Statement of Martin Eakes
Before the Federal Reserve Board
On Home Ownership and Equity Protection Act
June 14, 2007

Governor Kroszner and members and staff of the Board, thank you for holding this hearing about how the Board might use its rulemaking authority under section 129(l)(2) of HOEPA to address abusive lending practices and the problems of foreclosures. And thank you for the invitation to speak today.

On the most fundamental level today we are talking about people's homes – their wealth and family's future – and their chances for long-term, sustainable homeownership. For borrowers currently at risk of foreclosure because they have been placed in an unsuitable exploding ARM, we must reform the market so either their next loan will be one that they can maintain for the life of the loan, or their servicers will provide a permanent modification that will enable they to stay in the loan. Equally important, for families who thus far have avoided being placed into an unsustainable subprime loan, we must make sure that they never will be. And for the communities in which both sets of borrowers live, we need to make sure they do not become devastated by foreclosures and remain viable places in which to live.

I testify as CEO of Self-Help (www.self-help.org), which consists of a credit union and a non-profit loan fund. For the past 26 years, Self-Help has focused on creating ownership opportunities for low-wealth families, primarily through financing home loans. Self-Help has provided over $5 billion of financing to over 55,000 low-wealth families, small businesses and nonprofit organizations in North Carolina and across the country, with an annual loan loss rate of under one percent. I write not as an opponent of subprime lending, but rather as one who has eagerly participated in this sector with the goal of enabling low-income and families of color to buy homes and build wealth. I am also CEO of the Center for Responsible Lending (CRL) (www.responsiblelending.org), a not-for-profit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices.

There is an urgent need to address the epidemic of foreclosures in the subprime market today—the highest rate of home losses in the modern mortgage era. Subprime lenders have virtually guaranteed rampant foreclosures by approving dangerous loans, recklessly underwritten, for families who will not be able to pay the loans back. The current wave of foreclosures facing cities in states such as Ohio makes clear that waiting until further damage is done is not an appropriate course of action.

Some areas of the country will suffer enormously from subprime foreclosures, and so will specific communities and racial and ethnic groups. People who lag the farthest behind in homeownership—African-Americans and Latinos—have had billions of dollars of wealth drained through foreclosures and equity stripping caused by dangerous loan products and

serial refinancings. It is likely that subprime mortgages could cause the largest loss of African-American wealth in American history.

Even in the midst of the current epidemic of foreclosures, market forces have not reined in abusive lending. A review by CRL of securitized loans during the first quarter of this year showed that a high share of subprime loans continue to have abusive features (82% penetration rate for hybrid ARMs, 72% had prepayment penalties and 43% were stated income). Subprime lenders are continuing to make loans packed with dangerous features, and they will continue to do so until their abusive products and practices are declared illegal. For example, Countrywide recently stated that it intended to continue to make hybrid subprime ARMs underwritten just to a teaser rate until it is required to stop.

Federal neglect has played a critical role in this situation. Thirteen years ago Congress required that the Board prohibit mortgage lending acts and practices that are abusive, unfair or deceptive. During that time, borrowers, state regulators, and advocates have repeatedly raised concerns about abuses in the subprime market. Seven years ago, members of the House Banking Committee urged the Board to use its authority under HOEPA to pass regulations banning predatory lending practices that were already devastating consumers. At that time, Representative Leach told the Board:

> [C]ongress…passed a law which was very strong in its sense of purpose in outlawing predatory lending, in effect, and then because Congress felt that the subtleties of this were beyond Congress, we gave to Federal regulators, most specifically the Federal Reserve Board of the United States, the authority to make definitions and to move in this direction….So the question becomes, if there is a problem out there, if Congress has given very strong authority to regulators and the Federal Reserve, our regulators, is the Federal Reserve AWOL?[1]

This is not an area where the Federal Reserve plays the function of setting monetary standards or supervising financial institutions—areas where it is entirely appropriate for the Agency to balance differing economic interests. Here, Congress has assigned the Federal Reserve the responsibility of enforcing a consumer protection principle, acting on behalf of Congress to ensure that consumers do not receive abusive loans.

