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Volume 6 | Issue 1 Article 6

2002

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Recommended Citation

Margot Saunders, *The Increase in Predatory Lending and Appropriate Remedial Actions*, 6 N.C. BANKING INST. 111 (2002).
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THE INCREASE IN PREDATORY LENDING AND APPROPRIATE REMEDIAL ACTIONS

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The author would like to thank Irv Ackelsberg for his eloquent presentation of this article before the Senate Committee on Banking Housing and Urban Affairs. Elizabeth Renaurt, staff attorney at the National Consumer Law Center, and Mark Benson, researcher for the National Consumer Law Center, provided invaluable assistance in researching and writing this article.

2. The National Consumer Law Center is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of fourteen practice treatises and annual supplements on consumer credit laws, including THE NATIONAL CONSUMER LAW CENTER, TRUTH IN LENDING (4th ed. 1999), THE NATIONAL CONSUMER LAW CENTER, COST OF CREDIT: REGULATION AND LEGAL CHALLENGES (2nd ed. 2000), and THE NATIONAL CONSUMER LAW CENTER, REPOSSESSIONS AND FORECLOSURES (4th ed. 1999), as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. These publications can be ordered from NCLC at http://www.consumerlaw.org/maninf2.html.

NCLC has advised legal services and private attorneys on litigation strategies to deal with predatory loans, and has provided extensive testimony to Congress regarding necessary protections to be included in federal law, including the Home Ownership and Equity Protection Act (HOEPA), and the Riegle Community Development and Regulatory Improvement Act, Pub. L. No. 103-325, Title I,

Abusive home equity lending is a longstanding problem that exploded in the early 1990's. Vulnerable homeowners who cannot access mainstream forms of credit have generally been the target of these abusive practices.[3] Many homeowners have been beguiled into obtaining home equity loans with high rates of interest to finance home repairs or for credit consolidation. The refinancing of low rate purchase money mortgages with high rate first mortgage loans has become a serious problem in low and middle-income communities leading to the increasing loss of homeownership. The terms of these high cost loans are not necessary to protect the lenders against loss;[4] indeed the terms are generally so onerous that they precipitate default and foreclosure. With these equity-based loans, even foreclosure does not pose actual risk of loss to the lender. The Home Ownership Equity Protection Act (HOEPA)[5] passed by Congress in 1994 to address these abuses, while helpful, has not significantly reduced the

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Subtitle B (Home Ownership and Equity Protection Act of 1994) (1994) (codified as amended to the Truth in Lending Act, at 15 U.S.C. §§ 1601 to 1693s. (2000)). Since the passage of HOEPA, NCLC has continued to work with a broad coalition of consumer and community groups and with various federal agencies to create a comprehensive solution to abusive lending practices.

NCLC launched a Sustainable Homeownership Initiative several years ago. As part of that initiative, NCLC works closely with Freddie Mac, Fannie Mae, the Neighborhood Reinvestment Corporation, banks, and housing counselors to sustain homeownership through training and coalition building, as well as specific intervention projects in cities such as Boston and Chicago.

3. Dozens of examples were raised in the variety of Congressional hearings held on these issues. *Problems in Community Development Banking, Mortgage Lending Discrimination, Reverse Redlining, and Home Equity Lending: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 103d Cong., 1st Sess. 258, 260 (Feb. 17, 1993); *The Home Ownership and Equity Protection Act of 1993: Hearing on S. 924 Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 103d Cong., 1st Sess. (May 19, 1993); *The Home Equity Protection Act of 1993: Hearings on H.R. 3153 Before the Subcomm. on Consumer Credit and Ins. of the House Comm. on Banking, Finance and Urban Affairs*, 103d Cong., 2nd Sess. (March 22, 1994); *Community Development Institutions Hearings Before the House Subcomm. on Financial Inst. Supervision, Regulation and Deposit Ins. of the House Comm. on Banking, Finance and Urban Affairs*, 103d Cong., 1st Sess. (Feb 2-4, 1993).

4. *Predatory Mortgage Lending: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 107th Cong., 1st Sess. 531 (July 26, 2001) (Testimony of Martin Eakes, Self-Help CEO and Coalition for Responsible Lending Spokesperson) [hereinafter Eakes Testimony].

5. The Riegle Community Development and Regulatory Improvement Act, Pub. L. No. 103-325, Title I, Subtitle B (Home Ownership and Equity Protection Act of 1994) (1994) (codified as amended to the Truth in Lending Act, at 15 U.S.C. §§ 1601 to 1693s. (2000)).

abuses faced by many low-income, minority and elderly homeowners.[6]

There has been considerable discussion over the supposed difficulty in defining a predatory mortgage loan. But, most predatory mortgage loans include one or more of the following basic ingredients: (1) the loan is equity based, rather than income based and as such, the lender's assurance of repayment is based on the equity in the home, not the homeowner's income; (2) high points and fees are financed in the loan; (3) the loan is refinanced and new points and fees are imposed; and (4) brokers, home improvement contractors and other third parties are used as expensive bird dogs to originate loans.

Part I of this article will first explore the escalating foreclosure rate as proof of how predatory lending has increased.[7] Next, Part II will discuss the causes of the current mortgage crisis in many American households.[8] Part III will outline some common signs of predatory loans.[9] In Part IV, this article will refute the argument that lower credit scores justify higher costs of predatory loans.[10] Next, Part V will explore the expansion of HOEPA as a means of addressing predatory lending.[11] In Part VI, it will contest the argument that increasing regulation will reduce access to legitimate credit for high credit risk families.[12] Part VII will address other federal laws that should be changed to address the problem of predatory mortgages.[13] Finally, this article will conclude that predatory lending must not be addressed piecemeal; tax and lending laws should be changed to protect borrowers from the unscrupulous, to discourage excessive home equity lending, and to ensure the stability and accessibility of homeownership for all Americans.

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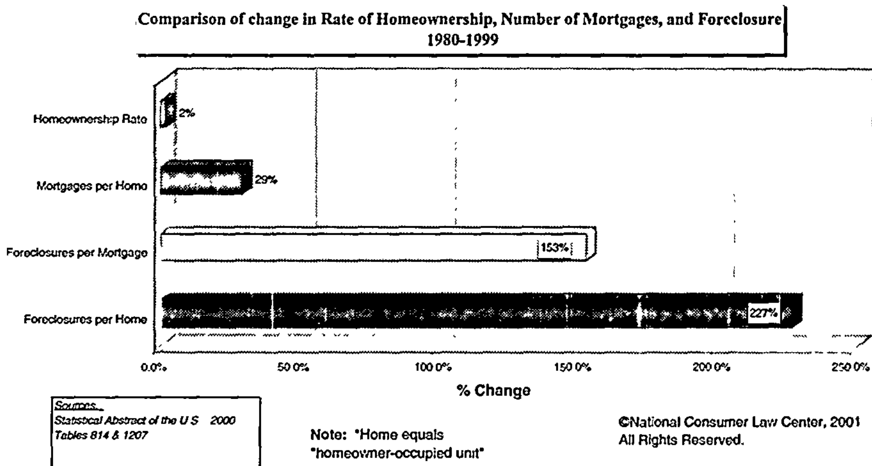
6. *See infra* notes 37-44 and accompanying text.
7. *See infra* notes 14-17 and accompanying text.
8. *See infra* notes 18-31 and accompanying text.
9. *See infra* notes 32-36 and accompanying text.
10. *See infra* notes 37-44 and accompanying text.
11. *See infra* notes 45-81 and accompanying text.
12. *See infra* notes 82-91 and accompanying text.
13. *See infra* notes 92-99 and accompanying text.

I. PROOF OF THE PROBLEM: ESCALATING FORECLOSURES

There should be no doubt that there is a mortgage-lending crisis in America. Between 1980 and 1999 both the number and the rate of home foreclosures in the United States have skyrocketed. The absolute number of foreclosures rose 338%.[14] This demonstrates that in spite of a period of economic prosperity, in 1999 lenders foreclosed on over four times the number of homes as they did in 1980.[15] This increase in foreclosures cannot be traced either to a rise in home ownership, or to the increase in mortgage loans being made. During the same time period, homeownership increased by only two percent, while the rate of foreclosures *per mortgage* increased by 153%.[16]



14. U.S. CENSUS BUREAU, Statistical Abstract of the United States, Tables 814-1207 (120th ed. 2000); Mortgage Bankers Association of America, *National Delinquency Survey, Quarterly* (on file with author). Data of mortgages in foreclosure at the end of each period studied comes from 130 different lenders and is representative of approximately half of the mortgages in existence. *Id.* These numbers are actually grossly undercounted because the foreclosures of mortgages made by finance companies are not included in the statistics compiled by the Mortgage Bankers Association of America (which provides the raw data for the Census statistics). Also, foreclosure statistics do not include homeowners who simply turn their home over to the lender to avoid foreclosure.

