Testimony of Martin Eakes, CEO, Center for Community Self-Help
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On Predatory Mortgage Lending
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Mr. Chairman and members of the Committee, thank you for holding this important hearing to examine the problem of predatory mortgage lending and thank you for providing the Center for Community Self-Help the opportunity to testify before you today.

I testify as CEO of Self-Help (www.self-help.org), which consists of a credit union and a nonprofit loan fund. Self-Help is a 20-year old community development financial institution that creates ownership opportunities for low-wealth families through home and small business lending. We have provided $700 million in financing to help almost 11,000 low-wealth borrowers buy homes, build businesses and strengthen community resources. Self-Help believes that homeownership represents the best possible opportunity for families to build wealth and economic security and take their first steps into the middle class. Accumulating equity in their homes is the primary way most families earn the wealth to send children to college, pay for emergencies and pass wealth on to future generations, as well as develop a real stake in society. Self-Help has had significant experience making home loans available to families who fall outside of conventional guidelines because of credit blemishes or other problems, and our loan loss rate is well under 0.5% each year. Self-Help's assets are $550 million.

I am also chair of the Coalition for Responsible Lending (CRL). CRL (www.responsiblelending.org) is an organization representing over three million North Carolinians through eighty organizations, as well as the CEOs of 120 financial institutions. CRL was formed in response to the large number of abusive home loans that a number of lenders and housing groups witnessed in North Carolina. We found that the combination of the explosive growth in subprime lending, the paucity of regulation of the industry and the unsophisticated nature of most subprime borrowers have created an environment ripe for abuse. We discovered that too many families in our state - over 50,000 - have lost their homes, as well as the wealth they spent a lifetime building, because of harmful home equity lending practices. Some lenders, we found, target elderly and other vulnerable consumers (often poor or uneducated) and use an array of practices to strip the equity from their homes[1]. We even found that abusive lenders "flipped" 15% to 20% of Habitat for Humanity borrowers from their 0% first mortgages to high interest and high cost subprime loans.[2] Although a small percentage of mortgage brokers and lenders are responsible for these practices, the problem is large and growing.[3]

Through our experience, we have come to focus on three objective, loan-level abusive lending practices. While there are other practices that should be addressed, we believe that stopping these practices from occurring is crucial to protecting the wealth that families have invested in their homes.

1. Credit insurance premiums should not be financed into the loan up-front in a lump-sum payment. One type of credit insurance, credit life, is paid by the borrower to repay the lender should the borrower die. The product (or its functional equivalent, debt cancellation or suspension agreements)[4] can be useful when paid for on a monthly basis. When it is paid for up-front, however, it does nothing more than strip equity from homeowners, which is why Fannie Mae and Freddie Mac have both agreed not to purchase any loan that includes financed credit insurance. Conventional loans almost never include, much less finance, credit insurance.
2. The borrower should not be charged fees greater than 3% of the loan amount (4% for FHA or VA loans). Points and fees (as defined by HOEPA) that exceed this amount (not including third party fees like appraisals or attorney fees) take more equity from borrowers than the cost or risk of subprime lending can justify. By contrast, conventional borrowers generally pay at most a 1% origination fee.
3. Any loan that has a higher than conventional interest rate should not include a prepayment penalty.
    - Prepayment penalties trap borrowers in high-rate loans, which too often leads to foreclosure. The subprime sector serves an important role for borrowers who encounter temporary credit problems that keep them from receiving low-rate conventional loans. This sector should provide borrowers a bridge to conventional financing as soon as the borrower is ready to make the transition. High interest rate loans become abusive, however, when they prevent borrowers from escaping once credit improves, which is precisely what prepayment penalties are designed to do.
    - Prepayment penalties are the "glue" that enables broker-based racial steering. Lenders will pay a "premium" to mortgage brokers who sell unsuspecting borrowers higher-than-justified interest rates on loans, but only if they can lock the borrowers into the loans through prepayment penalties long enough to recover the premium. Recent studies have shown that minority borrowers in particular are steered into high-rate subprime loans when they in fact qualify for lower cost loans. And borrowers in predominantly African American neighborhoods are five times more likely to be subject to a prepayment penalty than borrowers in white neighborhoods.[5] The marketplace will help enforce fair lending principles and police steering if borrowers can get out of bad loans as soon as they realize they are harmed, but prepayment penalties prevent this from happening.
    - Borrower choice cannot explain the prevalence of prepayment penalties in subprime loans. Only 2% of borrowers accept

> prepayment penalties in the competitive conventional market, while, according to the Mortgage Information Corporation, 67% of subprime loans charge them.