We applaud the Board for the recent issuance, with the other banking and credit union regulators, of the Proposed Statement on Subprime Lending, which we hope will be finalized quickly and without weakening any of its protections. But the Statement alone is insufficient, applying to only the portion of the subprime market that is originated by depositories or their affiliates, leaving no similar protections for consumers that borrow from state-chartered finance companies.

We are asking the Board to enact clear, bright-line rules, applicable to all mortgage lenders, to protect consumers from predatory lending practices ubiquitous in the subprime market today. The Board responded to Rep. Leach's plea in 2001 by, most significantly,

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[1] Representative Leach, May 24, 2000. House Banking Committee's "Predatory Lending Practices" hearing. Available at http://commdocs.house.gov/committees/bank/hba64810.000/hba64810_0.HTM.

including single premium credit insurance in the definition of points and fees to be considered high cost under HOEPA. Today, the need is to address basic underwriting failures by subprime lenders under section 129(l)(2) for all subprime loans. The Board not only has the authority, but also the statutory obligation, to address these lending abuses under HOEPA.

The Board has a mandate to prohibit unfair **or** deceptive mortgage lending practices and to address abusive refinancing practices. A practice is *unfair* if it causes (or is likely to cause) substantial injuries that reasonable consumers could not avoid (and is not outweighed by countervailing benefits to consumers or competition).[2] A practice is *deceptive* if it is likely to mislead reasonable consumers and the misleading representation (or act or omission) is material.[3]

Let me give you examples in each of the areas you asked us to focus on today:

Ability to Repay

Approving loans without evaluating a borrower's ability to repay is both an unfair and a deceptive practice because borrowers are deceived into thinking that they can afford the loans, and they are too often subjected to the ultimate of injuries – the loss of their home and hard-earned equity – when rates increase, as scheduled, after two or three years. **Lenders therefore should, at a minimum, be required to underwrite all loans based on the fully-indexed rate and fully amortizing payments, while using a debt-to-income standard (DTI) that considers property taxes, hazard insurance, and other debts, and it should be an unfair and deceptive practice to fail to do so.**

Escrows for Taxes and Insurance

In stark contrast to the prime mortgage market, most subprime lenders make loans based on low monthly payments that do not escrow for property taxes or hazard insurance. By routinely omitting escrows for taxes and insurance, subprime lenders have deceived borrowers into believing that their mortgage will be affordable when, in fact, it may well not be, and into believing that their mortgage will be cheaper than a responsible lender who does escrow. This deceptive practice is also unfair, since borrowers are often required to refinance their mortgage to raise the funds to pay the required fees, needlessly causing substantial injuries of approximately 8% of the loan amount (3% in upfront points and fees, 2% in third party fees, 3% in prepayment penalties), or $12,000 for a $150,000 loan. For those borrowers unable to refinance, foreclosure often becomes necessary. **The Board should declare that it is an unfair and deceptive act or practice to (A) exclude from the repayment analysis of a subprime loan the cost of hazard insurance and property tax escrows and (B) to fail to escrow taxes and insurance in subprime loans.**

[2] F.T.C. Policy Statement on Unfairness, *2-3 (Dec. 17, 1980) (Appended to *International Harvester Co*., 104 F.T.C. 949, 1070 (1984)).
[3] F.T.C. Policy Statement on Deception, *1-2 (October 14, 1983) (Appended to *Cliffdale Associates, Inc*., 103 F.T.C. 110, 174 (1984)).