15. U.S. CENSUS BUREAU, *supra* note 14, at Table 814.

16. *Id.* at Tables 814-1207.

The two conditions which unite to cause this alarming increase in foreclosures are the increase in the *number* of mortgage loans outstanding and the *quality* of those loans. The increase in home secured lending during this period was almost twofold, from 30 million loans outstanding in 1980 to 52.5 million loans in 1998.[17] The problem is that too many home loans are being made for purposes that have nothing to do with the home, and too often these loans are being made with terms that are inherently unconscionable and that increase the costs of homeownership and the risk of loss of homeownership to the borrower.

II. CAUSES OF THE MORTGAGE CRISIS FOR AMERICAN HOUSEHOLDS

Predatory mortgage lending has been facilitated by several important developments, including the deregulation of home lending laws, the limitation of tax deductibility of consumer debt to home secured loans, the increases in real estate values which has expanded availability of home equity for many households, and the proliferation of mortgage brokers. Each is examined separately below.

A. Deregulation of Home Lending

The single most expensive, complicated, and important investment most Americans make in their lifetime is thinly regulated in this nation. There are minimal federal or state laws that govern the rates, fees, or terms that lenders can charge for loans used to purchase or refinance a home. In the past two decades, Congress has done little to ensure that the needs of homeowners are balanced against the interests of the lending industry. Indeed, in furtherance of increasing homeownership, Congress has restricted the states' abilities to set limits on the rates and terms lenders can impose on home loans.[18] While there have

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17. *See id.* at Table 814.

18. In 1980, Congress preempted the ability of states to set interest rate caps on most first mortgage loans. Depository Institutions Deregulation and Monetary Control Act of 1980, Title V, § 501, Pub. L. No. 96-221, 94 Stat. 132, 161 (1980) (codified at 12 U.S.C. § 1735f-7a (2000)). In 1982, Congress prohibited states from limiting the types of terms (such as balloon payments and negative amortization) that

been slight increases in homeownership,[19] the lending industry has had its liquidity greatly increased by the development of a significant secondary market. Other than prohibitions against discrimination in the granting of credit, the Truth in Lending Act (TILA)[20] and the Real Estate Settlement Procedures Act (RESPA)[21] basically provide the only state or federal regulation of home loans. With slight exceptions, these two laws are mostly limited to disclosure requirements.[22]

Many homeowners go through the home purchase, financing and refinancing process without any problem. Many others, however, find themselves confused, feel deceived, or worse, they lose their home as a result of abusive or unjustified loan terms. These abusive loans are an indication of a failure in the marketplace; competition and self-regulation do not stop bad loans from being made.

B. *Wrong Message Sent by Tax Code*

In 1986, Congress changed the tax code to allow taxpayers to deduct the interest for consumer loans only if the loan is secured by the home.[23] This sent a pervasive message to homeowners that borrowing against home equity was sensible economic planning. Unfortunately, this is quite often incorrect, even for middle-income families. For low-income households, this tax deduction is generally of no benefit because the working poor have little or no tax liability, due to the earned income tax credit.[24] Others are paying at the tax system's lowest tax rates.

One consequence of limiting deduction of consumer debts to home equity loans is that many Americans are now paying

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could be allowed on many first mortgage loans. The Garn-St. Germain Depository Institution Act of 1982, Pub. L. No. 97-320, Title VII (Alternative Mortgage Transaction Parity Act of 1982) 96 Stat. 1469 (codified as amended at 12 U.S.C. §§ 3801-3806 (2000)).

19. *See supra* note 16 and accompanying text.

20. 15 U.S.C. § 1601 (2000).

21. Real Estate Settlement Procedures Act of 1974, 12 U.S.C. §§ 2601-2617 (2000).

22. The exceptions are: (1) TILA allows for a right of rescission, and (2) RESPA prohibits kickbacks and provides rules on escrow collections by servicers. 15 U.S.C. § 1601; 12 U.S.C. § 2601.

23. *See* I.R.C. § 25 (1999).

24. *See* I.R.C. §§ 32, 151 (1999).

much *more* interest on consumer debt, albeit generally at a lower rate per year. This is largely due to a lack of understanding and appreciation for the costs of financing debt over an extended period of time.

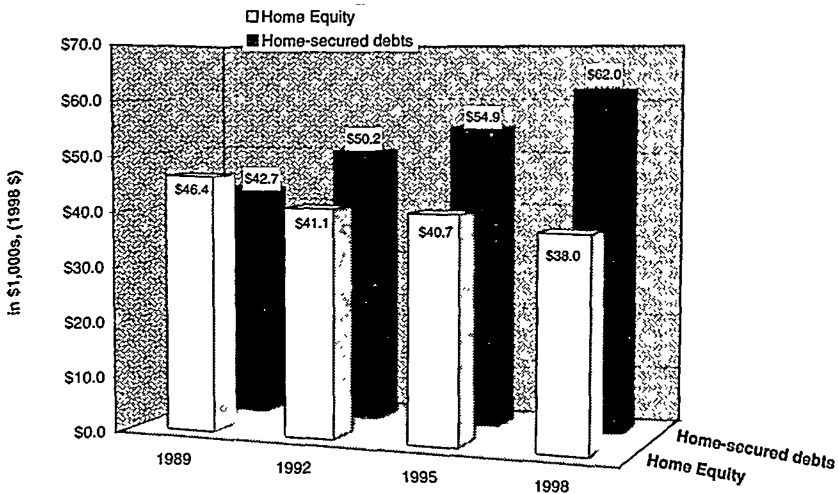
Generally, families are persuaded to pay off car loans, credit cards, and other non-housing related expenses with loans secured by their homes because of the perceived tax savings generated by the deductibility of interest related to home secured debt. This perception of savings is generally misplaced: although the actual rate of interest is lower, the money is lent for a much greater length of time. Even after tax benefits are considered the result is a costlier loan. For example, consider a car loan refinanced into a home loan:

- *Car loan paid in installments.* A $20,000 five-year loan with an interest rate of fifteen percent will have a total interest expense on the loan of $8,548. The total cost of the car is $28,548.
- *Car loan refinanced into home equity loan.* A thirty-year home loan for the same amount at an eleven percent interest rate effectively *costs* the homeowner more than four times as much in extra interest expense—even after counting the tax benefits. Just the interest charges on $20,000 over thirty years will be $48,567. The total cost of the car is $68,567. Even if thirty percent of the interest expenses results in a tax savings for the consumer, the net cost of financing the car over the life of a home mortgage is still seventy percent of $48,567 or $33,997; the total cost of the mortgage financed car is almost one and one-half times the cost of an installment car loan. (Note: even if this home loan is refinanced early, the amount of this debt for the car is always included in the amount owed, or when the home is sold, the net cash to the borrower is reduced by this amount.)[25]

A more serious consequence is the increase in *the loss of equity for American households.* The ratio of debt to savings for

25. Even if the interest rates are lowered in this example, to those generally available to the prime borrower, the end result is still the same. The cost of financing a car loan in a thirty-year home loan is far more expensive, even with the tax benefits.

American families has risen over the past thirteen years.[26] During the same period, the ratio of home equity debt to other debts has increased at a much greater pace.[27] This trend was largely caused by U.S. families *switching* much of their debt from installment or credit card loans, to home secured loans. This has the effect of significantly reducing the home equity savings for these households; and, home equity savings has long been the traditional method of building assets for American families.



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26. FEDERAL RESERVE BULLETIN, Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances (2000), 19-26, *available at* http://www.federalreserve.gov/pubs/bulletin/2000/0100lead.pdf (last visited Feb. 1, 2002).

27. *Id.*

The preceding graph shows the dramatic *increase* in home secured debt in the past decade, as well as the *decrease* in home equity. This bleeding of home equity causes a general diminution of the wealth and security of millions of American families.

C. *Increases in Available Home Equity*

Many finance companies[28] target homeowners who have substantial equity in their homes in order to protect their investments when the borrowers cannot pay. Elders are a common target for this equity based lending, because many have built significant equity in their properties over time. Based on this equity, a lender is in an advantageous situation: either the borrower pays the loan back with high interest, or foreclosure on the home permits a recovery from the property directly. In fact, when foreclosure occurs and the borrower's property is sold to the lender for less than fair market value (as it generally is),[29] the lender can resell the property after foreclosure and realize the homeowner's equity. These anticipated windfalls encourage some lenders to make loans designed to result in foreclosure. Given appreciating real estate values throughout much of the country, finance companies are able to make loans at high costs with very little risk.