CRL spearheaded an effort that resulted in the overwhelming passage of the North Carolina predatory mortgage law in 1999.[6] The bill was supported by associations representing the state's large banks, community banks, mortgage bankers, credit unions, mortgage brokers and realtors, as well as the NAACP, AARP, consumer, and community development and housing groups.

CRL supported the bill because, while not perfect legislation, it was consistent with our three principles. First, the bill outlaws financed up-front credit insurance altogether for all home loans. Second, it sets a fee threshold for "high cost" loans at 5%. If a loan reaches this threshold, a number of protections come into place: the lender cannot finance any up-front fees or make a loan without considering consumer's ability to repay the loan; the loan may not be structured as a balloon where the borrower owes a large lump sum at some point during the term or permit negative amortization; and the borrower must receive housing counseling to make sure the loan makes sense for his or her situation. Third, the bill does not allow prepayment penalties on any home loan of less than $150,000.

What Congress Should Do

The major federal law designed to protect consumers against predatory home mortgage lending is the Home Ownership and Equity Protection Act of 1994. HOEPA has manifestly failed to stem the explosion of harmful lending abuses that has accompanied the recent subprime lending boom. As I will describe below, through HOEPA, Congress did provide the Federal Reserve Board (hereinafter, the "Board") with significant authority to address these problems through regulation, but to date the Board has not taken advantage of this authority.

In the absence of Board action, strengthening HOEPA is important to protect homeowners from abuse. I recommend for the Committee's consideration two excellent bills: the legislation co-authored by Representative LaFalce and Senator Sarbanes as well as the bill introduced by Senator Schumer. Parenthetically, Representative Schakowsky's bill has many outstanding features, while the bill sponsored by Representative Ney would result in more abusive lending rather than less and would represent a substantial step back from existing law.[7]

A simpler step for Congress to take than to modify HOEPA at this point would be to repeal an obscure law -- the Alternative Mortgage Transaction the Parity Act of 1982 (the "Parity Act")[8] -- that has outlived its usefulness yet results in thousands of homeowners losing the equity in their homes. In the midst of the high interest rate environment of the early 1980's, thrifts generally made fixed-rate fixed-term mortgages and, because secondary markets were not well developed, were required to hold these loans in portfolio. Because of the asset-liability mismatches this created between long-term, fixed rate mortgages and short-term deposits, Congress passed the Parity Act to encourage thrifts to originate ARM's and other "alternative" mortgages, notwithstanding state limitations that might prohibit such lending. The Parity Act thus gave state-chartered institutions (depository and non-depository) parity with federal depository institutions to make such mortgages. If a state housing creditor followed this alternative federal scheme, it could enforce alternative mortgage transactions "notwithstanding any State constitution, law, or regulation."[9] The OTS role is to identify which of its federal thrift regulations would also apply to state housing creditors on alternative mortgage transactions.

