Also, in the area of compensation, the prohibition in the "Home Ownership and Equity Protection Act of 1993" against brokers receiving a just fee for arranging a refinancing of a high cost mortgage they originally transacted will certainly work to consumers' disadvantage.

Most always the original broker would probably be able to arrange a refinance more economically than would a second broker unfamiliar with the loan but if the first broker is not to be compensated for his professional services the borrower will most certainly end up with the second broker and pay more.

Proceeding to Section Three, paragraph (d) of the Act which provides any assignee of the original creditor shall be subject to all claims and defenses the consumer could assert against the original creditor I can only say, Senators, that this would decimate the secondary market at a time when our economy needs stimulus not impediments.

Like the "Eight Percent Fee Rule," the elimination of balloon payments and the requirement that all "high cost" loans be fully amortized will work against exactly the persons who most need the financial assistance.

Earlier I pointed out that people frequently take equity home loans because of sudden financial difficulties. One thing they usually need is to have their monthly payments arranged to allow them to meet the emergency that led them to seek the loan in the first place.

Balloon payment loans, loans that are not fully amortized, allow the broker, at the borrower's request, to structure the monthly payments so as to provide immediate economic relief while giving the borrower time to overcome his or her financial difficulties.

Interest only provisions are almost always arranged for the same reasons as are prepaid payments that give the borrower in dire straits breathing room while they right their financial ship.

Elimination of prepayment charges would dampen the incentive for private lenders to make long term home equity loans.

Take an investor who decided to fund a junior lien loan for four years in June of 1991. The interest rate may have been 11 percent while the banks were offering eight percent on CDs.

If 18 months later the borrower paid off that loan the lender would be faced with the unpalatable choice of taking three or four percent from the bank in lieu of the 11 percent he'd planned for when he made the home equity loan in 1991 or scrambling to find another investment.

Make another junior lien loan? Perhaps, if one were available that suited that lender's needs and most probably at less than 11 percent. Add to this scenario the hypothetical that the Act had been passed and was in effect. Would the lender want to make a "high cost" mortgage in a down economy?

It only seems fair that a lender who judiciously plans for his financial future should be compensated if a borrower chooses to change the rules of their agreement in midstream.

Not only is it fair, it is a universally accepted concept and part of the finance industry's basic operational principles, it is, if you will, established within public policy that compensation where a prepayment occurs is a justified benefit.

While I am on hypothetical situations let me advance one which I think points to an aspect of the Act which would work against Americans purchasing homes in the first place.

Imagine two Southern Californians both employed by a defense firm in 1983. In 1986 one chooses to pursue the American Dream and purchases a home. The other continues to rent and save at a bank.

In May of 1991 both these persons are laid off. Two years have passed and neither has been able to find employment. The renter has \$50,000 in savings or investments he lives on. The home owner has exhausted his savings but has a \$75,000 equity in his property.

Sadly, the bank won't or can't loan him money to live on or save his home if it is in foreclosure. Why? Because he hasn't worked in two years and has no income. If his application for a home equity loan through one of our Members had to be labeled "high cost" might it not be difficult to find a lender? If he does, might not the lender demand higher interest because the Federal government has identified the investment as less than ideal?

By creating unrealistic barriers to home equity lending would we not be telling potential home buyers they had better re-consider tying up their funds in property because they might not be able to access theirs equity when they most need to in an emergency situation?

Members of the Committee, I have been in the real estate industry for more than three decades and in real estate financing for 25 years.

I have always believed that my profession provides a needed service to my community and my neighbors and I am proud to say that during all these years I have helped thousands of borrowers and lenders and performed my professional responsibilities in keeping with the law and the dictates of ethical business practice as has the vast majority of my fellow California brokers.

Reference has been made to "shady" representatives of the lending industry and certainly any profession that numbers millions nationally will have bad apples.

Some of the abuses cited by critics relate to unscrupulous "home improvement" businesses colluding with lenders to induce homeowners to contract to make questionable repairs and encumbering the victim's residence to pay for the work.

This is egregious and CIMBA would support any reasonable legislation to prevent these practices.

California's system of real estate equity lending works. There were more than 129,000 California property owners who availed themselves of the services of a mortgage loan broker in 1991.

Are we to dismantle or seriously impair a system that works for so many? I hope not and I hope that this Committee agrees and proceeds with the disclosure aspects of the "Home Ownership and Equity Protection Act of 1993" and cautiously studies its other provisions more closely before proceeding.

In conclusion, again, thank you for allowing me to speak here today on behalf of the Membership of my Association and the thousands of borrowers and lenders we represent.

If there are any questions I will be happy to answer them to the best of my ability.

STATEMENT OF ALFRED M. POLLARD

DIRECTOR, GOVERNMENT RELATIONS, SAVINGS & COMMUNITY BANKERS OF AMERICA

Dear Senator Riegle:

Savings & Community Bankers of America has had the opportunity to review the proposed Home Ownership and Equity Protection Act, S. 924. SCBA supports your initiative to protect consumers from losing their homes as a result of unscrupulous lenders luring them into home equity "ripoffs." SCBA is also mindful of the need to preserve the ability and incentives for legitimate lenders to make loans to a segment of the market that may not qualify for standard loans, and to this end, SCBA has both general and specific comments about this proposed legislation.

The proposal expands the approach of the Truth-In-Lending Act (TILA). Since its enactment twenty-five years ago, TILA has, with only extremely minor exceptions, been a disclosure bill. TILA reflected the view that consumers need information on which to base informed choices. The marketplace was to provide a range of choices by creditors. Although the proposed Home Ownership and Equity Protection Act includes some additional disclosure requirements, its major thrust is to limit the terms on which certain loans can be made. This is contrary to the rest of the TILA and opens the door to other product specifications by legislation. It is somewhat ironic that TILA already contains provisions designed to protect consumers from home equity ripoffs through disclosures and particularly by establishing the three day right of rescission.

This bill would impose additional paperwork requirements, which runs counter to the belief of many in Congress that excessive disclosure and recordkeeping requirements impede lending. Furthermore, while the bill only applies to "high cost mortgage" loans, because of the difficulty of determining at the time a loan is being made whether it will be included in this category, this bill could effectively require additional disclosures with respect to all home mortgages, except purchase money loans and open-end home equity loans.

SCBA suggests that the bill exempt loans made by insured depository institutions. Reported abuses have not generally involved insured institutions, which are already heavily regulated and examined regularly by federal agencies. Regulated institutions have no incentive to make loans that are designed to end in foreclosure. Foreclosure is expensive and time-consuming, and real estate acquired by foreclosure often has a negative impact on bank capital. Having to manage foreclosed property diverts the institution from extending credit, the business with which it is most familiar. Furthermore, adding more regulations would have a chilling effect on depository institutions' offering fixed term mortgage loans other than purchase money mortgages, with the heaviest impact on entrepreneurs who employ their homes as security for small business loans, and on minority or inner-city neighborhoods, where debt-to-income ratios are more likely to trigger the statutory provisions.

SCBA also suggests that refinancings be excluded. There is no evidence of abuse in this area, and refinancings have proven a boon to consumers, who benefit from smaller payments and an overall reduction in the cost of credit.

Specific Issues

Standards. Although the bill attempts to set standards so high that they will identify only loans perceived as "ripoffs," the standards for a high cost mortgage that would trigger the provisions of the bill might well pick up some legitimate loans. The debt-to-income ratio in particular could prevent loans being made at both ends of the income scale. High income borrowers could prudently have high debt-to-income ratios and maintain sufficient remaining income to support living expenses, as the latter do not necessarily rise proportionately to income. Low income borrowers might find limited credit availability if lenders have to discontinue programs they have established to meet CRA requirements that permit high debt to income ratios provided other safeguards exist.

In addition, the provisions establishing debt-to-income standards raise serious practical problems of how and by whom debt and income are defined. In measuring income, for example, different lenders have different approaches to seasonal workers, or to the self-employed. Debt measurement raises issues such as the treatment of contingent liabilities. Having a federal agency define these terms is exactly the kind of micro-management that financial institutions are now struggling to work away from, but without such definitions lenders may feel that they have unacceptable exposure to the onerous consequences of violations.

There may also be practical problems with the standard concerning interest rates and its applicability to adjustable rate instruments. The bill states that where the initial rate "may be different than the rate or rates that will apply during subsequent periods," the APR must be calculated "taking into account the subsequent rates." Although this provision purports to apply only to some ARMs, all ARMs are loans where subsequent rates may be different from the initial rate. Additionally, unless the loan is tied to the rate on Treasury securities, it may be impossible to calculate the extent to which subsequent rates will exceed the Treasury yield.

The provision permitting the Federal Reserve Board to set a different cap for the consumer's total monthly debt payments as a percentage of his monthly gross income, in addition to the practical problems noted with this measurement, is a mixed blessing. In general, some flexibility for the regulator is preferable to a rigid statutory standard, but it also admits the possibility that the regulator could set an even more rigid standard or that this could be interpreted to permit a lower trigger ratio, but not a higher one. Clarification is needed to establish whether this language permits a case-by-case determination, or whether the Federal Reserve Board would have to set standards across the board.

Disclosures. Aside from the problems with preparing and training staff to deal with yet another set of disclosures to be given at yet another time, the requirement that a disclosure three days in advance of closing include the APR effectively requires the lender to lock in the rate at that time. This may remove a benefit to the consumer of waiting until closing to lock in a rate.

Loan Terms. The prohibition of prepayment penalties, balloon payments, and negative amortization is contrary to prudent lending practices and fails to recognize the benefits these terms can have for the consumer. These are all parts of many legitimate loans and serve the borrower as well as the lender. Prepayment penalties allow the lender to recover its costs if the loan is paid off early; without this contract provision, lenders would have to cover this possibility by charging more for each loan, either as up-front fees or in higher interest or would have to decline to accept early repayments. Prepayment penalties limit this cost to those who actually cause the lender to incur these expenses, and can be taken into account by borrowers when they determine whether to pay a loan off early.

Balloon payments and negative amortization can also benefit borrowers. These terms can maximize the loan amount available to borrowers, and are especially suited to those who do not have a large downpayment but who expect to be able to refinance in a few years when the rising value of the property increases their equity. While increasing property value is not a driving force today, there may well be areas where this remains a reasonable expectation or where borrower circumstances would justify balloon payments or negative amortization, such as a borrower who offers his home for security but reasonably anticipates repayment from a future source, e.g. the sale of a business. Balloon payments and negative amortization are also essential elements of the reverse annuity mortgage that allows the elderly to borrow against their equity in the home to provide income. These loans permit older persons who need to tap their equity in their homes but do not want to sell to avoid the painful choice of selling the house to secure cash they need to live on or accepting a greatly reduced standard of living in order to keep the home.

The bill seeks to prevent a situation where the borrower cannot escape a loan, or cannot possibly make payments sufficient to retain a home. It might be preferable to couch this in terms of prohibiting unfair practices or loans that the lender knew or should have known could not be repaid, as determined by the Federal Reserve on a case-by-case basis. While this approach likewise has problems, it will affect fewer institutions and gives them some hope of being judged by a reasonable standard.

Civil Liability. Damages are set extraordinarily high, and the standards for setting damages are very rigid; they do not appear to include any exception for *de minimis* errors (e.g., a small error in the APR in required disclosure), and it is unclear whether any failures to identify correctly the loans to which the provisions apply would qualify as an unintentional violation or *bona fide* error. This is particularly troubling in light of the provision that assignees are liable for violations of the

assignor, when the assignee may not be able to ascertain that the loan was a high cost mortgage subject to these provisions.