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28. Mainstream banks nearly abandoned low-income neighborhoods across the country, especially minority low-income neighborhoods. This created a vacuum for finance companies charging high rates of interest. Indeed, some mainstream banks helped fill the vacuum by setting up high rate finance companies or, alternatively, by funneling cash to unscrupulous lenders. The term "reverse redlining" has been coined to describe a practice wherein banks make loans at one rate in white communities through their banking arm and at another higher rate in communities of color through separate finance company subsidiaries. Evidence in a case brought in Atlanta, for example, established that black borrowers were charged 11.06% in up front fees by Fleet Finance Co. (a subsidiary of Fleet Bank). Alexander v. Kaye-Co, No. 91-RCCV-601 (Ga.Super.Ct. Oct. 2, 1992) (alleging reverse redlining where African Americans were targeted for these loans in violation of Georgia Fair Housing Act) (on file with author). In comparison, white borrowers were charged fees of 8.26% of the loan amount (still too high a figure). *Id.*

29. It is the experience of the NCLC that the borrower's property is generally sold to the lender at less than its fair market value.

D. *Incentives for Brokers and "Bird Dogs"*

The U.S. Housing and Urban Development Department (HUD) estimates that mortgage brokers handle about half of all home mortgage loans, or about three million mortgages per year totaling $333 billion.[30] Lenders often pay brokers to bring them loans. These lender payments are usually paid in one of two ways: by a "yield spread premium" or "volume-based compensation." A yield spread premium is a fee from a mortgage lender to a mortgage broker paid when the broker arranges a consumer mortgage loan where the interest rate on the loan is inflated to an amount higher than the "par" rate to cover the cost of the fee.[31] The par interest rate is the base rate at which the lender will make a loan to a borrower on a given day. Some lenders also compensate brokers based upon the volume of loans which brokers steer their way.

These payments to brokers drive up the cost of mortgage loans and create reverse competition where brokers have incentives to steer borrowers to lenders that pay brokers the most rather than to lenders who give borrowers the most favorable terms. This problem is exacerbated for low-income borrowers because unscrupulous elements of the mortgage industry perceive them as vulnerable targets.

Home improvement contractors often act as mortgage brokers as well, having agreements to funnel customers in need of financing to a lender. Sometimes, the contractor receives a payment from the lender. Other times, the contractor is simply content to have a funding source ready when a homeowner mentions that he or she cannot afford the suggested work.

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30. *See* Alan J. Heavens, *Binding Rules; Proposed Mortgage Regulations Would Require Early Cost Disclosure*, CHI. TRIB., Sept. 28, 1997, at 3B.

31. *See, e.g.*, NATIONAL CONSUMER LAW CENTER, THE COST OF CREDIT: REGULATION AND LEGAL CHALLENGES § 11.2.1.4.3 (2d ed. 2000 & Supp. 2001).

III. SIGNS OF A PREDATORY LOAN

The most meaningful mark of a predatory loan is in the high amount of points and fees[32] financed by the borrower.[33] The more the borrower is charged up-front, the more the immediate financial gain achieved by the lender. This is why many of these loans are not affordable to the homeowner—the lender has an incentive to make them non-performing loans. If that loan does not perform such that the homeowner is forced to refinance, it just means more profit for the lender at each refinancing. For the homeowner, it means more equity is stripped from the home each time. Consider the following high cost loan:

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32. The NCLC, speaking on behalf of many groups, includes the high costs of single premium credit insurance in our definition of fees.

33. There are numerous other predatory mortgage loan indicators, as set out below. Each must be addressed. But the single most important aspect of predatory lending is the financing of points and fees. Until this part of the problem is directly addressed, predatory lending will continue, without significant reduction of the problem.

- **Credit insurance** packing with high priced pre-paid term credit insurance which add thousand of dollars in unnecessary costs to loans for borrowers who could obtain more reasonably priced credit insurance if paid on monthly basis.
- **Prepayment penalties** that are high and unfair.
- **Mandatory arbitration clauses**, which require the homeowner to arbitrate at considerable expense before arbitrators who have no incentive to follow consumer protection laws, and whose decisions are not reviewable by any court.
- **Spurious open end loans** whereby the lender is allowed to avoid making the more comprehensive disclosures required by closed end credit, and thereby avoid any chance of the homeowner asserting the right of rescission, as well as completely avoiding the restrictions under the HOEPA, regardless of the cost of the loan.
- **Paying off low interest mortgages** such as purchase money loans with FHA with much higher interest rate loans.
- **Refinancing unsecured debt** for which the borrower could not lose the home, with high interest rate debt which must be paid to avoid foreclosure.
- **Yield spread premiums** paid to the broker even when the homeowner has already paid all closing costs, increases the cost of the loan.
- **125% loan to value loans** are predatory for a different reason than the typical predatory loan we most often see in the low-income community. These loans effectively prohibit homeowners from selling their homes or filing bankruptcy to escape unaffordable debt, without losing their home.

Table 1 **High Cost Loan**		
Borrower receives:	$70,000	
Borrower pays:[34]		
5 Points	3,850	($3,850 all profit to lender)
Closing Costs	1,400	($1,000 profit to lender)
Credit Insurance	2,200	($1,000 commission to lender)
Total Loan Amount	$77,450	$5,800 – immediate profit to lender upon sale of loan to investor
Interest Rate of 12%	30 Year Term	Monthly Payment – $796.66

After thirty-six payments, the loan balance is $76,495.40 yet this homeowner has paid $28,680 over three years and only received a total of $70,000.

So long as there is sufficient equity in the home (and there generally is plenty), this lender *benefits* every time the borrower defaults. A default provides the lender with reason to make a new loan and charge more points and fees. This creates another immediate opportunity to turn a quick profit. Even if the borrower does not default, predatory lenders convince borrowers to refinance their loans and receive a small amount of additional cash. The lender thus takes advantage of the large prepayment penalty typically included in these kinds of refinanced loans.

Assume in three years, the borrower in the above example falls behind and refinances. The refinanced loan will effectively

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34. *See Hearing Before the House Comm. on Banking and Financial Services on Predatory Lending Practices,* 106th Cong. 24-49 (May 24, 2000) (statement of Andrew G. Celli, Chief of Civil Rights Bureau, Office of the Attorney General for the State of New York). Mortgage brokers routinely charge up to ten percent of the total loan value in fees. *Id.* at 26. Conversely, the Federal Housing Finance Board's *Monthly Interest Rate Survey* shows initial fees and charges averaging less than one point from 1993 through 2000 on conventional residential mortgages. Federal Housing Finance Board, Monthly Interest Rate Survey *at* http://www.fhfb.gov/MIRS/MIRS_rates.htm (last updated Dec. 13, 2001).

cost the borrower another ten percent of the loan amount in points, fees and closing costs. Thus, even though the borrower has paid almost $30,000 in home secured debt in three years, once he refinances again, his home equity plunges by another $7,650.

The result of these practices for homeowners is a dramatic loss of equity. In the course of ten years, assuming a refinancing each three years, the financial consequences will be devastating:

Table 2
Loss of Equity

	ORIGINAL LOAN	REFINANCE #1 @ 3 YEARS	REFINANCE #2 @ 6 YEARS
Value to homeowner	$70,000	$0	$0
Pay off of prior loan		$76,495	$83,107
Loan with 10% points and fees financed	$77,450	$84,145	$91,300
Home equity lost at closing[35]	($7,450)	($14,145)	($21,300)[36]
Total amount paid by homeowner to "achieve this lost equity"		($28,680)	($59,839)

The current state of the law encourages, even rewards, the type of loan described above. Yet, the high points and fees financed in these loans are not necessary to compensate the lender in this market. These costs are charged because there is a complete failure of competition in this marketplace, necessitating increased regulation.

35. This amount assumes the market value of the home remains the same.

36. It should be noted that if the same $70,000 loan had only three points in fees financed instead of ten, and there were no subsequent refinancings, this homeowner would not have lost any equity by year six.

IV. LOWER CREDIT SCORES DO *NOT* JUSTIFY HIGHER COSTS OF PREDATORY MORTGAGES

Subprime lenders justify the financing of high fees and interest rates as necessary based on the risk of loss from loans to homeowners with blemished credit. However, the typical structure of subprime loans creates minimal risk of loss due to either a default or a foreclosure. When credit is secured by a home, and the loan-to-value ratio is more than sufficient to protect against foreclosure losses seventy percent or less, there is no basis for significantly increased rates and fees. Actually, the higher pricing itself creates more risk, and the excessive fees charged up front cause the most damage to the homeowner by stripping equity from the home. An examination of the risks in mortgage lending supports this point. Losses to a mortgage lender can result from four events: (1) late payment and default; (2) foreclosure; (3) prepayment of the loan before the lender has recouped the expenses incurred in making the loan; or (4) litigation expenses.