However, the mortgage world has fundamentally changed since the Parity Act's passage 18 years ago. Thrifts can easily manage their asset-liability problems by selling off fixed-rate and term home loans through secondary markets, and "alternative" mortgages are now commonly accepted by state regulators. In addition, subprime lending has exploded and it has turned out that the most significant home lending abuses have been perpetrated by non-depository, largely unregulated finance companies and mortgage brokers. These lenders are able to structure their loans as "alternative mortgage transactions" and therefore take advantage of the Parity Act to preempt state protections.[10]

The best solution to the legacy of problems caused by the Parity Act is simply to repeal the legislation. It serves no good purpose anymore, and in fact, many unregulated non-depository institutions are taking advantage of federal preemption without any corresponding regulatory obligations. If the Parity Act were repealed, state housing creditors would not be able to use the federal law to avoid meaningful regulation by states. The Director of the Office of Thrift Supervision has supported repealing the Act.[11] To its credit, the OTS has issued Announced Notice of Proposed Rulemaking (ANPR) and particularly asked for comment on the Parity Act.[12] For reasons discussed below, Self-Help will suggest to the OTS that it stop allowing non-depository institutions to preempt state laws, like North Carolina's, that limit prepayment penalties by piggybacking on preemption that should only be available to regulated depository institutions.

What the Federal Reserve Board Should Do

CRL believes that the Federal Reserve Board is the regulatory agency with the most existing authority to address predatory lending practices. Chairman Alan Greenspan and Governor Edward Gramlich deserve credit for their recent statements noting the problem of predatory lending.[13] CRL believes that the Board should use the full extent of its existing regulatory authority to deal with this national problem, one that has only increased since the July 1998 HUD-Fed Joint Report Concerning Reform to TILA and RESPA. The Board's authority is primarily through issuing regulations under HOEPA, but also extends to the Home Mortgage Disclosure Act, and Community Reinvestment Act.

Specifically, CRL suggests the following (please see attached comments, which describe these suggestions in more detail[14]:

1. The Board should use its authority under HOEPA to prohibit certain specific abusive lending practices. HOEPA provides the Board with broad authority to prohibit unfair or deceptive mortgage lending practices and to address abusive refinancing practices. While this grant of authority occurs in HOEPA, Congress granted this authority for all mortgage loans, not just HOEPA loans defined as "high cost". Specifically, the Board should (1) prohibit the financing of credit insurance premiums for all loans, (2) prohibit prepayment penalties for loans with interest rates greater than conventional, (3) prohibit lenders from "flipping" borrowers through repeated fee-loaded refinancings, (4) outlaw balloon payments altogether for HOEPA loans, and (5) outlaw mandatory arbitration for HOEPA loans.
2. The Board should add certain charges to the HOEPA definition of "points and fees". The Board has the authority to add additional charges to the HOEPA definition of "points and fees". The Board should use this authority to add three charges currently excluded from "points and fees" that some lenders impose to evade HOEPA's protections:

    - The Board should include the costs of financed up-front credit insurance. Congress and the Board both identified this issue as one that might need to be addressed, and the problem has become evident in the five years since the implementation of HOEPA. CRL has seen a number of instances where financed credit insurance totaled 20% of the original loan balance, yet the borrowers still did not qualify for HOEPA protection.
    - The Board should include back-end lender payments to mortgage brokers. Such payments, known as yield-spread premiums, compensate a mortgage broker for putting a borrower into a home loan with a higher interest rate than the borrower actually qualifies for. The higher rate, particularly when coupled with a prepayment penalty, is equivalent to an up-front fee. Either way, the lender is guaranteed a certain number of "points" of compensation.
    - The Board should include prepayment penalties, since a higher interest rate plus a prepayment penalty is exactly the same as up-front discount points. Some will argue that a prepayment penalty is not a fee because it is contingent. However, if a loan is priced at the rate a borrower qualifies for, no prepayment penalty is needed since the borrower should be satisfied with the loan. If the loan is priced higher than the borrower qualifies for and has a prepayment penalty, the lender gets the certainty of receiving "points", since it either collects higher interest if the borrower does not prepay, or the penalty in the event the borrower does.

3. The Board should exercise its discretion under HOEPA to reduce the interest rate trigger for high-cost loans from 10% over comparable treasury rates to 8%.
4. The Board should improve HMDA disclosures.

- The Board should remove the HMDA reporting exemption for non-depository lenders whose mortgage lending is less than 10% of total loan originations.