Effective Date. The amount of time provided for the implementing regulations is insufficient. Six months is an unworkably short time for promulgating a regulation on such a substantive topic, even when it does not include the normal delay of effective date. Initial drafting, clearing and publication take at least two months. Sixty days is the minimum for a fair public comment period, and then analysis of the comments, final drafting, adoption and publication require a minimum of an additional sixty days. Nine months to a year is a more appropriate time frame for a rule-making of this type.

SCBA appreciates the opportunity to share our views of this legislation. Please do not hesitate to call me if you should want further information.

HOUSEHOLD
INTERNATIONAL

STATEMENT
OF BUSINESS
PRINCIPLES

DEAR FELLOW EMPLOYEE:

HOUSEHOLD INTERNATIONAL'S MOST VALUABLE ASSETS ARE ITS PEOPLE AND THE PRINCIPLES FOR WHICH THEY AND THE CORPORATION STAND. THE CHARACTER OF OUR EMPLOYEES, PAST AND PRESENT, TOGETHER WITH THE CORPORATION'S PHILOSOPHIES, HAVE EARNED THE CORPORATION THE HIGHEST OF REPUTATIONS SINCE HOUSEHOLD'S FOUNDING MORE THAN 100 YEARS AGO.

IT IS THIS REPUTATION FOR INTEGRITY THAT IS THE BASIS FOR ALL OUR BUSINESS ENDEAVORS; IT IS THE RESULT OF CONTINUED DEDICATION AND COMMITMENT TO THE HIGHEST ETHICAL STANDARDS IN OUR RELATIONSHIPS WITH EACH OTHER, WITH INDIVIDUALS OUTSIDE THE CORPORATION AND WITH OTHER ORGANIZATIONS.

AS A CORPORATION SENSITIVE TO THE HUMAN AND SOCIAL IMPACT OF OUR OPERATIONS, AND BY RESOLUTION OF HOUSEHOLD'S BOARD OF DIRECTORS, "IT IS THE POLICY OF HOUSEHOLD INTERNATIONAL TO CONDUCT THE BUSINESS OF THE CORPORATION IN FULL COMPLIANCE WITH THE LAWS AND REGULATIONS OF EVERY COMMUNITY IN WHICH IT OPERATES AND TO ADHERE TO THE HIGHEST ETHICAL STANDARDS. TO THESE ENDS, THE OFFICERS, EMPLOYEES AND AGENTS OF THE CORPORATION AND SUBSIDIARY COMPANIES ARE EXPECTED AND DIRECTED TO MANAGE THE BUSINESS OF THE CORPORATION WITH COMPLETE HONESTY, CANDOR AND INTEGRITY."

AS YOU WORK FOR HOUSEHOLD INTERNATIONAL OR A SUBSIDIARY COMPANY, WE ENTRUST OUR REPUTATION WITH YOU. OUR REPUTATION WAS BUILT BY PEOPLE, AND SO IT MUST BE MAINTAINED.

I REQUEST THAT YOU CAREFULLY READ AND FOLLOW OUR STATEMENT OF BUSINESS PRINCIPLES. ITS PURPOSE IS TO PRESERVE HOUSEHOLD'S GREATEST ASSET FOR ALL OF US.

SINCERELY,



DONALD C. CLARK
CHAIRMAN OF THE BOARD AND
CHIEF EXECUTIVE OFFICER

THE FUNDAMENTAL PRINCIPLE

In all its endeavors, it is the policy of Household International to act honestly and fairly at all times. It is the Corporation's policy to comply with all applicable laws and regulations in all that it does. Each Household International employee is expected to do the same.

In dealing with employees, customers and suppliers, the Corporation makes decisions without regard to race, color, religion, national origin, sex, age or handicap which can be reasonably accommodated.

With regard to employees, the Corporation is committed to affirmative action and equal opportunity. Supervisory personnel are reminded to hire, assess and reward employees strictly on the merit of qualifications and job performance. Because the Corporation respects each employee's private life, social conscience and personal beliefs, supervisory

personnel may not ask employees to perform personal tasks nor attempt to coerce employees into supporting any particular public issue, social cause or political candidate. An employee's decision whether to support such issues, causes or candidates is entirely voluntary and will have no effect on his or her employment relationship with the Corporation.

In dealing with customers, Household is dedicated to offering top quality products and services and to supplying only honest information about them. Household will offer its products and services on a competitive basis and will not tolerate the use or attempted use of improper incentives to obtain business. With regard to suppliers, the selection of products and services by employees with purchasing duties for the Corporation is based solely on quality, price and service.

COMPLIANCE WITH LAW

The Corporation is committed to conducting all of its affairs in accordance with the highest legal and ethical standards. This commitment requires adhering to the spirit, as well as the letter, of the law. At a minimum, each of the Corporation's employees is required to comply with all laws and regulations which apply to his or her

activity on behalf of the Corporation. It is each employee's responsibility to know the laws and regulations likely to apply to his or her conduct. Whenever any question exists about legal requirements or prohibitions, advice shall be sought from the General Counsel of the employee's subsidiary or the General Counsel of Household International.

CORPORATE SOCIAL RESPONSIBILITY

Household International is committed to good corporate citizenship through active involvement in the communities in which it operates. The Corporation invests in the work of nonprofit organizations that advance its philanthropic objectives. We encourage and support programs which promote growth, economic development and self-sufficiency. We constantly strive to

apply both our human and financial resources where they can serve as a catalyst for progress. Household considers itself in partnership with its employees, customers, shareholders and the communities in which it operates, working to foster an environment that enhances the quality of life through educational, health and human service, cultural, civic and community development programs.

CONFLICT OF INTEREST

For the Corporation to thrive, it must have the loyalty of each of its employees; employees must be free of conflicting interests in the performance of their duties for Household. Conflict of interest occurs in situations that might influence an employee's judgement as to what is in the best interest of the Corporation. As a general guideline, employees should avoid, or disclose for the Corporation's approval, any situation that could cast doubt on their ability to act with total objectivity. Such areas of concern include gifts and entertainment from any individual or firm having or seeking to have a business relationship with the Corporation, or from those seeking to gain information about the Corporation. Employees may never solicit a gift. Employees may accept only limited, occasional and casual entertainment or insignificant gifts or favors of nominal value, meaning gifts or favors of less than \$100. Gifts or favors of more than nominal value should be returned with an appropriate written explanation and the incident reported by the employee to the General Counsel of his or her subsidiary. Gifts of cash may never be accepted.

Other potential sources of conflict of interest include holding any outside employment position or conducting personal business which may interfere with the employee devoting full attention and loyalty to the Corporation during working hours; holding a direct or indirect financial interest in a competitor company or in any firm or entity with which the Corporation does business (excepting normal investments in publicly owned companies); holding a direct or indirect financial interest in any firm or entity which is a supplier of or vendor for the Corporation (excepting normal investments in publicly owned companies); holding or acquiring an interest in any property or business in which the Corporation has or proposes to acquire an interest; serving as a director or officer of any firm which is a competitor, customer or supplier of the Corporation; or conducting business on behalf of Household with an individual related by blood, marriage or adoption. To disclose such information for approval, an employee should submit a written statement to the General Counsel of his or her subsidiary or to the General Counsel of Household International.

CONFIDENTIALITY

Information learned while on the job is the exclusive property of the Corporation and should be carefully guarded. Confidential information includes, but is not limited to, non-public technical, business and financial information and plans about the Corporation, trade secrets and private information about customers, suppliers and employees. Confidential information must not be disclosed to unauthorized persons, including competitors and reporters, or to other employees whose duties do not require use of such information. Confidential information may not, under any circumstances, be sold or conveyed for a profit to unauthorized persons. While it is Household's policy to respond

to legitimate requests from news media about business operations, it must be done through authorized officers of the Corporation. Employees are to direct all media requests to the designated spokesperson for the subsidiary.

When it is necessary to disclose confidential information, employees are reminded to impress upon the recipient the importance and obligation of maintaining the confidentiality of the information. Additionally, employees may not use or permit others to use confidential information for any personal gain, such as trading or recommending trades in Household stock or securities of other companies on the basis of material "inside" information.

COMPETITION

Household believes in the free enterprise system and is dedicated to the maintenance of fair competition in an open market. Employees are to avoid any circumstances which will, or would appear to, violate antitrust laws. Employees shall refrain from discussing or entering into any arrangements or understandings with competitors concerning prices, production limits, allocation of customers, products or territories, boycotting certain customers or suppliers or in any way engaging in other anti-competitive practices. Normal business activities occasionally require contacts with competitors, but on such occasions discussion of any of the above mentioned subjects must be avoided. Any violation of these conditions should be reported immediately to the General Counsel of the employee's subsidiary or to the General Counsel of Household International.

Whenever any doubt exists as to the legality of a particular action, advice from the General Counsel of the employee's subsidiary or the General Counsel of Household International should be sought before engaging in this activity. In this same spirit, employees should refrain from making disparaging comments about the products or services of Household's competitors.

Employees are prohibited from making, offering or soliciting any payment which is in the nature of a bribe, kickback or other illegal payment to any Household customer, supplier or any other person. If any customer, supplier or any other person solicits or requests such a payment, that solicitation or request should be reported immediately to the General Counsel of the employee's subsidiary or to the General Counsel of Household International.

CORPORATION RECORDS

Household's accounting records and other essential data are to be maintained with accuracy and honesty in strict compliance with applicable laws, accounting principles and management's general authorization. When preparing such records, employees are not to make false or misleading entries in records nor permit to exist any fund or asset which is not fully and properly recorded on the Corporation's books. No transactions or payments shall be entered into, made or

recorded with the understanding that their use is other than the stated purpose.

Employees shall not make any false or misleading statements about such records or conceal information from management or the Corporation's auditors. Any omissions or inaccuracies in the Corporation's records should be reported immediately to the General Counsel of the employee's subsidiary or to the General Counsel of Household International.

 GOVERNMENT AND PUBLIC AFFAIRS

Household advocates the democratic system and is committed to upholding the political, legal and governmental processes of the local, state and federal systems of the United States and other countries where the Corporation operates. Further, Household recognizes that participation by citizens in civic and political activities is necessary for this system to function properly. The Corporation encourages employees to exercise their right to vote, to participate actively in the political process, to be informed on public issues and on the positions and qualifications of public officials and candidates for public office and to support issues, candidates and parties of their choice, as individual citizens.

Employees are prohibited from making or

offering any payment which is in the nature of a bribe, kickback or other illegal payment to any government official, political candidate or any other person. If any government official, political candidate or any other person solicits or requests such a payment, that solicitation or request should be reported immediately to the General Counsel of the employee's subsidiary or to the General Counsel of Household International. Only authorized officers of the Corporation are permitted to make political contributions on behalf of Household and only where permitted by law. Employees should not use the Corporation's name, either directly or indirectly, to endorse any public issue, political candidate, political party or business interest, product or service, unless otherwise authorized by the Corporation.

 INQUIRIES AND INTERPRETATIONS

The basic principles presented in this Statement are intended as general guidelines rather than rules and regulations for all situations. Should any question arise as to the interpretation of a particular principle or situation, the employee shall refer the question to either the General Counsel of the employee's subsidiary or to the General Counsel of Household International.

Inquiries and information reported under this policy will be kept in confidence except as may otherwise be required to protect the Corporation's interests. There shall be no reprisals for reporting information pursuant to this policy.

Any information concerning a violation of this Statement of Business Principles should be reported immediately to the General Counsel of the employee's subsidiary or to the General Counsel of Household International.