A. Risk of Loss from Defaults

Defaults do not necessarily result in foreclosure. In fact, the industry agrees that most defaults are self-corrected by borrowers, particularly within the first three months from default.[37] Lenders recoup default expenses from late fees and additional interest charges. Late fees are structured to compensate creditors for expenses incurred when payments are made late, such as dunning notices. Additional interest is generally charged for the loss of use of the principal while the payment was late. Late fees in the mortgage context are usually five percent of the payment then due. If the monthly payment is one thousand dollars, the late fee is fifty dollars. Given the collection of late fees and additional interest, the risk of loss due to a mere default is negligible.

37. Comment of the National Consumer Law Center and the Consumer Federation of America, to the Federal Deposit Insurance Corporation, How to Avoid Purchasing or Investing in Predatory Mortgage Loans (Jan. 31, 2001), *available at* http://www.consumerlaw.org/predatory_lending/fdic.html (last visited Feb. 1, 2002).

B. Risk of Foreclosure

A more serious loss could arise if a default continues and results in a foreclosure sale. In this instance, the lender stands to lose only if the sale brings less than the combination of the balance due on the mortgage plus the costs and fees incurred in the foreclosure. As foreclosure sales generally recoup less than fair market value of the property, mortgage lenders traditionally protect against this risk by requiring a loan-to-value ratio no greater than eighty percent. When the loan-to-value ratio is greater than eighty percent, private mortgage insurance of some sort is generally required.

Subprime lenders, however, usually insist that the loan-to-value ratio be no greater than sixty to seventy-five percent. This ratio insures little or no loss in case of a foreclosure sale. When the loan-to-value ratios are so low, the risk of loss due to foreclosure also does not justify the increased pricing in the subprime market.

C. Risk of Prepayment

When a lender extends considerable expenses in the making of a loan, the lender does risk loss if the loan is prepaid before the regular payments on the loan allow the recoupment of these expenses. In the prime mortgage market, the effect of competition protects lenders: the low interest rate the borrower currently has discourages the borrower from prepaying the loan. Typical prime mortgage loans stay on the books for an average of five years. Thus, only two percent of prime loans have a prepayment penalty.

The subprime market is a different story. Fully seventy percent of subprime loans have prepayment penalties because of lack of perceived options on the part of the borrowers.[38] In the

38. *See* ERIC STEIN, NORTH CAROLINA COALITION FOR RESPONSIBLE LENDING, QUANTIFYING THE ECONOMIC COST OF PREDATORY LENDING 7 (July 25, 2001) (citing Joshua Brokman, *Fannie Revamps Prepayment-penalty Bonds*, AM. BANKER, July 20, 1999, at 16; *Inside Mortgage*: *Freddie offers a new A-, prepay-penalty program*, MORTGAGE MARKETPLACE, May 24, 1999; GAIL MCDERMOTT, LESLIE ALBERGO, NATALIE ABRAMS, ESQ., ANALYSTS, STANDARD AND POOR'S, NIMS ANALYSIS: VALUING PREPAYMENT PENALTY FEE INCOME (Jan. 3, 2001), *available at* http://www.standardandpoors.com (search for "NIMS Analysis"), *available at*

subprime mortgage market, the brokers are generally the gatekeepers for the loans, and they operate on the reverse competition method of yield spread premiums. The higher the premium paid to a broker, the more likely the broker will match a lender up with an unwitting borrower. The hefty price paid to the broker in the yield spread premium is an expense that the lender must recoup in order to avoid a loss, especially considering that the same broker has an incentive to market aggressively another loan to the same borrower. Thus, the lender must charge prepayment penalties to protect itself from the costs incurred by yield spread premiums.

If prepayment penalties were disallowed, unreasonable yield spread premiums would not be paid by lenders, because they could not afford the risk. This would not mean that loans would not be made; they are made every day in the prime market without hefty premiums and prepayment penalties.

D. *Risk of Loss from Consumer Litigation*

Although lending to homeowners with blemished credit does not by itself create the potential for losses sufficient to justify the increased prices and many of the practices in the subprime mortgage industry, there is still considerable risk of loss to investors. The risk of loss comes from lawsuits challenging the predatory activities, not from borrowers' failure to comply with the contract terms.[39] However, this risk of litigation resulting from the lender's own bad acts certainly does not justify higher charges, and should not be considered a valid reason to avoid regulation which might effectively stymie this type of credit.

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http://www.responsiblelending.org/CostofPredLend.pdf (last visited Feb. 1, 2002)) (last visited Feb. 28, 2002).

39. For example, United Companies and First Alliance Mortgage Company filed bankruptcy in recent years largely to protect themselves from litigation precipitated by predatory practices. Diana B. Henriques, *Troubled Lender Seeks Protection*, N.Y. TIMES, Mar. 24, 2000, at A1.

E. What Risks Justify High Costs?

According to studies by Freddie Mac,[40] and extensive analyses of the prospectuses of a variety of subprime lenders, annual losses rarely exceed three percent even in the lowest rated subprime mortgage loans.[41] Therefore, there is little justification for interest rates or fees which are at least fifty percent higher than those charged on prime mortgages.[42] Certainly there is no justification for the huge differential in rates and points, fees and costs currently charged by many subprime lenders.[43] Regulation which has the effect of preventing loans with unjustified costs will not prevent extensions of credit with justifiable rates.

One particularly outrageous practice of many predatory lenders is the charging of high fees and rates even though the homeowner's credit status qualifies for a lower cost loan. According to Fannie Mae, approximately half of all subprime

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40. *See* Howard Lax, Michael Manti, Paul Raca & Peter Zorn, *Subprime Lending: An Investigation of Economic Efficiency* (Feb. 25, 2000) (unpublished paper, on file with the author) (discussing a Freddie Mac study which compared the interest rates on subprime loans rated A-minus by the lenders originating these loans with the rates on prime loans purchased by Freddie Mac which Freddie Mac then rated A-minus using its underwriting model). Freddie Mac found that, on average, the subprime loans bore interest rates that were 2.15% [215 basis points] higher; the study could find no justification for such a large discrepancy. *Id.*

41. Typical subprime lenders experience annual loss rates below one percent of their loan portfolios. For example, Banc One reported in a March 1999 prospectus supplement that its net losses as a percentage of the average amount outstanding on all serviced mortgage loans was .78%. *See* Banc One Financial Services Home Equity Loan Trust 1999-2, Prospectus Supplement at S-20, *available at* http://www.sec.gov/edgarhp.htm (last visited Feb. 1, 2002). For example, Aames Financial Corp. reported in February 1999 that its actual annual losses as of December 31, 1998 were 1.08% of the serviced portfolio, and it estimated cumulative (i.e. not annual, but over the life of the loan pool) losses of 2.7% of the balance of loans securitized. Aames Financial Corp. 10-Q (Feb. 22, 1999), *available at* http://www.sec.gov/edgarhp.htm (last visited Feb. 1, 2002). A more conservative lender, New Century Financial, reported in March 2000 that its current loan production was a mix of about twenty-five percent "C" category loans, twenty percent "B" category loans, and fifty-five percent "A-"or "A" category loans. *See* New Century Home Equity Loan Trust Series 2000-NC1, Prospectus Supplement, form 424(b)(5) (Mar. 22, 2000) S-25, *available at* http://www.sec.gov/edgarhp.htm (last visited Feb. 1, 2002).

42. An interest rate of twelve percent is fifty percent higher than an interest rate of eight percent.

43. Eakes Testimony, *supra* note 4.

borrowers could qualify for lower cost conventional financing.[44] This practice is abetted by the industry habit of not reporting mortgage payment data to credit reporting agencies. The failure to report *positive* mortgage payment habits by homeowners actually helps these lenders hold homeowners captive in high cost lending relationships.

V. THE SHAPE OF REFORM: ADDRESS PREDATORY MORTGAGE LENDING BY EXPANDING HOEPA

The government, as well as the housing and lending industries, has done an excellent job in recent years of expanding programs to establish new homeownership opportunities for low-income families. The next challenge is to enhance the long-term sustainability of the homeownership experience for these families. The ultimate success of homeownership as an asset building strategy will be measured by the degree to which new homeowners are able to afford proper maintenance, avoid foreclosures, build equity in their homes, and use their equity effectively as wealth. As illustrated in Part I above,[45] the market does not work to protect homeowners from abusive mortgage loans.