- To fulfill the purposes of HMDA, the Board should add two data codes to the loan type field -- subprime and manufactured housing -- and add two data fields -- interest rate and HOEPA points and fees or total settlement charges. The main purposes of HMDA are helping determine whether lenders serve their communities' housing needs and identify possible discriminatory lending patterns. Requiring lenders to report these elements would provide objective information to help assess the meeting of needs and help root out the practice of steering minority groups to more expensive loans than they would otherwise qualify for.

5. Lenders should receive unfavorable CRA consideration for their or their affiliates' purchase, origination or facilitation of loans with harmful characteristics -- those with prepayment penalties if the loan's interest rate exceeds conventional rates, financed credit insurance premiums/debt cancellation or suspension fees, or "points and fees" of more than 3% (4% VA/FHA) as defined by HOEPA.
6. The Board should provide more scrutiny over the subprime lending operations of bank holding company subsidiaries and bank affiliates. The Board should take an expansive role in overseeing and monitoring potentially predatory activities of non-bank affiliates. When the Board cannot act on problems, it should make referrals to other agencies. Since many bank affiliates offer subprime loans, some lenders are engaging in abusive practices without effective oversight by the Board or anyone else.

What HUD Should Do

CRL strongly supports HUD's proposal to increase its affordable housing goal levels for Fannie Mae and Freddie Mac (the GSEs). CRL wants to ensure, however, that these goals do not have the unintended consequence of promoting secondary market activities that lead to the origination of more loans with harmful characteristics.[15]

The GSEs participate in the burgeoning subprime mortgage market in four ways: by purchasing subprime loans directly, by guaranteeing GSE mortgage-backed securities backed by these loans, by purchasing private-label securities backed by subprime loans, and by "wrapping" (guaranteeing the senior portions of) these private subprime securities. Through this participation, the GSEs have an unparalleled opportunity to reduce harmful lending practices by enforcing positive standards on the industry. In fact, strong GSE subprime lending standards are one of the best hopes we have for reforming an industry that strongly needs reformation.

For example, Fannie Mae's Timely Payments Reward product provides a superb model for how subprime lending should occur: upfront fees are limited, financed credit insurance and prepayment penalties are prohibited, the interest rate is reasonable given the slightly higher risk, and the loan provides a bridge to a lower conventional-type rate as credit improves and payment performance becomes proven. GSE products of this type provide a service to borrowers, significantly improve the subprime industry and justify GSE involvement in subprime lending, since subprime, as well as prime, borrowers should be allowed to reap the benefits of GSE activities.

If, however, the GSEs simply provide greater liquidity to subprime loans that strip equity from vulnerable consumers, then their efforts will have done far more harm than good, even if subprime interest rates fall slightly as a result of their work. HUD should ensure that establishing higher affordable housing goals does not inadvertently provide the GSEs an incentive to increase their participation in subprime loans that may have harmful characteristics. CRL therefore recommends that HUD give the GSEs full affordable housing goal credit for subprime loans that adhere to wealth-preserving lending standards. The GSEs should be encouraged to fund responsible loans to families that fall outside of prime standards; these borrowers need good financing just as prime borrowers do.

Conversely, however, CRL believes that HUD should not allow the GSEs to purchase loans with harmful characteristics at all. If HUD determines that it lacks the authority for such a requirement, at a minimum, HUD's final rule should disallow goals credit for loans that include harmful, wealth-depleting terms, defined as loans that violate one or more of CRL's three principles.

In addition to not receiving affordable housing goals credit, the GSEs should be required to disclose all harmful loans that they become involved in. Disclosure of information regarding prepayment penalties, financed upfront credit insurance or DCAs, total HOEPA-defined points and fees, and interest rates would provide valuable data on the pervasiveness of these practices in the subprime mortgage industry, as well as GSE support for these activities. Finally, as the safety and soundness regulator for the GSEs, HUD, through OFHEO, should recognize that loans with harmful characteristics are inherently risky loans.[16] When borrowers have equity stripped away, their loans are at significant risk of default and the actual collateral value may often be less than the loan amount. Therefore, HUD should impose higher risk-based capital requirements for loans with harmful characteristics.