Violations of this policy and failures to report known violations will subject the employee to disciplinary procedures, including termination of employment. In addition, employees who should have, through the exercise of due diligence, discovered violations of this policy, but who failed to do so, may be subject to discipline, including termination of employment.



Understanding Money & Credit

Understanding Money & Credit.

Every day, across the United States, millions of families and individuals use credit to purchase products and services and to help manage their money. The ability to qualify for credit is essential, whether to buy goods and services or to be prepared for emergencies. However, getting and using credit wisely requires that you be familiar with a few basic terms and facts.

The decision to learn more about money and credit is a smart one. It will allow you to have many more options about how to deal with your financial affairs. Whether or not you decide to use credit will be entirely up to you.

Borrowing money or establishing credit may seem complicated, but **Understanding Money and Credit** will accurately introduce you to the basic principles of how credit works. In general terms, we cover what credit is, how to get it, how to use it, and how to keep it. If after reviewing these materials, you would like more detailed information or if you have a specific question about money or credit, you can call the HFC office nearest you. Someone there will be pleased to assist you.

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What Is Consumer Credit?

Credit is a way to purchase products or services now in exchange for agreeing to make regular payments in the future. In this brochure, we will be talking about "consumer credit," which is the type of credit families and individuals use for their personal needs (other types of credit are available for businesses, but we will not be talking about them here). Consumer credit is based on trust in the customer's ability and willingness to pay his or her bills when they are due.

It is very important to know that credit is not an increase in income. Everything purchased on credit must be paid for with present or future earnings. Using credit to obtain things you want but cannot afford to pay back is a misuse of credit and can lead to financial trouble.

How Does Credit Work?

When a store, a bank, or other kind of company extends you credit, they are, in effect, lending their money to you. In most cases, there is a charge for this service, and this charge, called "interest" or the "finance charge," is based on a percentage of what you owe. The amount you owe is commonly called "the balance."



Some types of stores and credit cards do not charge interest if the bill is paid in full within a certain period of time (usually 30 days).

Types Of Consumer Credit.

There are basically two types of consumer credit: Sales Credit and Cash Credit.

Sales Credit is credit you can get when you purchase merchandise or services. You can get it at stores, automobile dealers, repair services, contractors and other sellers of goods and services. Bank cards are also considered a form of Sales Credit since you present a credit card to obtain goods or services.

With Cash Credit, instead of receiving merchandise or services you receive cash. You may then spend the cash for a variety of purposes. You can obtain cash credit through certain credit card companies, lending agencies, and financial institutions. You could use the money to purchase goods and services, to meet emergencies, or to pay off accumulated debts. For example, if you needed money to pay for your child's college tuition, you could use cash credit.

With both Sales and Cash credit, there is often a time limit to pay off the purchase or loan, usually through monthly payments. In some cases there might be an initiation fee to open the credit account, and interest is usually charged on the balance.

Pros And Cons Of Using Credit.

Consumer credit is a powerful financial tool, but like any other tool, its effectiveness depends on the skill of the user. Before using credit, it is important to understand its advantages and disadvantages and to evaluate them in terms of **your own** financial situation.

Consider these **advantages**:

- **Credit allows the use of goods and services while paying for them.** Consumer credit makes it possible to purchase, use and enjoy goods and services as they are needed and to pay for them out of future income.

- **Credit provides an opportunity to raise one's standard of living.** You have a choice when considering your finances: wait until you save enough to pay cash for an item or service, or use credit. Saving for costly purchases, such as an automobile, home improvements or a college education may mean waiting for a long time. In these cases, credit can help you improve your style of life today, while paying over a period of time.

- **Credit can help you handle financial emergencies.** Consumer credit offers at least a temporary solution to unexpected financial difficulties due to unemployment, sickness, an accident or death. If you have limited cash or savings available, credit can help by sparing you the alternative of borrowing from friends and relatives or using all of your savings.

It is also important to remember there are **disadvantages** to using consumer credit:

- **Credit ties up future income.**

Purchases made on credit must be paid for out of future income. Before making a credit purchase, it is important to consider whether making a credit purchase or obtaining cash immediately is worth the extra cost - or whether it would be more prudent to wait until money can be saved.

- **Credit requires discipline.**

Sometimes, it seems too easy to buy today and pay tomorrow. As a result, you may overspend, overcommit income, and create serious financial problems for yourself. One basic fact to remember: Credit is only a **temporary substitute** for cash - it must be paid back! It is important to consider how much credit can be used without putting a strain on present and future income.

- **Credit may result in loss of merchandise, income or the ability to obtain additional credit in the future.** If payments for sales credit are not made on schedule, you run the risk of losing the merchandise. When credit requires collateral, such as a home or car, failure to make timely payments may result in the loss of income and valuable property in order to compensate for nonpayment. If you do not manage your credit carefully, you could end up with a bad credit rating, and it can be difficult to get back on the right track. Information detailing bad credit stays on your record for seven years.

Your Ability To Obtain Credit.

Measuring Credit Worthiness.

Your chances for obtaining credit depend largely on your credit worthiness, which is determined by three factors: character, capital and capacity.

- Character is determined by your integrity in money matters. It is based on your honesty, reliability, willingness to pay your bills on time, and your record of financial responsibility, which is documented on your credit report.
- Capital is defined as your financial resources, including equity in a home, household goods, an automobile, life insurance and a savings account.
- Capacity is judged by your earning power - present and future income - and your current financial obligations (the number of bills you have today).

Applying for Credit. Each time you apply for credit from a different source, you will be asked to complete an application and/or interview. A creditor may ask you questions, such as:

- Where do you work...for how long...what kind of job do you have... how much do you earn? By providing a work history, you are assuring the creditor that you have been employed steadily and that you are earning enough income to repay the amount you borrow.
- Where do you live...for how long...do you rent or own...where did you live previously? Like your employment history, a brief residence history will assure creditors that they can depend on you to make your payments. It also will help them determine how much credit you can afford.
- Do you have a checking account...a savings account? If so, where? Showing the creditor that you have a checking or savings account will indicate that you manage money in a businesslike manner.

- Do you have other charge accounts...debts...loans? If so, where? By providing a creditor with proof that you have other charge accounts or loans, you are demonstrating that others have already considered you to be credit-worthy. This information also helps give the creditor some idea of how much more credit you can afford.

All of the above information is used to determine whether you should receive credit, and, if so, how much. Consumer credit is based on the creditor's trust in your ability and willingness to meet payments. That trust is established primarily by your past performance and earning capacity.

Knowing Your Rights. The **Equal Credit Opportunity Act** makes it unlawful for creditors to deny credit on the basis of sex, marital status, religion, race, or national origin. You also cannot be turned down for credit (or charged higher rates for credit) on the basis of your age. A creditor also cannot ignore retirement income in rating an application, cannot require you to reapply, change the terms of your account or close it because you reach a certain age or retire. The Act also requires that you be notified within 30 days of applying whether your application was accepted or rejected. If you do not understand why your application was denied, discuss the reasons given with the creditor. If you feel you've been discriminated against, the state or federal agency you should contact depends on where you applied for credit. **The creditor must furnish the name and address of the appropriate agency.**

Credit History.

Establishing a Credit History.

Having "good credit" means that you have had credit before and have shown that you pay bills when they are due. Following are several "first steps" that a person who has had no experience with credit can take to show that they are able and willing to pay for credit. HFC is ready to help you get started. Just stop by any one of our branch offices, and we will help you with your financial needs.

Open a checking or savings account.

Generally, credit applications will ask you to provide information about your checking or savings accounts. To most lending institutions, the fact that you have a checking or savings account means that you understand how money works and that you can handle money in a responsible way.

Open a retail charge account. This kind of credit is the easiest to obtain. Many retail stores offer their own charge accounts or credit cards. Use your charge card to make small purchases that you would have otherwise bought with cash and pay your bill promptly to establish good credit.

Apply for a bank card, for example, Visa or Mastercard. These all-purpose

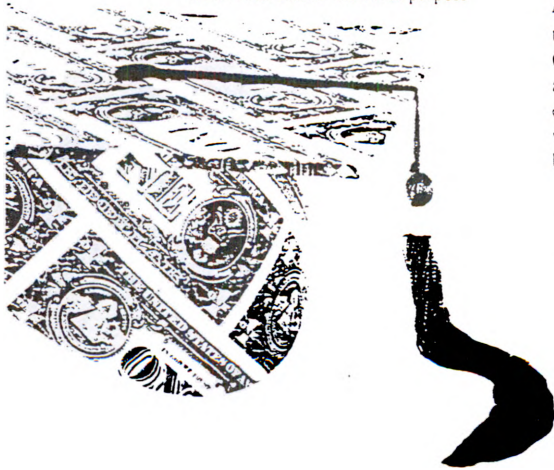
credit cards are honored nationwide and all around the world. When you get a bank card, you are given a limit on the amount you can charge, which may increase as your income and your credit history improve.

Take out a small loan. If you follow the steps above, you may be eligible for a small loan from a financial institution. By obtaining a small loan and making timely payments, you establish yourself as a good credit risk. It is always better to start small because that will give you some practice with handling money. Once you feel comfortable with credit and have shown that you make payments on time, you can then take out bigger loans.

However, you should avoid applying for credit from several sources within a short period of time. Each of these credit "inquiries" is logged in your credit history, and a number of inquiries could indicate to lenders that the borrower does not intend to use credit in a responsible manner. This could actually decrease your chances of being granted credit.

Maintaining a Good Credit History. It is impossible to underestimate the importance of a good credit history. Once you slip from a "good" credit rating to a "bad" one, it takes a good deal of time and effort to prove to creditors that you are worthy of their financial trust again. To build and maintain a good credit history:

- be truthful when applying for credit.
- use credit only in amounts that you can comfortably repay.
- fulfill all terms of a credit agreement.
- pay promptly.
- consult creditors immediately if you cannot meet payments as agreed.



Credit Bureaus.

What They Are and What They Do. Most lenders and retailers depend on credit bureaus to verify the information on a credit application.

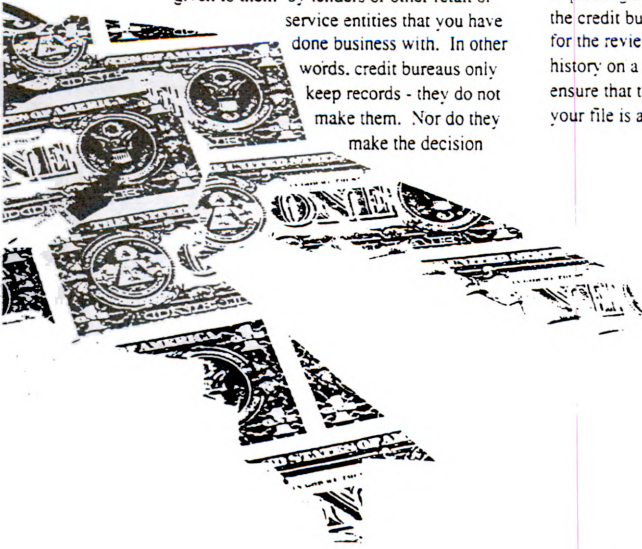
Credit bureaus keep track of consumer credit information that is provided to them by a variety of sources, primarily lenders. The records they maintain commonly concern basic identifying information, such as your name, address, Social Security number, employer, income and a listing of your payment record. Most also include information concerning any legal action taken against you which affects your ability to meet financial obligations. All of this information makes up your *credit history*, and that information, when distributed, is referred to as a *credit report*.