In 1994, Congress passed HOEPA to prevent some predatory lending practices after reviewing compelling testimony and evidence presented during a number of hearings that occurred in 1993 and 1994.[46] This law created a special class of regulated closed-end loans made at high rates or with excessive costs and fees.[47] Rather than cap interest rates, points, or other costs for those loans, the protections essentially prohibit or limit certain abusive loan terms and require additional disclosures.[48] HOEPA's provisions are triggered if a loan has an APR of ten points over the Treasury security for the same term as the loan, or points equal to more than eight percent of the amount borrowed.[49]

44. *See Buyers and Cellars/More Blacks Using Subprime Lenders/Acorn: Borrowers Pushed into High-Cost Loans*, NEWSDAY (New York), Nov. 10, 2000, at C03.

45. *See supra* notes 14-17 and accompanying text.

46. 15 U.S.C. §§ 1601-1693s (2000).

47. *Id.*

48. *Id.*

49. *Id.* § 1602(aa)(1)(B) (2000).

It was hoped that HOEPA would reverse the trend of the past decade, which had made predatory home equity lending a growth industry and contributed to the loss of equity and homes for so many Americans. However, experience over the last six years has shown that while HOEPA has made a start at addressing the problems, there are still huge numbers of unprotected borrowers subject to the abuses of high cost home equity lenders.

The three most significant problems with HOEPA:

1. HOEPA does not in any way limit what the lender can charge as up-front costs to the borrower. It is the combined fees, closing costs, credit insurance premiums, and points, which deplete the equity in abusive loans. These excessive fees are charged over and over, each time the loan is refinanced. And, with each refinancing, the homeowner's equity is depleted by these charges because they are all financed in the loan.[50] The effect of this situation is to encourage lenders to refinance high cost loans because they reap so much immediate reward at each closing. If the law limited the amount of points and closing costs that a lender could finance in high cost loans, this incentive to steal equity would be stopped cold.

2. The interest rate trigger and the points and fees trigger in HOEPA are both too high, allowing many abusive lenders to avoid HOEPA strictures by making high cost loans just under the trigger.

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

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50. *See supra* notes 34-36 and accompanying text.

Other than these issues, HOEPA contains some good ideas. It is based on the economic rationale that the higher the charges for the loan, the more regulation is necessary and appropriate. By passing HOEPA, Congress has already recognized two essential truths: that there are some loans for which the marketplace does not effectively apply restrictions; and that government must step in to provide balance to the bargaining position between borrowers who either lack the sophistication to avoid bad loans or do not believe they have a choice if they want the credit.

Senator Sarbanes' (D-MD)[51] bill from the 106th Congress, the Predatory Lending Consumer Protection Act of 2000 (Predatory Lending Act) leaves the basic structure of HOEPA in place while expanding its coverage and prohibiting abusive terms not currently addressed in the law.[52]

A. Covering More High Cost Loans

The Predatory Lending Act covers more high cost loans in several ways. It lowers the annual percentage rate trigger to six points over the equivalent Treasury securities for first mortgage loans.[53] The Bill establishes an annual percentage rate trigger to eight points over the equivalent Treasury security for junior mortgage loans.[54] This has the effect of encouraging lenders to make second mortgage loans because they are permitted a higher interest before their loan is regulated. This will address the problem of high rate lenders refinancing low interest rate first mortgages with a higher rate loan just to extend slightly more credit to the homeowner. The Predatory Lending Act also extends the application to open-end lines of credit secured by the home.[55]

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51. Senator Sarbanes serves as Chairman of the Senate Committee on Banking, Housing and Urban Affairs. He also serves on the Joint Economic Committee, Senate Foreign Relations Committee, Senate Committee on the Budget; and he is Chairman of the Maryland Congressional Delegation. Biography: U.S. Senator Paul S. Sarbanes, http://sarbanes.senate.gov/pages/biography.html (last visited Feb. 1, 2002).

52. Predatory Lending Consumer Protection Act of 2000, S. 2415, 106th Cong. (2000).

53. *Id.* § 2(a).

54. *Id.*

55. *Id.*

This will address the spurious open-end credit that is quite prevalent in the predatory mortgage market. The Bill also includes all points and fees (explicitly including yield spread premiums paid to mortgage brokers) and credit insurance charges in the points and fees trigger, and limits it to five percent of the total amount of the loan.[56]

B. Providing More Substantive Protections for Covered Loans

1. Limitation on Financing of Points and Fees

A key regulation is the limitation on the financing of points and closing costs. Loans covered would be prohibited from financing all but three percent of the loan in points or closing costs.[57] To the homeowner, the worst abuse in the predatory mortgage market is the financing of high points and fees.[58] *The essential core of the Predatory Lending Act is in the expansion of HOEPA protections to prohibit the financing of points, fees and credit insurance premiums, and the charging of prepayment penalties.*

The Predatory Lending Act does not put a cap on the points or fees that can be charged for high rate loans; it only prohibits lenders from financing more than three percent of them.[59] Clearly, for most borrowers, prohibiting the financing of these charges will be the same as prohibiting the charges altogether, but this will not necessarily mean that these loans cannot be made. It will only mean that these fees will be rolled

56. *Id.* §§ 2(a), 4(a), 4(b).

57. *Id.* § 4(b).

58. In the Predatory Lending Act, the points and fees trigger includes *all* points, fees, and insurance charges. Predatory Lending Consumer Protection Act of 2000, S. 2415, 106th Cong. § 2(b) (2000). Under current HOEPA law, there are confusing rules to determine which fees and insurance charges are included in the trigger for up-front costs. For example, under current law, the HOEPA trigger excludes "reasonable" charges if they are not retained by the creditor and are not paid to a third party affiliated with the creditor. 15 U.S.C. § 1602(aa)(4)(C) (2000). Fees for appraisals performed by unaffiliated third parties would not be counted if only the direct cost is passed on to the borrower. *Id.* On the other hand, such a fee is counted if the cost is padded. *Id.* Determining what is "reasonable" for purposes of triggering coverage, however, is a difficult burden for homeowners to meet. The closing costs trigger should include all points and all fees for closing costs.

59. Predatory Lending Consumer Protection Act of 2000, S. 2415, 106th Cong. § 4(b) (2000).

into the interest rate charged to the borrower. The lender will pay the fees and recoup them through the interest payments on the loan. The rate of interest charged borrowers will increase, but the borrower's equity ownership in the home will be preserved. Additionally, there are indisputable advantages flowing from the limitation on financing of more than three percent in points and fees.

One advantage would be that less equity will be stripped from the home. The amount of money that the borrower owes interest on will be much closer to the amount which benefits the borrower. Every payment the borrower makes will reduce the loan amount. If there are repeated refinancings, the loan amount will not rise. The *equity* in the home is no longer the source of funding for the loan. Instead, the lender receives all income—and profit—on the loan from the borrower's payments made from the borrower's income.

A second advantage would be that the lender will have the incentive to make these loans affordable. Currently, a typical predatory mortgage transaction creates thousands of dollars of immediate profit to the lender upon sale of the loan to an investor. When the borrower refinances the loan, the lender sees a substantial profit, providing an incentive to the lender to encourage refinancings, regardless of whether the borrower can actually afford to repay the refinanced loan. Yet, if the lender only reaps a benefit from the loan through the *payments*, the lender has a clear incentive to make sure that the borrower can afford the payments.

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

2. Financing Credit Insurance Premiums

The Predatory Lending Act prohibits the financing of single interest credit insurance premiums, as well as the related product of debt cancellation agreements.[60] Mortgage borrowers rarely make a separate, considered decision to purchase these products. Credit insurance sometimes provides lenders with a substantial portion of their profits.[61] We[62] have found that the premiums are included in loan documents with little or no prior discussion with the homeowner, who is faced with the daunting prospect of canceling a loan at a closing as the only way to avoid this expensive add-on purchase.

The dual market for credit insurance products has a marked disparate impact on minority homeowners. As recent studies by HUD amply demonstrate, subprime mortgage lending is disproportionately concentrated in minority neighborhoods of major cities.[63] The same minority homeowners are paying the high cost of single advance premium credit insurance, while predominantly white homeowners with conventional mortgages are offered the less expensive monthly premium credit insurance products, which are also offered separately from the mortgage transaction.[64] There are significant financial incentives, creating a reverse competition in the sale of credit insurance.[65] It is the creditor which selects the insurance which will be sold to its customers, which leads the creditor to select the products most

60. Predatory Lending Consumer Protection Act of 2000, S. 2415, 106th Cong. §§ 4(a), 5.

61. *Equity Predators: Stripping, Flipping and Packing Their Way to Profits: Hearing before the Special Comm. on Aging*, 105th Cong. 2d Sess. 33-34 (Mar. 16, 1998) (statement of Jim Dough, former employee of predatory lender).