In summary, if Congress will take this opportunity to repeal the outdated Parity Act, if the Board will use the full extent of its discretion to address abusive lending practices, and if HUD will ensure that the GSEs are not rewarded for promoting loans with harmful characteristics, then we will have come a long way to making sure that family home equity wealth is protected.

Thank you for the opportunity to testify before this Committee today. I am happy to answer any questions and to work with the Committee in the future.

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[1] See an example loan document at www.responsiblelending.org/hud1.pdf. Note that the borrower in this case needed $53,755.22 to pay off other debts. But total loan amount was $76,230.12, a difference of over

$20,000. $5,000 was dispersed to borrower. The bulk of the rest of the fees are a $4,063 origination fee and an $11,630 up-front credit insurance premium. The loan also includes a $63,777.71 balloon payment due at the end of the 15 year term. This is not an atypical case. Abusive lenders often obtain a list of homeowners in lower-middle class neighborhoods and target those with high equity, low-income and credit blemishes. The sales pitch focuses on lowering monthly payments by consolidating debts, getting cash for a vacation, or other needs. The unwitting borrower signs the loan, not realizing it is packed with credit insurance premiums, high origination fees, hidden balloons (that allow the lender to charge high fees AND show a lower monthly payment) and/or prepayment penalties that lock the borrower into the loan. And then, if there is more equity left, the same lender or broker or another lender will come and offer to refinance the loan again (or "flip it") and charge high fees once more.

[2] See http://www.responsiblelending.org/PL%20Issue%20-%20Habitat%20FAQ.htm

[3] See Senator Grassley's March 1998 Aging Committee hearings: http://www.senate.gov/~aging/hr14.htm. See also New York Times Special Report by Diana Henriques with Lowell Bergman: MORTGAGED LIVES: A SPECIAL REPORT: Profiting From Fine Print With Wall Street's Help, March 15, 2000, Section 1, page 1 (companion piece ran on ABC's 20/20 the same night), and The Woodstock Institute Report: Two Steps Back, November 1999 at www.woostockinst.org/2steps.pdf.

[4]see http://www.responsiblelending.org/Credit%20Insurance%20Financing.htm

[5] See footnotes 13, 14, p. 6 of attached document: CRL Suggestions for Federal Reserve Board to Address Abusive Home Lending Practices, May 19, 2000. http://www.responsiblelending.org/FEDsug.htm

[6] A copy of the NC law (session law 1999-332) and many other documents on predatory lending can be found at www.responsiblelending.org.

[7] See CRL analysis of Ney bill at http://www.responsiblelending.org/Ney1.htm and http://www.responsiblelending.org/Ney4.htm.

[8] Title VIII of the Depository Institutions Act of 1982, 12 U.S.C. §3800 et seq., P.L. 97-320, 96 Stat. 1469 (Oct. 15, 1982).

[9] 12 U.S.C. 3803(c).

[10] See http://www.responsiblelending.org/pactcite.PDF for link to standard Associates Financial Services of America note that references Parity Act preemption, presumably for state laws limiting prepayment penalties.

[11] See April 5, 2000 American Banker, "Moving Against Predators, OTS takes Aim at Loophole" by Kevin Guerrero. See also April 4 OTS press release at http://www.ots.treas.gov/docs/77038.html.

[12] See OTS April 3, 2000 Notice of Proposed Rulemaking - Responsible Alternative Mortgage Lending at http://www.ots.treas.gov/docs/73083.pdf

[13] See Chairman Greenspan's March 22, 2000 remarks at the National Community Reinvestment Coalition conference and Governor Gramlich's April 14, 2000 remarks at the Fair Housing Council of New York, in Syracuse.

[14] CRL recommendations also available at: http://www.responsiblelending.org/FEDsug.htm. Credit Insurance amortization tables at: http://www.responsiblelending.org/Financing.PDF.

[15] CRL comments at: http://www.responsiblelending.org/HUD%20Goals%20Comments.htm

[16] CRL comments to OFHEO at http://www.responsiblelending.org/OFHEO%20comment.htm