It is important to remember that credit bureaus only process and record information given to them by lenders or other retail or service entities that you have done business with. In other words, credit bureaus only keep records - they do not make them. Nor do they make the decision

whether or not credit will be granted to you. Credit bureaus simply report information to credit grantors. The credit grantor will then give you a credit rating by applying certain criteria to your credit history shown on your credit application and the bureau report.

Accessing Your Credit Bureau Report. If you are refused credit or the charge for credit is increased because of information obtained from a credit bureau, the credit grantor must give you the name and address of the credit bureau that produced the report.

If you are denied credit because of information from a credit bureau report, you have 30 days to visit or write to the bureau and, free of charge, review your credit history with a trained consumer interviewer. If you have not been denied credit or you have waited more than thirty days before requesting a review of your credit history, the credit bureau may charge you a small fee for the review. Reviewing your credit history on a regular basis is a smart idea to ensure that the information contained in your file is accurate.



How To Handle Financial Difficulties.

Financial situations change over time, and there may be instances when your expenses (or need for money) are temporarily higher than your income. For example, you might have a medical emergency, or your roof might need to be repaired. Unplanned expenses, over which you have little or no control, are a part of life. When these things happen, and they happen to everybody, you will either have to increase your income, reduce your expenses, or both.

If you encounter financial difficulties, it is imperative to talk to your creditors early and often. Most creditors, **if they know the facts surrounding your problem and are convinced of your good will and intent to pay**, are usually understanding and willing to help. They may postpone payments or refinance the debt to reduce the size of the monthly payments. But it is important to go to all your creditors before payments are overdue, or as soon as possible thereafter, to see what arrangements can be made for fulfilling obligations. The worst thing you can do when unable to meet payments on schedule is to avoid your creditors.

If obligations are too great to be handled by temporarily deferring or reducing payments, or if some creditors are unwilling to wait for payments, it may be advisable to find a lending agency who will arrange a

loan large enough to pay off all other bills and arrange one lower monthly payment extended over a longer period of time. This is called a *consolidation loan*. While this type of loan is designed to help you improve your financial situation, **it can only do so if you forego additional credit purchases and get spending in line with income.**

Counseling Services. Some families have financial problems due to unexpected situations and others because they buy on impulse. In either case, credit counseling offers a viable solution. These services are provided for a small fee by organizations like legal aid societies, welfare agencies, the clergy and some financial organizations.

Creditors, the Better Business Bureau, the Chamber of Commerce or the National Foundation for Consumer Credit can provide information on credit counseling services and tell you whether there is a nonprofit agency available in your area. Beware of "bogus" firms charging high fees who claim they can "fix" your credit report or record.

CONGRESS MORTGAGE COMPANY

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TELEPHONES

FAX (408) 996-3409

(408) 996-0444 or 1-800-772-7123

June 9, 1993

Senator Donald W. Riegle, Jr.
 Chairman
 United States Senate Committee on Banking,
 Housing, and Urban Affairs
 534 Dirksen
 Senate Office Building
 Washington DC 20510

Dear Senator Riegle:

I am in support of your bill proposing the "HOME OWNERSHIP
 AND EQUITY PROTECTION ACT OF 1993".

I am President and CEO of California based Congress Mortgage
 Co, a licensed Certified Public Accountant, a licensed California
 Real Estate Broker, a licensed California Consumer Finance
 Lender, a member of the California Independent Mortgage Brokers
 Association (CIMBA), a member of the Mortgage Institute of
 California, a member of the American Institute of Certified
 Public Accountants, and a member of the California Institute of
 Certified Public Accountants.

I am well aware of the need for additional legislation of
 our industry.

I have enclosed my testimony in support of your bill and ask
 that it be included in the record of the May 19, 1993 hearing.

Thank you for your consideration.

Respectfully,



Robert S. Gaddis, CPA
 President

Enclosure

✓cc: Matt Roberts

ROBERT S. GADDIS, CPA
PRESIDENT
CONGRESS MORTGAGE CO

TESTIMONY TO THE UNITED STATES SENATE COMMITTEE ON BANKING,
HOUSING, AND URBAN AFFAIRS

Mr. Chairman, Members of the Committee on Banking, Housing, and Urban Affairs, I am Robert S. Gaddis, CPA, President and CEO of Congress Mortgage, a lending institution doing business in the State of California for the past ten years.

I AM IN SUPPORT OF THE HOME OWNERSHIP AND EQUITY PROTECTION ACT OF 1993, now under consideration by your committee, and thank you for allowing my testimony.

DISCLOSURES

One of the benefits of this legislation is that it will bring other States up to the high level of California's existing loan disclosure practices. Most of the disclosure requirements included in this bill are already in effect in my State of California. This legislation will provide one new California disclosure as well, the requirement to disclose the disposable income after the new loan is completed. This additional disclosure will be beneficial.

BALLOON PAYMENT LOANS

The most important part of this bill is the section which addresses the problem of balloon payment loans. It gets right to the heart of the homeowners' problem caused by short term loans which have a large balloon payment due at the end. This bill will eliminate this type of troubled loan and I support this.

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This will have the effect of reducing the existing risk of borrowers facing a large balloon payment which they are unable to re-finance, which increases the possibility of losing their homes through foreclosures. Even if borrowers are able to find lenders willing to re-finance this type of loan, they are faced with again having to pay high points and fees, which further reduce their equity in their homes.

Especially in today's market, with home values, and therefore equity, actually decreasing for the homeowner, rather than increasing as in past years, the balloon payment type loan has become outdated and represents too high a risk for homeowner borrowers.

Many of the owners who come to Congress Mortgage seeking re-financing are already in foreclosure with a lender and have already been turned down by conventional lenders such as banks and savings and loans. The goal of Congress Mortgage is to help these homeowners save their homes from their present foreclosure by providing them with a non-balloon type of loan, usually 30 years, fully amortized, which will help them avoid future foreclosures. Many of these potential Congress Mortgage borrowers have fallen prey to the short term, high point, high interest type of loan that calls for a balloon payment. We often find that so much of the equity has been drained from these homeowners by previous short term loans, that we are unable to

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help them. They simply do not have enough equity left in their homes to support a new loan. Although our main requirement for making a loan is the assurance that the borrower will be able to repay the loan, since this is the only way we make our money, we must also look to the security for the loan which is the amount of equity the homeowner has.

The majority of California brokers do not offer loans that call for a balloon payment, and therefore will not be affected by this new legislation. The brokers who deal in this type of loan are far from the pride of the industry.

CAUTION

95+ percentage of borrowers who save their homes from foreclosure do so by means of High Risk Loans. Therefore, we have to be careful that Federal restrictions, while trying to save the few who are destined to lose their homes anyway, don't deny High Risk Loans to the majority who are saved by them. Making High Risk Loans too restrictive might push investors into not providing the funds necessary for these loans. Without this type of loan a homeowner faced with the loss of their job, a divorce or a death of the breadwinner, would most likely lose their home to a foreclosure, since they would not meet the qualifications for a conventional type of loan. The High Risk Loan should have additional restrictions, but should not be eliminated. This type of loan has a place in the industry, and

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is often the only resource a borrower has to save their home from foreclosure, when banks and savings and loans are unwilling to extend them additional credit.

Restrictions which directly affect the interest return and protection of the investors in the High Risk Loan market, such as the prepayment clause, should be approached with caution. It would be a mistake to create legislation that is so restrictive that this vital source of funding becomes unavailable. This would cause an increase in the number of homes lost to foreclosure since it would deny credit to those who are in need of a High Risk Loan to save their homes.

In conclusion, I support the disclosure requirements and the proposed restrictions on short term balloon payment loans. This will protect homeowners from putting their homes at risk by having to resort to an expensive, temporary solution, which will only serve to stall, rather than cure their foreclosure problems. However, don't be too restrictive or you will cause more foreclosures than you are trying to prevent.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR BOND
FROM LAWRENCE B. LINDSEY**

Q.1. Mr. Lindsey, do you believe that this legislation provides for too many additional disclosures? A sufficient amount? Because, as I mentioned earlier, I believe we must be careful not to require so many disclosures that the borrower is so overwhelmed, he or she doesn't bother to look at any of them.

A.1. I don't believe S. 924 generally provides for too many additional disclosures, though the disclosures about loans with variable rates duplicate somewhat information currently required to be given to consumers at the time of application. S. 924 does introduce an additional layer of Truth-in-Lending Act (TILA) disclosures that must be given three days prior to consummation (before a consumer becomes obligated) on an extension of credit. The standard TILA disclosures must be given prior to consummation. We understand that one purpose of this new disclosure scheme three days prior to consummation is to minimize the effectiveness of lenders and other persons trying to get consumers to commit quickly to high cost home-secured financing agreements.

Despite this effort to ensure that consumers have a better understanding of the terms of high cost mortgage loans or that they not enter into them at all, it is not clear that more disclosure will be very effective in addressing the concerns about such loans. Consumers already receive a substantial amount of disclosure information about the terms and costs of a loan. In addition, under current law consumers obtaining home secured credit generally have a three day period after becoming obligated to review the contract documents and TILA disclosures, and decide whether to cancel the transaction. Yet it appears that consumers with high cost loans are not taking advantage of this rescission right.

Different constituents are targeted for high cost loans, among them consumers in dire financial straits, elderly homeowners, and home owners with low income and high home equity needing home repairs or credit for emergencies. While enhanced disclosure as provided in S. 924 or some other alternative (such as enhanced rescission rights on high cost loans) may be effective for some of the consumers being offered these loans, it is not clear that additional disclosure will have a significant enough impact to alleviate the problems associated with high cost loans, particularly where fraud and misrepresentation are involved in the process.

Q.2. Mr. Lindsey, you mention in your testimony that you want the legislation to have a "tight focus" to protect the availability of credit. One way to do that, you said, is to require that two of the three criteria of high cost mortgages be met. Do most of these high cost mortgages meet two of the three criteria? Do you think that would be too narrow—that we would be providing too large a loophole for these lenders?

A.2. I have concern that the conditions defining a high cost mortgage loan in S. 924 are too broad and may cover transactions not intended to be covered. For example, a \$10,000 home-secured loan with closing costs exceeding \$800 would be considered a high cost mortgage subjecting a lender to additional disclosure requirements, substantive prohibitions, increased civil liability and, in the case of

a loan purchase, possible loss of holder in due course status. This could discourage legitimate lenders.

To ensure that the proposed legislation maintains a limited scope, not burdening legitimate lenders and targeting only those loans that clearly cause concern, we suggested requiring that two or more conditions be met before a loan is considered a high cost loan. While we have no specific data on high cost mortgage loans, it is our general understanding and belief that typically the points and fees on these loans are high, the interest rate is high, and little if any credit analysis is done, consequently, we believe that most of the loans you wish to target would be captured by a "two of three" test. Alternatively, we suggest narrowing each condition (and even exempting certain transactions such as government-sponsored loans) to keep the legislation tightly focused. Various recommendations for narrowing each of the three conditions have been offered in the staff analysis attached to the Board testimony on S. 924.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM LAWRENCE B. LINDSEY

Q.1. Predatory lending practices have a market in part because of the lack of traditional financial services in low income communities. Why do traditional lenders find it so hard to serve these communities?