62. Testimony presented on behalf of several agencies, *supra* note 1.

63. *See, e.g.*, HUD, *Unequal Burden: Income and Racial Disparities in Subprime Lending in America* (April 2000) (discussing the results of studies conducted in Atlanta, New York, Baltimore, Los Angeles, and Chicago). Key findings of the Department of Housing and Urban Development analysis show that: (1) from 1993 to 1998, the number of subprime refinancing loans increased ten-fold; (2) subprime loans are three times more likely in low-income neighborhoods than in high-income neighborhoods; (3) subprime loans are five times more likely in black neighborhoods than in white neighborhoods; and (4) homeowners in high-income black areas are twice as likely as homeowners in low-income white areas to have subprime loans. *Id.*

64. *Id.*

65. *See generally* NCLC, COST OF CREDIT: REGULATION AND LEGAL CHALLENGES § 8.2.3.2 (2d ed. 2000).

profitable for it, the full cost of which is passed on to the homeowner. It is a profitable enough venture that some major lenders have their own insurance affiliates.

A recent study calculates that over two billion dollars in excess premiums were paid by borrowers in 1997.[66] Some estimates are that half of subprime mortgages have credit insurance, compared to six percent in the prime mortgage market.[67] Compensation ratios on credit insurance products range from approximately thirty-three percent for credit life to over fifty percent for credit unemployment.[68] Additionally, creditors often benefit from claims experience. This back-end stake gives creditors a financial disincentive to help homeowners through a claims process, which can be especially burdensome for credit disability insurance.

The remedy for this reverse competition is to only allow credit insurance to be sold when the premiums can be paid monthly, along with the loan payments, and the credit insurance can be canceled at any time.[69] The Federal Reserve Board and HUD specifically endorsed this proposal in their Report to Congress in July 1998.[70] Several state and local laws and

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66. *See id.* § 8.1.

67. *See* Comments of Self-Help and the Coalition for Responsible Lending on Docket #R-1090 (Feb. 20, 2001), *available at* http://www.responsiblelending.org/hoepa.htm (last visited Feb. 11, 2002).

68. *See* Mary Griffin & Birny Birnbaum, *Credit Insurance: The $2 Billion A Year Rip-Off*, at 3 (1997 figures) (March, 1999 Consumers Union and the Center for Economic Justice). The report notes that in Texas, commissions for auto dealers averaged around fifty percent, compared to an overall average of thirty-five percent for credit life and disability. *Id.* at 15. A 1999 SEC 10-K filed by American Bankers Insurance Group (now part of Fortis, Inc.) listed the following data for 1998: Operating expenses: 13.9%; *Commissions 43.7%*; benefits, claims, losses & settlement expenses, 35.5%. Am. Bankers Ins. Grp. 10-Q (Mar. 30, 1999), *available at* http://www.sec.gov/edgarhp.htm (last visited Feb. 1, 2002) (emphasis added). For the five-year period between 1994 and 1998, commissions ranged from 40% to 43.7%. *Id.*

69. Allegations of coercion in the sale of what is suppose to be a "voluntary" product have been the subject of federal enforcement cases and private litigation. *See, e.g.*, In re US LIFE Credit Corp. & US LIFE Corp., 91 F.T.C. 984 (1978), *modified on other grounds* 92 F.T.C 353 (1978), *rev'd* 599 F.2d 1387 (5th Cir. 1979); Lemelledo v. Beneficial Management, 674 A.2d 582 (N.J. Super. 1996).

70. Board of Governors of the Federal Reserve System, Department of Housing and Urban Development, *Joint Report to the Congress Concerning Reform to the Truth in Lending Act and the Real Estate Settlement Procedures Act*, July, 1998, at 74, *available at* http://www.federalreserve.gov/boarddocs/RptCongress/tila.pdf (last visited Feb. 9, 2002).

ordinances designed to stop predatory lending only permit this.[71] Further, several of the largest subprime lenders have announced, after significant public pressure, that they will forego the sale of single premium credit insurance on the mortgage loan products in the future.[72]

3. Prohibiting Prepayment Penalties

The prohibition against financing points, fees and credit insurance premiums only works if it is accompanied by a protection on the back end of the loan: a prohibition against prepayment penalties. Without such a prohibition, predatory mortgage lenders will still be able to strip equity and will not be forced to make their loans actually competitive.

Subprime lenders claim that borrowers voluntarily choose prepayment penalties to reduce their interest rates. Borrower choice cannot explain, however, why some seventy percent of subprime loans currently charge prepayment penalties and only two percent of conventional loans do (almost all in California). The real reason is that conventional mortgage markets are competitive, and sophisticated borrowers have the bargaining power to avoid these fees; borrowers in subprime markets often lack sophistication or are desperate for funds and simply accept the penalty that lenders insist that they take. The Predatory Lending Act addresses this issue by only allowing prepayment penalties to be charged if the loan is refinanced in the first twenty-four months and limiting the penalty to that amount of three percent of the loan amount that was not financed in the original loan.[73] The rationale for this is that three percent is sufficient to cover the lender's costs for making the loan; any more than that is

71. North Carolina's anti-predatory lending statute prohibits prepayment fees on most home loans under $150,000. N.C. GEN. STAT. § 24-1.1 (2001). Regulations for the states of New York and Massachusetts prohibit prepayment fees for borrowers with debt payments exceeding fifty percent of income or if fees, including insurance, exceed five percent of the loan. N.Y. COMP. CODES R. & REGS. §§ 41.1, 41.9 (2001); MASS. REGS. CODE. tit. 209 §§ 32.32, 40.00, 42.00 (2001) Illinois regulations prohibit these fees for "high cost loans." ILL. ADMIN. CODE tit. 38, §§ 160, 190, 345, 1000, 1050, 1075 (2001).

72. *See, e.g.*, Patrick McGeehan, *Third Insurer to Stop Selling Single-Premium Credit Life Policies*, N.Y. TIMES, July 21, 2001, at C3.

73. Predatory Lending Consumer Protection Act of 2000, S. 2415, 106th Cong. § 3(b) (2000).

unnecessary equity stripping. In this scheme the lender has the option of whether to charge all or part of the three percent up front or if there is an early prepayment of the loan. This aspect of the bill is crucial to clamping down on the frequent loan flipping which is the cause of the loss of equity.

4. Protections for Homeowners in Home Improvement Loans

Recognizing the high number of abuses which flow from home improvement loans, the Predatory Lending Act establishes new protections applicable to all *home improvement loans* secured by the home.[74] This home improvement law would ensure that: (a) homeowners have an effective method of enforcing their warranty rights, and (b) lenders are held responsible for the actions of home improvement contractors.[75]

One of the primary problems which arises from home improvement loans is the application of the "holder in due course" rule. This rule generally applies to purchasers of negotiable instruments, such as mortgage loans.[76] The holder in due course doctrine protects assignees of negotiable instruments from liability for the wrongdoing performed by the original lender though the borrower might be harmed.[77]

Thus, generally regardless of a home improvement contractor's wrongdoing, the homeowner's obligation to pay the lender/assignee continues as long as the assignee purchased the loan without notice of the fraud or other misconduct. In the mortgage context, the homeowner is left to pay the mortgage despite having perfectly valid claims and defenses arising out of the home improvement transaction. Problems often arise because some home improvement contractors are insolvent, or they

74. *Id.* § 3(e).

75. *See id.*

76. A promissory note is an unconditional promise to pay a fixed amount of money, with or without interest, that is payable to order or to bearer, is payable upon demand or at a definite time, and does not state any other undertaking. U.C.C. § 3-104(a), (e) (1990). The actual note or loan document signed by a borrower secured by a mortgage is ordinarily considered a negotiable instrument and bought and sold on the secondary mortgage market. For a more in depth discussion of this doctrine, see Julia Patterson Forrester, *Constructing a New Theoretical Framework for Home Improvement Financing*, 75 OR. L. REV. 1095, 1103-09 (1996).

77. *See* U.C.C. § 3-302.

disappear (and reincorporate under a new name or file bankruptcy) at the first hint of litigation.

In 1976, the Federal Trade Commission (FTC) passed a rule limiting the holder in due course doctrine for the purchase of consumer goods or services.[78] The purpose of the FTC Holder Rule is to give consumers the right to assert claims and defenses against creditors in situations where a seller provides or arranges financing and then fails to perform its obligations.[79] The FTC Holder Rule rightly shifts the risk of seller misconduct to creditors who could absorb the costs of misconduct.[80] While the FTC rule created some protection for consumers in this context, it is limited in several ways. First, the consumer rights provided by the FTC rule depend upon seller compliance in placing a required notice in the loan document. Second, recovery by the consumer for seller wrongdoing is limited to the amount paid under the consumer credit contract. Third, there is no private right of action to enforce the FTC rule.