Stated Income and Low Doc Loans
The misuse of stated income and low doc loan products and the failure to verify income is an unfair and deceptive practice because, while lenders purport to evaluate borrowers and underwrite loans, in reality, without adequate documentation, a lender's approval of a loan is meaningless. This practice is deceptive because borrowers often do not understand that they are paying extra higher interest rate not to document their income, even though their W-2's are readily available, or that their income is overstated; it is unfair because it increases the interest rate borrowers pay for no reason and has been proven to overstate incomes, understate repayment ability, and therefore increase foreclosures. Fitch recently noted that "loans underwritten using less than full documentation standards comprise more than 50 percent of the subprime sector . . .." "Low doc" and "no doc" loans originally were intended for use with the limited category of borrowers who are self-employed or whose incomes are otherwise legitimately not reported on a W-2 tax form, but lenders have increasingly used these loans to obscure violations of sound underwriting practices. **The Board should declare that a lender's failure to verify and document all sources of income using either tax or payroll records, bank account statements or any reasonable alternative or third-party verification is unfair and deceptive.**

Prepayment Penalties
Prepayment penalties are an unfair practice in the subprime market because they provide no economic benefit to consumers. The fact, as shown on subprime rate sheets, that they allow mortgage brokers to lock in high yield spread premiums has the result, we've shown, of not decreasing interest rates on subprime loans even though they can cost borrowers thousands of dollars. In fact, prepayment penalties serve to trap borrowers in high cost loans, or cause the borrower to lose significant home equity in order to escape them. They also limit the ability of responsible lenders to help borrowers refinance out of a loan at risk of ending in foreclosure. The high penetration rates of prepayment penalties (almost two-thirds of subprime loans include prepayment penalties) coupled with a lack of economic benefit to the borrower demonstrate that these penalties are also deceptive in the context of subprime loans—there is no way that borrowers choose prepayment penalties in such high numbers when they should want to maximize their chances of escaping higher cost or even dangerous products to prime products. The unfairness of prepayment penalties is even more disturbing when you consider that they are more prevalent on subprime loans in communities of color. **These penalties should be banned for all subprime loans as an unfair and deceptive term.**

And I would add a fifth area of concern: accountability.

Accountability
Finally, to effectively address subprime abuses, it is important to take a stronger approach to addressing the unfair and deceptive tactics that brokers use to push subprime refinances on borrowers. In today's marketplace, three-quarters of subprime loans are brokered, which is an extremely lightly regulated industry. It is brokers who most commonly present borrowers with loans that appear affordable, highlighting a low

monthly payment without presenting hidden costs like taxes and insurance payment requirements, prepayment penalties on the back end, or exploding interest rates, because the broker will receive higher compensation for that loan. And lenders should not be allowed to use their profitable relationships with brokers as a shield to make abusive loans – lenders cannot simply offload the responsibility to place borrowers in loans they can afford. At a minimum lenders must engage in proper due diligence of the brokers they use and the brokered loans themselves. **The establishment of lender liability for broker acts and omissions is a critical step to clamp down on unfair, deceptive and abusive practices.**

Just as lenders should be held accountable for the abusive exploding ARMs and the willful disregard of a borrower's ability to repay, **regulations to prohibit the deceptive subterfuge occurring with abusive piggy-back second mortgages should also be put into place**. An ability to repay standard could be rendered meaningless if we don't make sure that originators are not simply splitting the loan into two loans (80% first, 20% second) without underwriting the costs of both to circumvent the law and force borrowers into situations where they cannot afford to stay in their homes. Abusive uses of piggy-back seconds (and piggy-back seconds with abusive terms) are of great concern—and it appears that approximately 50% of subprime borrowers have piggy-back second mortgages.

As to all of these practices, mere "disclosures" are insufficient. This is true both legally and practically. As a legal matter, HOEPA provides that the Board "shall prohibit" – not merely require disclosure of – acts and practices found to be unfair, deceptive, or (with respect to refinance transactions) abusive or not in the interest of the borrower. As a practical matter, consumers are overwhelmed with paper at a closing, and even sophisticated consumers can find themselves confused or misled.

We applaud the Board for focusing on these issues today, and urge prompt action to promulgate the regulations that I describe. I look forward to answering any questions. Thank you.