A.1. Traditional lenders are obliged, under the Community Reinvestment Act (CRA), to serve the credit needs of their entire community, including low- and moderate-income areas, in a manner consistent with the safe and sound operation of the institution. We are doing all we can to encourage financial institutions to meet the credit needs of their entire community by offering their products and services to low- and moderate-income borrowers, consistent with a realistic expectation of repayment. Some progress has been made. Financial institutions that want to target borrowers who do not meet standard underwriting criteria have adopted more flexible criteria or offered special loan products, but they are not obliged to make subsidized loans or to extend credit to noncreditworthy individuals. Some individuals affected by high cost mortgages may not realistically be able to be served by most financial institutions, even under the standards of the Community Reinvestment Act. Therefore, another legislative solution might be necessary if Congress wants to ensure that this market is served by alternative sources of affordable credit. The administration has indicated that it will be recommending legislation to promote the availability of credit in very low-income areas. These ideas may help to address the problems faced by the more marginal credit applicants who suffer under the terms of high cost mortgages and who may not be able to be served by more traditional lenders.

Q.2. In attempting to combat reverse redlining in this legislation, we have sought to strike a careful balance, targeting the loans that have been particularly troublesome without restricting the flow of credit on fair terms. How effectively does this legislation meet these goals? To what extent will lenders withdraw from making

loans which are covered by this legislation rather than complying with the required disclosures and substantive prohibitions?

A.2. In addressing the issue of abusive practices in the “second” mortgage lending market it is important that any proposed legislative solution not burden the general credit market. With the modifications I have suggested, the proposed legislation could generally seem to meet its goal of targeting the loans associated with abusive lending practices, without unfairly restricting the flow of credit. We believe there is a need for some of the conditions defining a high cost mortgage in S. 924 to be more narrowly drafted and have offered some recommendations in the staff analysis attached to the Board testimony on S. 924. We cannot anticipate with certainty, of course, how lenders that would be subject to S. 924 will react to the substantive prohibitions and additional disclosures. Some may look to other markets. In reaction to the substantive prohibitions, some may reprice high cost loans as defined, possibly rising the interest rates. Some may stop making high cost loans or stop making loans generally. It’s very hard to predict with any certainty what could happen.

Q.3. The bill protects borrowers through enhanced disclosures, including a warning that they could lose their homes if they can’t make their payments. How effective are such disclosures? Will providing these streamlined disclosures on a separate document be more effective than usual?

A.3. S. 924 provides that a few highlighted disclosures be given three days prior to consummation to consumers entering into high cost loans as defined. Highlighting the disclosures in the manner provided in S. 924—in a conspicuous type size and on a separate piece of paper—may more easily draw the consumer’s attention to the disclosures. A statement about the risk of losing one’s home if the consumer fails to meet the loan obligations and the amount of money available to pay other monthly debts, as well as other information required to be disclosure by S. 924, may affect a consumer’s decision about entering into a high cost loan. Nevertheless, it is not clear that these disclosures will be more effective than what they now receive. Consumers currently receive a substantial amount of disclosure information about loans. More importantly, consumers generally have the right to cancel most home-secured loans up to three business days after becoming obligated for an extension of credit. But consumers entering into high cost loan agreements do not seem to be taking advantage of this protection. Perhaps the enhanced disclosures will cause a homeowner needing only a few thousand dollars for home repairs to reconsider entering into a high cost loan. On the other hand, a person obtaining credit for emergency purposes to avoid losing his house, for example, because of a tax lien, may not be affected by enhanced disclosures or the right to rescind. The substantive prohibitions of S. 924 against certain terms like balloon payments would seem a more effective protection for those consumers.

Q.4. The disclosures mandated by the Home Ownership and Equity Protection Act must be provided at least 3 days before settlement of a High Cost Mortgage. How might this cooling-off period benefit

consumers? Is there a danger this provision will hamper legitimate lenders?

A.4. To the extent that there is a concern about entities using high pressure tactics to solicit business from certain consumers and arrange immediate financing, the three day cooling off period prior to settlement, particularly when coupled with a three day cooling off period after settlement, would give consumers ample time to rethink whether they should go through with the transaction. Nevertheless, it is not certain that a large number of consumers being offered high cost loans will react to these disclosures. As previously mentioned, few of these consumers take advantage of the existing statutory right to rescind a transaction. And, of course, to the extent that fraud or misrepresentation are an element of the "second" mortgage lending process, neither additional disclosures or a cooling off period would likely have any impact.

The requirement to provide disclosures three days prior to consummation would not seem to substantially hamper legitimate lenders subject to S. 924 (provided the scope of S. 924 remains narrow). There would be ongoing costs associated with providing TILA disclosures three days prior to consummation (which ultimately may be passed on to consumers). Where feasible, lenders might lessen the compliance burden by giving the standard TILA disclosures at the same time, but in a different document.

Q.5. In addition to the new disclosures, the bill protects consumers who may not be adequately warned by disclosures by prohibiting "high cost mortgages" from containing certain provisions that have led to abuses in the past. Are the substantive prohibitions included in this bill appropriate? Would you suggest others that might be added or substituted?

A.5. Generally we favor Federal disclosure laws and not substantive law prohibitions to address consumer credit issues, because of our belief that credit markets work best when unencumbered and when consumers have the information needed to compare available credit terms. But in light of the current amount of TILA information available to consumers and the fact that consumers entering into high cost mortgages do not take advantage of the benefits of receiving this information (or of the Federal law rescission right), if Federal law is to provide protections to consumers entering into high cost loans against the abuses we are aware of, the substantive law prohibitions of S. 924 might be more effective.

Q.6. Previous testimony suggested that many abuses in home equity lending are perpetrated by small, fly-by-night loan originators who sell their loans in the secondary market. The originators are often nowhere to be found when the homeowners later seeks redress. Will the bill successfully enlist the secondary market in policing these loan originators?

A.6. It would appear that the potential loss of holder in due course status for the purchaser of a high cost loan as defined in S. 924 would certainly cause the purchaser to more closely scrutinize the paper being purchased. Alternatively, they may remove themselves from this market because of the risk. This latter result may dry up

a source of funds for some creditors originating high cost loans. For disreputable lenders, this would not necessarily be a bad result.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR BOND
FROM MARGOT SAUNDERS**

Q.1. . . . It appears to me that you seek to tighten the legislation in many ways. Has your organization examined whether your recommendations could have the unintended effect of shrinking the availability of credit for low- and moderate-income homeowners?

A.1. The availability of *some* credit to low-income borrowers will be reduced when strong Federal legislation goes into effect prohibiting certain overreaching practices. That is our intended effect. However, the type of loans which will be more difficult to obtain will be those which should not be made in the first place. Those loans which will *not* be available after enactment of a strong Federal Home Ownership and Equity Protection Act will include those (a) which require loan payments impossible for the borrower to make, or (b) which include loan provisions, high interest rates, onerous fees and loan padding, which make an otherwise affordable loan too expensive to be repaid. Unless the enactment of S. 924 changes the market of home equity lending, little will be accomplished. We cannot rely on private enforcement of the remedies available in S. 924 to protect homeowners; the overreaching lenders must change their practices out of fear of being caught in the net of S. 924. Only then will low-income homeowners be protected from the lending practices that S. 924 seeks to prohibit.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE
FROM MARGOT SAUNDERS**

Q.1. Predatory lending practices have a market in part because of the lack of traditional financial services in low-income communities. Why do traditional lenders find it so hard to serve these communities?

A.1. There are a number of reasons why traditional lenders have not adequately served low-income communities. These reasons include (a) a misunderstanding about the credit worthiness of low-income customers; (b) a misconception about the needs of the low-income community; (c) institutional history; (d) a desire to make larger loans than low-income people generally need; (e) racism; (f) an institutional requirement for higher profit margins than is possible on the smaller loans many low-income customers prefer; and (g) the exclusion of representatives from the low-income community from the boards and upper management of traditional lenders such that these communities' needs are simply not addressed unless an outside force requires that attention be focussed on the community.

Q.2. In attempting to combat reverse redlining in this legislation, we have sought to strike a careful balance, targeting the loans that have been particularly troublesome without restricting the flow of credit on fair terms. How effectively does this legislation meet these goals? To what extent will lenders withdraw from making loans which are covered by this legislation rather than complying with the required disclosures and substantive prohibitions?

A.2. The current draft of S. 924 is an excellent start at designing a means to address some of the worst abuses in the home equity lending market, but it does not go far enough. Without some changes, as recommended in the written testimony that we presented before the committee, (copy attached) only a fraction of the evils this legislation seeks to address would in fact be stopped. More specific discussion of the changes that we recommend to S. 924 are addressed in the answer to question #5 below.

With regard to the second part of the question in #2, whether lenders will withdraw from making loans which are covered by this legislation, rather than complying with the required disclosures and substantive prohibitions, we believe that there will be an appropriate reduction of loans (see answer to Senator Bond's question, above). However, legitimate lenders should not find the additional disclosure requirements burdensome, nor should their lending practices be impaired in any way by the prohibitions. Legitimate lenders rarely combine high interest rates with balloon payments or prepaid payments or negative amortizations, and so legitimate lenders should not be inconvenienced in any way by the bill. For example see the testimony by the representative of Household International to the committee on May 19.

More information on these points can be found in our response to Senator Bond's question above.

Q.3. The bill protects borrowers through enhanced disclosures, including a warning that they could lose their homes if they can't make their payments. How effective are such disclosures? Will providing these streamlined disclosures on a separate document be more effective than usual?

A.3. Possibly, but we do not believe that disclosures, even the potentially helpful ones required by S. 924 will do much to curb the abuses that the committee is attempting to address. The homeowners who receive the loans targeted by the committee are already bombarded with so many pieces of papers—75 percent of which are not required by any law but which are only provided to obfuscate and confuse—that more pieces of paper with more information on them is not likely to curb many abuses. However, to the extent that any disclosures will truly inform and warn homeowners of the dangers of a home equity loan, the timing and the content of the disclosures required by S. 924 are appropriate.

S. 924 will effectively deal with many of the abuses in the home equity market by *prohibiting* certain practices, such as are currently included in the bill, abetted with those additional prohibitions addressed in the answer to Question #5.

Q.4. The disclosures mandated by the Home Ownership and Equity Protection Act must be provided at least 3 days before settlement of a High Cost Mortgage. How might this cooling-off period benefit consumers? Is there a danger this provision will hamper legitimate lenders?

A.4. Regarding the first part of this question, please see the response to Question #3. Legitimate lenders will doubtfully be making high cost loans covered by the bill, such that the requirement for additional disclosures should not hamper them at all.

Q.5. In addition to the new disclosures, the bill protects consumers who may not be adequately warned by disclosures by prohibiting "high cost mortgages" from containing certain provisions that have led to abuses in the past. Are the substantive prohibitions in the bill appropriate? Would you suggest others that might be added or substituted?

A.5. The substantive prohibitions in the bill are appropriate and badly needed to address the abuses in the industry. Please see written testimony presented to the Committee on May 19 for a full explanation of why each substantive prohibition currently included is necessary and appropriate. In addition, in our testimony we detail some specific language that could be used to strengthen the prohibitions included in the bill.