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

5. Prohibit Mandatory Arbitration Clauses

Over the last few years, including mandatory arbitration clauses in consumer credit contracts has become standard operating procedure. Creditors use arbitration clauses as a shield to prevent homeowners from litigating their claims in a judicial forum, where a consumer friendly jury might be deciding the case. Arbitrators, who typically handle disputes between two businesses,

78. 16 C.F.R. §§ 433.1-433.3 (2001).

79. Forrester, *supra* note 76, at 39.

80. *Id.* at 1107-08.

are unfamiliar with consumer protection laws, and may be unsympathetic to consumers. Creditors also prefer arbitration because their exposure to punitive damage awards is dramatically reduced, and the threat of class actions is generally nullified.

Arbitration also limits discovery in most cases, benefiting the creditor, not the homeowner. Additionally, the arbitration may cost the homeowner far more than bringing an action in court.[81] By comparison, low-income consumers generally can file actions in court and waive all fees. And, homeowners lose their rights to appeal the arbitrator's erroneous interpretation of the law. This allows arbitrators to ignore state or federal consumer protection statutes and judicial precedent.

Consequently, any comprehensive law addressing predatory mortgage lending must include a prohibition against mandatory pre-dispute arbitration clauses. The Predatory Lending Act appropriately includes such a provision.

C. *Best Practices Promises by the Industry Will Not Stop Predatory Lending*

Recently, intense public pressure on lenders has yielded some partial, but significant changes in the way some lending companies say they will conduct their business. However, for a

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81. While arbitration proceedings can theoretically be inexpensive, lenders intentionally make their arbitration proceedings costly as an added deterrent to consumers pursuing their rights. This financial cost is exemplified by one of the few cases in which a predatory lending victim actually pursued "justice" in a lender required arbitration proceeding. Candace Truckenbrodt, a victim of the notorious lender, First Alliance Mortgage Co. (FAMCO), filed her claims in arbitration. Ms. Truckenbrodt was required to pay $1,350 merely to initiate the arbitration, a cost ten times greater than filing a case in federal court (unlike court proceedings, arbitration does not provide for the waiver of fees for consumers who are poor). Her total expenses were $2,377.14 to obtain, one year later, an arbitration ruling that denied her claims against FAMCO without any explanation and without any right to appeal. This is the same FAMCO that has been pursued by several Attorneys General (including Massachusetts, Illinois and Minnesota) for its predatory lending practices and has been found by the Federal Trade Commission to have engaged in deceptive lending practices. Truckenbrodt v. First Alliance Mortg. Co., No. 96 C 1822, 1996 WL 422150 (N.D. Ill. July 24, 1996) (on file with author); *see* In re First Alliance Mortgage Company, No. 00-964 Civ. (C.D.CA. Jan. 9, 2002); FTC v. First Alliance Mortgage Company, No. 00-964 (D. Ca. filed 2000), *available at* http://www.ftc.gov/os/2000/10/ firstalliancecmp.htm (last visited Feb. 3, 2002).

number of reasons, these concessions alone will be unable to protect consumers from the threats of predatory lending.

1. Permanence

Industry concessions can be withdrawn without any public input or recourse. In contrast, sound protections offered by legislation require public action by legislators who are accountable to their constituents.

2. Enforceability

Statutory prohibitions of predatory lending can provide a variety of enforcement options that are available to consumers, as well as local, state and federal authorities. On the other hand, the enforcement of corporate pledges is left to leadership of these institutions. Should a lender violate a pledge, it would likely face nothing more punitive than fleeting public disdain.

3. Scope

Of the few lenders who have made statements, none has promised to eliminate all of the abuses that exist in the marketplace. Thorough consumer protection cannot be provided piecemeal, with some lenders offering to stop some practices, while other lenders fail to offer consumers even such small guarantees. True consumer protection can only be provided through federal legislation that applies to all actors and addresses all abuses.

VI. INCREASED REGULATION WILL *NOT* REDUCE ACCESS TO LEGITIMATE CREDIT

The premise of HOEPA is that when rates or fees are charged which are considerably higher than the norm, additional regulation is appropriate. The higher the rates and fees, the more likely the loan is predatory, and the more necessary closer

regulation becomes.[82] When Congress first passed HOEPA, there was little concrete information available about the number of loans that would be affected by the triggers, or the extent to which credit availability would be limited by HOEPA. We[83] now have the data supplied by the staff of the Federal Reserve Board and other federal agencies,[84] and an analysis by Professor Cathy Mansfield.[85] Current information shows that while some subprime lenders charged as much as thirteen points above comparable treasury rates, the *median* subprime mortgage rates are typically four to five percentage points above comparable treasury securities. Thus, the bulk of subprime lending is well below the proposed eight or six point HOEPA triggers in the Predatory Lending Act.

Reducing the trigger to six points will not substantially affect legitimate subprime mortgage credit. However, loans above the trigger are highly likely to have predatory features, or involve borrowers at very high risk of default and foreclosure, for whom HOEPA protections are especially important. Professor Mansfield's data suggest that even a reduced cutoff of six points would affect fewer than twenty-five percent of loans made in the 1995 to 1999 period.[86] Yet, these are the loans most in need of the protective provisions of HOEPA.

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82. *See generally Problems in Community Development Banking, Mortgage Lending Discrimination, Reverse Redlining, and Home Equity Lending: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs,* 103d Cong., 1st Sess. 103-137 (Feb. 3-24, 1993); *Home Ownership and Equity Protection Act: Hearing on S. 924 Before the Senate Banking Comm.,* 103d Cong., 1st Sess. (May 19, 1993), *The Home Equity Protection Act of 1993: Hearings on H.R. 3153 Before the Subcomm. on Consumer Credit and Ins. of the House Committee on Banking, Finance and Urban Affairs,* 103d Cong., 2d Sess. (March 22, 1994); *Community Development Institutions: Hearing on 103-2, Before the House Subcomm. on Financial Inst. Supervision, Regulation and Deposit Insurance,* 103d Cong. 1st Sess. (Feb. 2-4, 1993).

83. Testimony presented on behalf of several agencies, *supra* note 1.

84. Comments of the National Consumer Law Center on Docket #R-1090 (Mar. 9, 2001) *available at* http://www.consumerlaw.org/predatory_lending/comments_frb.html#_ftn9 (last visited Feb. 11, 2002).

85. Cathy Lesser Mansfield, *The Road to Subprime "HEL"* Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market,* 51 S.C. L. REV. 473, 536-37 (2000) ("HEL" stands for Home Equity Lending).

86. *Id.* at 537. It should be noted that the HOEPA trigger is based on APR, which is generally higher than the interest rate. On the other hand, a significant difference between the APR and the interest rate on a long-term mortgage loan

To the industry's cry of reduced credit availability, the advocacy community responds: only bad credit will be reduced, not good credit. Because they fall so far outside the median, no amount of additional credit risk can justify these rates, without the added protections of HOEPA. The Federal Reserve Board commented on this point:

> A borrower does not benefit from . . . expanded access to credit if the credit is offered on unfair terms or involves predatory practices. Because consumers who obtain subprime mortgage loans have fewer credit options than other borrowers, or because they perceive that they have fewer options, they may be more vulnerable to unscrupulous lenders or brokers.[87]

We[88] agree with the Federal Reserve Board that access to predatory lending is not a benefit to homeowners.[89] Destructive credit is worse than no credit at all. This is evident in light of the increase in foreclosures, the disintegration of many low-income and minority neighborhoods,[90] and the erosion of the tax base of cities due to foreclosures. Further, we[91] maintain that access to credit will not be reduced if predatory mortgage lending is severely curtailed. Predatory mortgage loans have simply replaced other forms of credit that were not as devastating. For example, prior to the explosion in home mortgage lending, homeowners without access to mainstream banks typically obtained credit from finance companies. Small loans, typically with interest rates around thirty-six percent, and relatively high second mortgage loans, typically with interest rates of eighteen percent or more, provided

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results from very high pre-paid finance charges (points), which is another strong indicator of potential predatory practices.

87. Regulation Z, Truth in Lending, 65 Fed. Reg. 81,438, 81,441 (Dec. 26, 2000).

88. Testimony presented on behalf of several agencies, *supra* note 1.

89. Regulation Z, *supra* note 87.

90. *See* Abt Associates, *Analyzing Trends in Subprime Originations and Foreclosures: A Case Study of the Boston Metro Are*, (Sep. 2000) (on file with author); Woodstock Institute, *Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development*, Woodstock Institute (Nov. 15, 1999).