While the prohibitions in S. 924 are appropriate, they are not sufficient to stop the evils the bills seeks to eliminate. Additional prohibitions are necessary, including the following:

A. Add a Prohibition Against Unfair, Deceptive or Evasive Acts. The lenders who have created the problems this committee is trying to remedy are exceptionally ingenious and resourceful when it comes to designing ways to avoid the limitations of consumer protection laws. Although the bill appropriately prohibits some of the worst abuses identified to date, *there is no doubt other methods of charging unreasonable amounts from unwary homeowners will be devised.* Moreover, a number of known abuses have not been targeted by the bill, for example:

(1) Entering into a home equity loan if there is no reasonable probability that the homeowner will be able to make payments according to the terms of the loan;

(2) Taking advantage of the borrower's infirmities, lack of education or sophistication, or language skills, necessary to understand fully the terms of the transaction;

(3) Charging unreasonable premiums for credit insurance, or charging premiums for unreasonable amounts or kinds of credit insurance, or failing to supply a contract of insurance at the time of closing;

(4) Refinancing other loans owed by the homeowner which had not been accelerated by reason of default of the homeowner prior to the application for the home equity loan, unless the new loan is at a lower interest rate or has lower monthly payments;

(5) Financing a mortgage broker's commission unless the borrower entered into a separate written contract with the broker prior to the date of application for the home equity loan;

(6) Taking action or interfering with any other consumer protection laws or regulation designed to protect the homeowner;

(7) Assisting in the falsification of information on the application for a home equity loan;

(8) Disbursing to a home improvement contractor more than 80 percent of funds due under a home improvement contract which exceeds \$10,000, before the completion of the work due under the home improvement contract. Loan disbursements for a home improvement contract shall not be made in a form other than an instrument jointly payable to the primary borrower and the contractor;

(9) Engaging in any other unfair, deceptive or unconscionable conduct which creates a likelihood of confusion or misunderstanding.

Further, the current bill leaves a number of loopholes through which an inventive lender may avoid the application of this Act altogether.¹ The best way to prohibit each and every evasive activity would be to identify each activity in the bill and prohibit them. A second best way would be as follows:

Adding the following language to the bill, as a new subsection (g) to Sec. 129 (page 7, line 3):

“(g) UNFAIR, DECEPTIVE OR EVASIVE ACTS PROHIBITED.— Creditors of contracts governed by this section shall not commit, in the making, servicing, or collecting of a home equity loan, any act or practice which is unfair or deceptive. An attempt to evade the provisions of this section by any devise, subterfuge, or pretense whatsoever shall be considered a unfair act under this section.”

B. Amend the Federal laws which prohibits States from setting interest rate caps and limitations on terms and conditions of loans for non-purchase money first mortgages. As mentioned above, Congress’ passage of the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA)² and the Alternative Mortgage Transaction Parity Act of 1982 (AMTPA)³ prohibited States from limiting interest rates and terms and conditions of first mortgage loans. The purpose of this deregulation was to stimulate the sale of homes by ensuring that *purchase money* first mortgage loans were not unduly restricted by State interest rates, and to strengthen a national market of home lenders.

These Federal preemptive laws went too far: not only did they remove limits on the interest rates charged for loans used to purchase homes, they also prohibited the imposition of interest rate ceilings on loans which were also secured by first mortgages and were *not* used to purchase the home—non-purchase money loans. Just as serious, the Federal deregulation set the stage for many States to remove rate caps and other limitations on lending including second mortgage lending. Whatever the overall merits of economic deregulation, it undeniably unleashed the greedy instincts of unscrupulous operators all over the country.

With the passage of DIDMCA and AMTPA Congress threw the baby out with the bathwater. Rate caps and other limitations on lending have been employed by regulators since biblical times. It has long been recognized that such protections are needed to guard the trusting, the unsophisticated, the unwary, and the necessitous consumer from the “oppression of usurers and monied men who are eager to take advantage of the distress of others.”⁴

¹One example of a comparatively simple method a lender could use to avoid this Act would be to make the loan look like a *purchase money loan*. The borrower need never know; the lender would simply need to add a couple of pieces of paper to the multitude that is already provided to the borrower to confuse: a deed for transfer of the home from the borrower to the lender, and then a deed for the purchase of the home by the borrower back from the lender.

²12 U.S.C. § 1735f-7a.

³12 U.S.C. § 3800, *et seq.*

⁴*Whitworth & Yancy v. Adams*, 5 Rand 333, 335, 26 Va. 333 (Va. 1827).

A Federal usury ceiling would be the best remedy to assure that the abuses identified by this committee do not continue. The 1970's problem of a mismatch between a statutory cap and the market rate could be easily resolved by the imposition of a statutory ceiling which can float with a specified market-related index.

Failing a Federal usury ceiling on non-purchase home loans, the next best step would be to allow States to impose State specific protections on these loans. To accomplish this end, we recommend that S. 924 be amended to allow States' to impose limits on the interest, fees and other terms of non-purchase money first mortgages. Such a change in Federal policy would have the additional benefits of re-establishing Congressional approval for interest rate protections when appropriate. *Specifically, the following addition to S. 924 would accomplish this:*

On page 6, line 16, making the following Sec. 3, and renumbering the remaining sections accordingly:

“Sec. 3. STATES' RIGHTS TO REGULATE HIGH RATE MORTGAGE LOANS.

“Notwithstanding the provisions of 12 U.S.C. § 1735f-7a, and 12 U.S.C. § 3800 *et seq.* the limitations imposed by the States on the interest, fees and other terms on first mortgages shall not be preempted for loans secured by first liens of residential real property which were not used for the purchase of the property.”

C. Eliminate Holder-in-Due Course Status for Assignees of Home Equity Loans. One of the difficulties borrowers face is the complete insulation afforded to assignees and other holders of their loans by the Holder-in-Due Course rule that exists in every State's Uniform Commercial Code. This rule works as a bar to the borrower's attempt to raise claims and defenses which exist against the original lender when the note is held by another party. Fraud claims, usury claims, unfair and deceptive trade practice claims, etc., can rarely be raised against the holder of the note, even if the cumulative effect of such claims and defenses would work as a complete defense to a foreclosure action.

The Federal Trade Commission has recognized the inequities in this rule, and has eliminated its effect for the purchase of consumer goods or services, in its Preservation of Consumer Claims and Defenses Rule.⁵ (There is thus no holder insulation for home improvement credit sales, while there is still such protections for straight mortgage loans.⁶) Congress also limited the holder rule somewhat for certain credit card purchases.⁷

No doubt lenders will vigorously argue that limiting the holder rule on home loans will dry up the credit market for legitimate home equity market. This argument holds no water. Although the credit industry vigorously opposed the FTC Rule, making hair-raising predictions about how the auto financing market would disappear. The auto financing market is stronger than ever, and its

⁵ 16 C.F.R. § 433.

⁶ However, lenders for home improvement credit sales generally do their best to avoid the application of the FTC rule by making their loans look like original loans. They are sometimes successful because they will extend additional credit to the borrower, over and above what is required to pay for the credit sale which engendered the home loan in the first place.

⁷ 15 U.S.C. § 1666i.

very health should prove that the only creditors the elimination of the holder rule would drive out of business are the crooked ones.

Elimination of the holder rule will force the industry to do more self-policing. If assignees of high cost mortgages will be clearly liable for the claims the borrowers have against the originators, the holders will more carefully screen those with whom they do business. That will dry up the financial lifeline that has enabled the predatory mortgage companies to operate.

Therefore, we recommend the following change in S. 924 on page 8, line 6, by rewriting that section to read:

“(d) HIGH COST MORTGAGES—Any assignee of the original creditor of a high cost mortgage governed by section 129, shall be subject to all claims and defenses that the consumer could assert against the original. Recovery under this subsection shall be limited to the total amount paid by the consumer in connection with the transaction.”

Q.6. Previous testimony suggested that many abuses in home equity lending are perpetrated by small, fly-by-night loan originators who sell their loans in the secondary market. The originators are often nowhere to be found when the homeowners later seeks redress. Will the bill successfully enlist the secondary market in policing these loan originators?

A.6. No, the bill as currently written, does not successfully enlist the secondary market in policing these loan originators. The only way to accomplish that would be to add the language recommended above, in part C of the answer to Question 5.

Thank you very much for the interest you have shown in the plight of our low-income clients. If there is any further information that we can provide for you, please do not hesitate to ask.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BOND FROM EUGENE A. LUDWIG

Q.1. Mr. Ludwig, you and I have discussed previously the issue of bank regulatory burden. I believe that in enacting any new legislation, we should consider its effect on regulatory burden and weigh the costs and benefits. Do you see this legislation as having a substantial impact on reg burden? minor impact? Please explain.

A.1. I do not believe that the Home Ownership and Equity Protection Act of 1993 would impose an undue regulatory burden on second mortgage lenders. Traditional second mortgage loan originators—including commercial banks and other insured depository institutions—would be virtually unaffected by the bill, because the interest rates, fees, and loan service ratios on their loans are well below the levels that would trigger the bill's restrictions. The higher-cost segment of the second mortgage market—which includes many legitimate lenders—would be more significantly affected, but the bill would not prevent any institution from originating mortgages that serve legitimate credit needs. The only loans that the bill would deter are those that charge excessive interest rates or up-front fees, or have repayment terms that borrowers cannot possibly meet.

The bill would impose some compliance costs on high-cost mortgage originators, but those costs appear to be modest, and to be clearly outweighed by the bill's benefits. The bill makes good use of disclosure requirements, which are among the least burdensome ways to promote consumer protection. Furthermore, the bill's specific prohibitions are narrowly targeted on abusive practices, and should have little effect on legitimate loans. Consequently, I do not believe the remedies contained in the bill would impose unreasonable compliance costs or interfere with legitimate financial transactions.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE
FROM EUGENE A. LUDWIG**

Q.1. Predatory lending practices have a market in part because of the lack of traditional financial services in low-income communities. Why do traditional lenders find it so hard to serve these communities?

A.1. The OCC believes there are many creditworthy borrowers in low-income communities, and we are encouraging national banks to increase their marketing of credit to potential borrowers in these communities. Many banks are already doing this, and we are using the resources of our office to communicate to other banks how they can become more active in lending to low-income communities.

Unfortunately, many traditional lenders have the misperception that residents of low-income communities are not creditworthy. Anecdotal information indicates, however, that low-income borrowers often pay their bills more regularly and promptly than many higher-income borrowers. Studies indicate that owning a home is of such importance to lower- and moderate-income borrowers that they will make major sacrifices in other areas to keep payments current.

Low- and moderate-income home owners generally have higher debt-to-income ratios than higher-income households, and they often obtain their mortgages through special programs that employ creative financing. Many of these programs are offered directly by banks or receive financial support from banks. Given the great need for affordable credit, however, the OCC is looking at additional ways to increase traditional credit flows into low- and moderate-income neighborhoods.

Q.2. In attempting to combat reverse redlining in this legislation, we have sought to strike a careful balance, targeting the loans that have been particularly troublesome without restricting the flow of credit on fair terms. How effectively does this legislation meet these goals? To what extent will lenders withdraw from making loans which are covered by this legislation rather than complying with the required disclosures and substantive prohibitions?

A.2. The Home Ownership and Equity Protection Act of 1993, strikes an appropriate balance between consumer protection and market efficiency. Its measures should curb abusive lending practices without restricting the flow of legitimate credit. Several features of the bill contribute to this result, and I urge the Committee to retain these features as the bill proceeds through markup:

- *Focus on fixed-term second mortgage loans.* Open-ended home equity lines of credit are wisely excluded from the scope of the bill; because they can be prepaid at any time, they are less subject to abuse. First mortgages are also excluded, because they are not generally provided by the door-to-door marketers who are responsible for many of the worst abuses.
- *Focus on high-cost mortgages.* Traditional mortgage loans—including those originated by commercial banks and other insured depository institutions—would be virtually unaffected by the bill, because the interest rates, fees, and loan service ratios on their loans are far below the levels that would trigger the bill's restrictions.
- *Use of disclosure.* One of the keys to curbing deceptive lending practices is to provide borrowers with better information. The bill's disclosure requirements—and the requirement that disclosures be made at least three days before a loan is consummated—would make it more difficult for a lender to pressure a homeowner into a disadvantageous mortgage, while still allowing the homeowner to obtain a high-cost mortgage if that is his or her informed choice.
- *Restricting specific practices that are conducive to abuse.* By restricting the use of negative amortization and balloon repayment terms on high-cost second mortgage loans, the bill would make it more difficult for reverse redliners to conceal excessive interest rates and fees, while continuing to allow the legitimate use of these practices in instruments in other types of loans (such as "reverse mortgages.")

Q.3. The bill protects borrowers through enhanced disclosures, including a warning that they could lose their homes if they can't make their payments. How effective are such disclosures? Will providing these streamlined disclosures on a separate document be more effective than usual?

A.3. One of the keys to curbing deceptive lending practices is to provide borrowers with better information. The bill's disclosure requirements should make it more difficult for lenders to pressure homeowners into disadvantageous mortgages.

We recognize the difficulties involved in providing effective disclosures, particularly to unsophisticated borrowers who may have pressing financial needs and no other sources of credit. The Truth-in-Lending Act already requires home equity lenders to disclose loan terms, and gives borrowers a three-day right of rescission. These requirements have not eliminated reverse redlining abuses, and we cannot be sure that the disclosure requirements proposed in the Home Ownership and Equity Protection Act will be effective at protecting all borrowers.

It makes sense, however, to make every effort to make disclosure work before turning to more intrusive forms of regulation, since disclosure is among the least burdensome ways of protecting consumers. I believe the Home Ownership and Equity Protection Act would improve the effectiveness of disclosure.

- Borrowers may pay more attention to disclosures that are provided separately from other loan documentation.

- Expressing loan payments as a fraction of the borrower's income may make the information easier to understand.

Q.4. The disclosures mandated by the Home Ownership and Equity Protection Act must be provided at least 3 days before settlement of a High Cost Mortgage. How might this cooling-off period benefit consumers? Is there a danger this provision will hamper legitimate lenders?

A.4. Many borrowers may be reluctant to exercise the right of rescission which is currently provided under the Truth-in-Lending Act, even if they believe the loan terms are unreasonable, because they feel obligated to honor the loan agreement they have signed. Others may be disinclined to reconsider a decision which they have put behind them. Providing disclosures earlier, while borrowers still feel the decision is theirs to make, may make it easier for borrowers to act on the information they receive.

Requiring lenders to disclose more fully the terms of their loans should not deter legitimate lending. The earlier timing of disclosure may add slightly to loan processing costs, but for most second mortgages, which involve other paperwork in the days preceding the loan commitment, the increase in regulatory burden should be modest.

Requiring advance disclosure could seriously hamper lenders who market second mortgages door-to-door, often obtaining loan commitments within hours of the initial contact. This is the segment of the market in which the worst abuses have been reported. It could discourage some such lending that is not unfair or deceptive, but this appears to be a reasonable price to pay for curbing the serious abuses that have occurred.

Q.5. In addition to the new disclosures, the bill protects consumers who may not be adequately warned by disclosures by prohibiting "high cost mortgages" from containing certain provisions that have led to abuses in the past. Are the substantive prohibitions in this bill appropriate? Would you suggest others that might be added or substituted?

A.5. Because there are some questions about the ability of disclosure requirements, by themselves, to eliminate abusive lending practices, the bill would also restrict the use of several devices—such as negative amortization and prep aid payments—that reverse redliners often use to make the terms of their loans appear more affordable than they actually are. In our experience, these devices are rarely features of traditional second mortgage loans. These restrictions should therefore help to curb abusive lending practices without interfering with legitimate credit flows.

Some of the practices that the bill would restrict, however, have legitimate applications in other types of banking products. For example, negative amortization is sometimes used by reverse redliners to conceal the true cost of their loans, but it is also a feature of reverse mortgages for elderly homeowners, and adjustable rate mortgages with frequent (i.e., monthly) rate adjustments that offer the convenience of equal monthly payments. It is therefore essential that the bill maintain its narrow focus on high-cost fixed-term second mortgage loans.

While the prohibitions in the bill are generally appropriate, we recommend two minor changes to fine-tune the bill.

- The definition of “high-cost mortgage” might be modified to exclude mortgages that charge more than eight points, if the dollar amount charged is less than some *de minimis* threshold. Otherwise, the limit on points could unduly restrict small loans, which may need to charge more points in order to recover fixed loan processing costs.

Adding a *de minimis* threshold would improve the bill’s accuracy in targeting the most abusive lending practices. Charging eight points on a \$2,000 home improvement loan, for example, might still be excessive, but it would not strip off much equity and would be unlikely to result in foreclosure.

Since loan origination fees and interest charges are fungible, it might make sense to have a *de minimis* exclusion for interest rate charges as well. A simple way to do this would be to exclude from the definition of high-cost mortgage all home equity loans below some threshold size.

- The bill might misclassify certain mortgages as high cost on the basis of high debt service ratios because the borrower’s current income was artificially low. An example would be an entrepreneur who had quit his or her previous job to start up a new business with a loan secured by the entrepreneur’s residence. One possible solution would be to waive the bill’s debt service trigger in cases where the borrower’s income was temporarily depressed and the loan did not qualify as “high cost” on the basis of interest rate or points charged.

Q.6. Previous testimony suggested that many abuses in home equity lending are perpetrated by small, fly-by-night originators who sell their loans in the secondary market. The originators are often nowhere to be found when the homeowners later seek redress. Will the bill successfully enlist the secondary market in policing these loan originators?

A.6. Under the Act, purchasers of high-cost mortgages could be held responsible for the original lender’s failure to provide disclosures or to observe the Act’s restrictions on loan terms. This would not interfere with legitimate loan transactions, but it would constrain reverse redliners, who are often thinly capitalized and must therefore sell the loans they originate before they can make more loans.

It might be a good idea for the bill to state explicitly that assignees would have no additional liability for loans securitized through Fannie Mae or Freddie Mac. This would eliminate any possibility that the bill would interfere with established secondary markets for mortgage loans. It would not diminish the consumer protection provided by the bill, since Fannie Mae and Freddie Mac’s underwriting standards would reject any mortgage loan with the excessive debt service ratios that characterize reverse redlining loans.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM DIANNE LOPEZ

Q.1. Predatory lending practices have a market in part because of the lack of traditional financial services in low-income commu-

nities. Why do traditional lenders find it so hard to serve these communities?

A.1. Banks are involved in a variety of outreach programs designed to expand credit services in low-income communities. Attached is a collection of examples of the types of efforts bankers across the country are currently undertaking to better serve their local communities: *Community Development 101: A collection of 101 Examples of Bank Community Development Efforts*, published by the American Bankers Association and *Taking Responsibility: Financing American's Community Development in 1993*, compiled by the Consumer Bankers Association. As you will see, there is a good deal of diversity in the programs, reflecting the diversity of needs in different communities. In addition, a copy of a brochure explaining First Interstate Bank of Texas's CRA program is attached.

While the specifics of the programs are tailored to meet the needs unique to each community, there are some common themes. For example, banks are working to make their underwriting standards more flexible. This involves such things as finding new ways to determine a potential borrower's creditworthiness, like looking at income stability instead of employment stability. This is particularly important for individuals who may change jobs often, but have maintained their income level. Another example is using a history of timely payment of rent and utility bills for applicants who have not established a credit history. Another example is to allow higher debt to income ratios for potential borrowers who have demonstrated the ability to manage high cost obligations such as rent, on low incomes. Banks are also actively involved in educating potential borrowers in a variety of financial skills including how to budget, how to save, how to establish a good credit history, how to fill out a loan application, etc. These are skills that are necessary to understand how the financial system works and how to use it.

Because banks are only one link in the housing finance chain, bankers are working with others, including appraisers, private mortgage insurers, and secondary mortgage market agencies to promote more flexibility in these areas without diluting sound lending practices. This is a critical element: the lending process involves many players, and banks cannot change the system alone. To be truly effective, each of the major players must be working toward the same goal.

While there are profitable business opportunities in low/moderate income communities, the fact remains that providing financial services in low/moderate income neighborhoods is relatively expensive. Community outreach and borrower education cost time and money, and because account and loan sizes tend to be smaller, transactions costs tend to be higher. Other elements such as viable commercial lending are also important in sustaining a branch. All of these factors make operating profitable branches in low/moderate income neighborhoods more challenging. In this regard, Congress could improve the situation by allowing banks to provide a wider array of products and services through their branch systems, thus increasing the profit potential of each branch as well as providing more convenient services to all neighborhoods.

Q.2. In attempting to combat reverse redlining in this legislation, we have sought to strike a careful balance, targeting the loans that have been particularly troublesome without restricting the flow of credit on fair terms. How effectively does this legislation meet these goals? To what extent will lenders withdraw from making loans which are covered by this legislation rather than complying with the required disclosures and substantive prohibitions?

A.2. As outlined in our testimony, we believe that the broad definition of high cost mortgage will have the unfortunate effect of discouraging banks from certain types of lending. Specifically, we are concerned about small, closed-end home equity loans, small mortgage refinancings, and certain loans with legitimately high debt to income ratios. Banks will tend to discontinue making these loans if they may fall within the definition of high cost mortgage in order to avoid the bill's substantive restrictions and disclosure requirements. Banks will feel compelled to raise minimum loan amounts, to the detriment of many borrowers.

The definition of high cost mortgage includes loans with fees and points exceeding eight percent of the loan. Many small closed-end home equity loans used for home improvement will exceed the eight percent limitation, but would not be considered abusive. Home improvement loans in the \$3,000 to \$7,000 range are not unusual. However, largely because of the nature of real estate loans, there are fixed costs associated with home equity loans, including many imposed by Federal and local government regulations, e.g.:

- lending and mortgage taxes;
- recording fees;
- title insurance;
- title search;
- appraisals;
- subordination fees;
- flood insurance determination;
- lead paint determination;
- environmental analysis;
- pest inspection;
- credit report;
- private mortgage and other insurance; and
- attorney fees.

The sum of these fixed costs, often paid to third parties, may easily push the point and fees percentage above eight percent for small loans. Using the median fees charged on open-end home equity lines reported in ABA's 1993 *Home Equity Lines of Credit Report* (figures for closed-end are not available), a sample of up-front costs amounts to \$786.

- appraisal fee \$200
- attorney fee \$175
- credit report \$25
- mortgage tax \$50
- property report \$60
- recording fee \$18
- subordination fee \$50
- title insurance \$150
- title search \$75

TOTAL \$786

This example is based on median fees. Fees are higher depending on the individual market. The example also excludes points and other potential fees paid to third parties. Of course, many lenders may waive fees under a variety of circumstances, but the list provides a sample of the potential unavoidable costs to the creditor. The example also excludes points which a consumer may wish to pay in order to get a lower interest rate because in the long term, it is cheaper for that individual consumer.

The same problem, though more uncommon, can apply to small mortgage re-financings, especially in rural areas and other areas where real estate values are much lower than average. Some mortgages and refinancings are under \$10,000.

Under the bill, a loan with \$600 in up-front fees and points on a \$7,500 loan would qualify as a high cost mortgage subject to the bill's severe substantive restrictions, civil liability provisions, and the disclosure requirements. Many banks would be compelled to not make any small closed-end home equity loans, to the detriment of many credit applicants and potentially in contradiction of the intent of the legislation.

For example, small home equity loans used for home improvements are popular products in low-income communities. In addition, for some borrowers who cannot qualify for an unsecured loan, a secured loan may be their only chance for any type of loan. These loans are the types of loans which we believe the authors of the bill hope to encourage traditional lenders to make.