91. Testimony presented on behalf of several agencies, *supra* note 1.

needed credit to these households. While there were problems with these types of credit (as equated to what was available from banks, this credit was comparatively expensive) their use did not have the devastating impact on homeownership and communities that predatory mortgage lending has had in the past few years.

If the result of extended regulation is actually to reduce the numbers of mortgage loans available to homeowners with impaired credit, other avenues of credit will quickly open up. It does not make sense to encourage the use of home secured credit if that credit creates an increased risk of losing the home.

VII. OTHER FEDERAL LAWS SHOULD BE CHANGED TO ADDRESS THE PREDATORY MORTGAGE PROBLEM

Just as there are a number of causes for predatory mortgages, a panoply of changes to federal law and policies are necessary to terminate the worst abuses. In addition to amending HOEPA, as proposed by the Predatory Lending Act, other changes in federal law are also necessary. Set out below is an overview of the other changes we believe are necessary.

A. *Tax Reform to Encourage Preserving Home Equity*

The changes in the 1986 Tax Reform Act that only permit personal interest deductions for loans secured by residences[92] should be amended to limit home secured debt to debt which is not only secured by the home, but is also obtained for reasons relating to the home. Also, all individual taxpayers should be permitted some measure of deductions for unsecured personal credit. We[93] propose that changes to the tax code be essentially revenue neutral, to both the U.S. Treasury, and to most individual taxpayers, along the following basic guidelines. First, loans for home-secured debt should be tax deductible only for that portion of the loan which is related to the purchase, repair or improvement of the home or related property. Second, in exchange, all individual taxpayers should be provided with a percentage of their income, which can be deducted for expenditures spent for consumer debt. Existing home mortgage loans could be

92. I.R.C. § 25 (1999).

93. Testimony presented on behalf of several agencies, *supra* note 1.

grandfathered, such that the interest expenses for these loans would remain deductible, in recognition of the decisions that millions of taxpayers to date have made.

The effect of this small, but significant, change in the tax laws would be to remove the unhealthy incentives that too many American households are faced with to spend their home equity to pay off consumer debt. This change would encourage the decades-old national policy of encouraging and sustaining home ownership, and reverse many of the terrible consequences of the 1986 tax code.

B. *Federal Protections Should Be Established in Foreclosure Proceedings*

Given the alarming increase in foreclosures over the past two decades, federal law must provide some additional protections to borrowers losing their homes to foreclosure. There should be increased funding for housing counselors and mandatory notice regarding their availability. Good housing counselors can facilitate loan workouts on purchase money mortgages that preserve home ownership, prevent foreclosure, and reduce costs for lenders. Fannie Mae, Freddie Mac, and the FHA have implemented loss mitigation tools to avoid foreclosure and housing counselors are an essential part of that process. All mortgage lenders should be required to provide some support for housing counselors and notice of the availability of housing counselors should be required before any foreclosure can proceed.

Additionally, lenders should provide homeowners with the opportunity to pay off the arrearage and avoid foreclosure. Although this seems obvious and in the best interest of both parties, this is not always done. Lenders should be required to give notice to defaulting homeowners of the amount past due and the amount needed to avoid foreclosure prior to the addition of fees. The notice should list the various workout options available. These options have been accepted by Fannie Mae, Freddie Mac, and the FHA as appropriate loss management tools in the industry. Lenders should also be required to attempt to avoid foreclosure through various loan workout mechanisms. Further, a lender should not be permitted to unreasonably reject a workout proposal and simply proceed to foreclosure.

C. *Expansion and Extension of the Community Reinvestment Act*

The Community Reinvestment Act (CRA)[94] should be expanded so that all mortgages made by a bank, as well as its subsidiaries and affiliates, are considered when a CRA rating is determined. All mortgages which are considered predatory should be counted against a bank's CRA rating. Similarly, the Home Mortgage Disclosure Act (HMDA)[95] should provide better information about all mortgage loans made by financial institutions, including information about rates, points and fees charged, refinancings and foreclosures.

We[96] propose that for each loan that a bank or its subsidiaries or affiliates makes which fits *any one* of the following criteria, there should be explicit negative consequences such as, the loan should be counted *against* the bank's CRA rating:

1. *Loans with excessive costs.* Loans in which more than three percent of the total loan amount (or four percent if the loan is FHA-insured) consists of up-front points and fees.[97]

2. *Loans with higher annual percentage rates.* Loans in which the annual percentage rate equals or exceeds four percentage points (four percent) over the yield on United

94. The Community Reinvestment Act of 1977, Pub. L. No. 95-128, 91 Stat. 1147 (codified as amended in scattered subsections of 12 U.S.C. § 2401 (2000)).

95. Home Mortgage Disclosure Act of 1975, Pub. L. No. 94-200, 89 Stat. 1124, 1125 (codified as amended at 12 U.S.C. §§ 2801-2810 (2000)).

96. Testimony presented on behalf of several agencies, *supra* note 1.

97. Points and fees must be defined as: (a) all items listed in 15 U.S.C. §§ 1605(a)(1)-(4), except interest or the time-price differential; (b) all charges listed in 15 U.S.C. § 1605(e); (c) all compensation paid directly or indirectly to a mortgage broker, including a broker that originates a loan in its own name in a table-funded transaction; and (d) the cost of all premiums financed by the lender, directly or indirectly for any credit life, credit disability, credit unemployment or credit property insurance, or any other life or health insurance, or any payments financed by the lender directly or indirectly for any debt cancellation or suspension agreement or contract, except insurance premiums calculated and paid on a monthly basis shall not be considered financed by the lender. Total loan amount means the principal of the loan minus the points and fees.

States Treasury securities having comparable maturities at the time the loan is made."[98]

3. *Loans with prepayments penalties and other abusive terms.* Loans which (a) have a prepayment penalty provision; (b) have a clause allowing for the interest rate to increase upon default; or (c) negatively amortize at any point during the term.

4. *Loans in which credit insurance is financed.* Loans in which the lender financed, directly or indirectly, any credit life, credit disability, credit unemployment or credit property insurance, or any other life or health insurance, or any payments financed by the lender directly or indirectly for any debt cancellation or suspension agreement or contract, except insurance premiums or debt cancellation or suspension fees calculated and paid on a monthly basis shall not be considered financed by the lender.

5. *Loans which contain mandatory arbitration clauses.* Loans which contain a mandatory arbitration clause that limits in any way the right of the borrower to seek relief through the judicial process for any and all claims and defenses the borrower may have against the lender, broker, or other party involved in the loan transaction.

98. The equivalent yield for the Treasury securities should be determined by the following rules: (a) it should be adjusted to a constant maturity of a comparable term (as made available by the Federal Reserve Board) as of the week immediately preceding the week in which the interest rate for the loan is established; (b) if the terms of the home loan offers any initial or introductory period, and the annual percentage rate of interest is less than that which will apply after the end of such initial or introductory period then the annual percentage rate of interest that shall be taken into account for purposes of this subsection shall be the rate which applies after the initial or introductory period; and (c) in the case of an annual percentage rate which varies in accordance with an index, the rate shall be the maximum rate permitted at any time by the loan documents. *But see* Eakes Testimony, *supra* note 4 (arguing that lenders should be able to compensate for higher risk with increased interest rates).

D. *Increased Data Collection is Critical: The Home Mortgage Disclosure Act Should Cover All Mortgage Loans*

Effective enforcement of these rules requires sunshine. HMDA should be changed to require the full disclosure of all information for all subprime lending by all mortgage lenders, regardless of whether the loans are made by the lender, its subsidiary or an affiliate. Specifically, HMDA should require the following information about each loan:

- the annual percentage rate and interest rate of the loan;
- the principal amount of the loan and the amount financed (as defined by TILA);[99]
- the total closing costs, points and fees, and financed credit insurance premiums (and related products);
- the delinquency and foreclosure rates on an annual basis (for all subprime loans, as compared to other types of loans in the total portfolio); and
- the length of time between purchase and refinance, if any, on an aggregate basis.

VIII. CONCLUSION

Over the past two decades, misguided public policies spawned an environment where predatory mortgage lenders can pursue endless profits by stripping the home equity of homeowners pursuing the American dream. As a result, the foreclosure rate on American homes has quadrupled and many borrowers' sole asset has been legally stolen. The problem demands changes to the nation's lending and tax laws to protect borrowers from the unscrupulous, to discourage excessive home equity lending, and to ensure the stability and accessibility of homeownership for all Americans.

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99. 15 U.S.C. § 1601 (2000).