While fees are often waived or reduced in these circumstances, many banks may choose to avoid complex compliance procedures, inadvertent violations, and potential liability imposed by the bill by eliminating small closed-end home equity loans altogether, just as potential liability under the Truth-in-Lending Act has compelled many banks to avoid adjustable rate mortgages. Moreover, banks should not be restricted in charging fair and reasonable fees and points to recover their own out of pocket costs. In effect, small loans are disproportionately subject to restrictions owing to unavoidable but wholly reasonable fees.

If the definition of high cost mortgage must retain a formula based on up-front fees, we believe that it should be limited to points, and should exclude fees which are "bona fide and reasonable in amount" as that term is already defined under Regulation Z (the Truth-in-Lending Act). In this fashion, the bill will still cover loans imposing excessive fees without inhibiting legitimate lenders charging reasonable fees.

The possibility of exempting loans with fees and points less than \$500 was discussed at the hearing. Many legitimate fees and points would approach or exceed that figure. Compliance would be difficult and inadvertent liability too risky. For example, if a fee rose by an amount which increased the total from \$475 to \$525, the loans would suddenly be subject to the bill and the significant liability. For many banks, it would be easier and less costly to simply avoid these small mortgage loans than risk violations.

As discussed at length in our testimony, we are also concerned about the debt to income ratio element of the definition of high cost mortgage. There are instances when the debt to income ratio will

legitimately exceed 60 percent. For instance, borrowers seeking work-out loans, by their very nature, will have high debt to income ratios. High income individuals may prudently have high debt to income ratios because they have sufficient income after debt to accommodate normal living expenses. Moreover, we are highly concerned about the compliance implications of defining debt and income and of documenting and proving compliance to bank examiners.

Q.3. The bill protects borrowers through enhanced disclosures, including a warning that they could lose their homes if they can't make their payments. How effective are such disclosures? Will providing streamlined disclosures on a separate document be more effective than usual?

A.3. We believe that a statement explaining that borrowers may lose their homes if they do not make their payments may be helpful in improving their understanding of the nature and consequences of a security interest in their residence. However, we think that it should be provided with the right of rescission notice. We do not believe that adding another set of separate disclosures as prescribed in the bill will particularly enhance the borrowers' understanding of loan terms.

Depending on the type of mortgage loan, credit applicants already receive a variety of documents explaining terms and conditions, including the annual percentage rate and that the creditor will retain a security interest in the borrower's residence. Applicants receive:

- general and specific information regarding open-end credit home equity lines and variable rate mortgages including closed-end home equity lines at the time of application;
- estimated settlement and lending costs, including an estimated annual percentage rate, within three days of application;
- actual settlement and lending costs prior to settlement; and information about the right of rescission at settlement.

It is also important to note that the estimated and actual lending costs required under the Truth-in-Lending Act must be clear and conspicuous, grouped together and segregated from other information. Usually, lenders comply by enclosing these important disclosures in a highlighted box and a separate document.

The following terms are contained in the Truth-in-Lending Act "fed box" of the estimated lending costs provided within three days of application and the actual lending costs provided before consummation:

- annual percentage rate;
- that the creditor has a security interest;
- the name of the creditor;
- amount financed;
- finance charge;
- information regarding variable rate loans;
- payment schedule;
- time of payments;
- demand features;;
- total sale price;
- prepayment and late payment penalties;

insurance;
 certain security interest charges;
 reference to the loan contract;
 assumption policy; and the
 required deposit.

In addition, the terms "finance charge" and "annual percentage rate" must be more conspicuous than any other disclosure (except the creditor's identity). Borrowers must also receive two copies of their right to rescind the transaction.

We believe that these disclosures are sufficiently succinct and focus on the terms most important to the borrower and that providing an additional abbreviated—disclosure on a separate document will not be more effective than the existing disclosures. There are already three separate occasions for providing disclosures. Adding a fourth one for certain types of loans will complicate compliance and confuse lending officers who must already discern among a myriad of various disclosures and timing requirements.

Rather, we believe that if disclosures need to be added or modified, the legislation should focus on the right of rescission and the consumers' notice of that right. The right of rescission is the consumers' most powerful weapon against unfair terms and conditions. This right permits the borrower to cancel the transaction and receive a refund of all fees paid to the creditor up to three business days after receipt of complete and accurate truth in lending disclosures or after settlement, whichever is later. This means they have three business days to review the lending cost disclosures, including the annual percentage rate and the fact that their residence is securing the loan. In contrast, if the borrower decides to cancel the loan prior to settlement, he or she may have to forfeit application, appraisal and other fees.

We suggest that if additional or modified disclosures are necessary, the right of rescission notice be made more understandable. For instance, the notice could include the language contained in the bill, "You could lose your home, and any money you have put into it, if you do not meet your obligations under the loan." This may be more meaningful than, "You have agreed to give us a security interest in your home as security for your existing credit account." Focusing on "You may lose your home" and "for not paying your loan payments" could improve borrower understanding of the consequences of a residential security interest.

Q.4. The disclosures mandated by the Home Ownership and Equity Protection Act must be provided at least 3 days before settlement of a high cost mortgage. How might this cooling-off period benefit consumers? Is there a danger this provision will hamper legitimate lenders?

A.4. As discussed in question three, we believe that providing the disclosures with the right of rescission notice is more advantageous to consumers. We also believe that adding another three days of delay will further delay disbursement of funds, to the annoyance and inconvenience of the consumer. Already, consumers express frustration that they must wait three business days after settlement for the right of rescission period to expire before they may receive their funds. The bill will add another three day delay.

Moreover, the bill provides that terms may not be changed after the disclosures have been provided. In a falling interest rate environment, it will not be the desire or in the best interest of consumers to lock-in a rate at the time the disclosures are made. This would be particularly disadvantageous if the disclosures are furnished some time before settlement, for instance, at the time of application or with other disclosures such as those required by the Real Estate Settlement Procedures Act.

We believe that it is critical for ease of compliance that creditors be permitted to supply the bill's disclosures at a time when other existing disclosures must already be provided. While the bill permits disclosures to be provided at any time prior to three days before settlement, as a practical matter, creditors will have to provide them separately from other required disclosures: the annual percentage rate cannot change after the bill's disclosures are made, and usually, the exact calculation of that term is unavailable at the time the other earlier disclosures are made.

In effect, the bill introduces a fourth disclosure timing requirement. Mortgage lenders must already contend with three disclosure timing requirements (time of application, three days after application, and settlement). Adding a fourth disclosure time will complicate compliance and confuse lending officers who must already discern among a myriad of various disclosures and timing requirements.

For these reasons, we strongly recommend that the disclosures be supplied with the right of rescission. In the alternative, the bill should allow the annual percentage rate to be identified as a good faith estimate or a recently used rate.

Q.5. In addition to the new disclosures, the bill protects consumers who may not be adequately warned by disclosures by prohibiting "high cost mortgages" from containing certain provisions that have led to abuses in the past. Are the substantive prohibitions included in this bill appropriate? Would you suggest others that might be added or substituted?

A.5. For the reasons outlined in our testimony, as a general matter, we do not believe that such restrictions are appropriate. The terms prohibited for high cost mortgages generally represent legitimate and prudent business practices: prepayment penalties; balloon payments; and points, prepaid finance charges, and discount fees on refinancings. General laws of conscionability and fairness already address any abuses of these practices.

To the degree that the definition of high cost mortgage encompasses proper and legitimate loans such as small home equity loans, these loans will not be allowed to use those commonly accepted terms. Many small banks, for example, employ balloon payments as a substitute for adjustable rate mortgages because of the complexity and potential liability associated with adjustable rate mortgage regulations. Moreover, the prohibition of practices for one type of loan casts a negative pallor on such terms even when used for other types of loans. We do not believe that Congress should be intervening in specific contract terms that are usually employed fairly when other general laws already address abuses.

Q.6. Previous testimony suggested that many abuses in home equity lending are perpetrated by small, fly-by-night loan originators who sell their loans in the secondary market. The originators are often nowhere to be found when the homeowners later seek redress. Will the bill successfully enlist the secondary market in policing these loan originators?

A.6. The Truth-in-Lending Act already provides that assignees are liable for any violation apparent on the face of the disclosure statements. Thus, even if the "fly-by-night loan originators" are "nowhere to be found" when the homeowner later seeks redress, the borrower currently may assert Truth-in-Lending Act claims and defenses against an assignee. Accordingly, if a bank buys a non-complying loan from a "fly-by-night" creditor, the borrower may sue the assignee bank or use the original Truth-in-Lending Act violation as a defense for failure to repay the assignee bank. Damages include actual damages, statutory damages up to \$1,000 per violation, and attorney fees. Class actions may claim up to \$500,000 or 1 percent of the assignee's net worth, whichever is less.

We believe that the existing Truth-in-Lending Act assignee liability is sufficient and proven to work. Victims of abusive lending practices are and have been able to sue assignees of those loans.

While the bill may help to police loan originators, we are afraid that the proposed liability provisions go too far. They may unintentionally inhibit the secondary market, especially if the high cost mortgage definition includes legitimate loans (such as those with appropriate high debt to income ratios and small loans with fees and points exceeding eight percent of the loan amount) and if the significantly increased statutory penalties are retained.

Today, banks may generally protect themselves from liability by reviewing the documents of loans they intend to purchase. They also endeavor to protect themselves by dealing with businesses known to be legitimate. However, while there may be cases when it is obvious that a business or creditor is shady and likely to be engaging in abusive practices, there are also many cases where a business or creditor is in fact or apparently a bona fide business, but nevertheless prone to good faith Truth-in-Lending Act errors. Knowing your customer is no protection against human error. For instance, a thrift or other business which later fails, could have made good faith errors regarding small closed-end home equity loans.

Creditors should not be held to a standard which requires them to have the prescience to know which business or creditor will make good faith errors or eventually fail or which is secretly involved in abusive lending practices which are not apparent on the face of documents. Liability should at least be limited to errors and violations they have some opportunity to discover.

Under the bill, loan purchasers have no ability to protect themselves from undiscoverable errors even when they are dealing with an apparently legitimate business. Consequently, many banks and other creditors will simply choose not to buy mortgage refinancings and closed-end home equity loans, much as some banks no longer buy adjustable rate mortgages because of the potential for violations and liability. Equally, banks who rely on the ability and opportunity to sell loans will be hindered: if they cannot sell the

loans, they may not be able to make new ones. Thus, while the bill may help to police some originators of abusive loans, it will also chill the secondary market, especially if the current definition continues to include legitimate loans.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR BOND
FROM DIANNE LOPEZ**

Q.1. Many of your comments on S. 924 are critical of the provisions of the bill as being burdensome to lenders with the potential to discourage certain consumer lending. Please identify the portions of the bill which can be supported by the American Bankers Association and the Consumer Bankers Association. What steps should be taken to address unfair lending practices?

A.1. We believe that if disclosures need to be improved to address abuses in mortgage lending, the bill should focus on making the notice of the right of rescission more understandable. As explained in the answer to Senator Riegle's question three, we believe that the right of rescission is a potent weapon for consumers. Making this right more understandable without complicating the disclosure will allow consumers victimized by abusive lenders to exercise their right to rescind. For instance, the disclosure contained in the bill, "You could lose your home, and any money you have put into it, if you do not meet your obligations under the loan," or a similar statement may be more effective in conveying the concept of a lien than references to a "security interest" or "lien." Focusing on "losing your home" and "for not paying your loan payments" could improve borrower understanding of the consequences of a residential security interest.



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