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Hearing on Predatory Lending Before the
House Financial Services Subcommittee on Financial Institutions and Consumer Credit
and the Subcommittee on Housing and Community Opportunity.

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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 for allowing me to testify before you today. I am proud to be representing both Self-Help and the Coalition for Responsible Lending.

Although I am relatively new to Self-Help, which opened an office here in Washington this year, I have many years of experience in community and economic development. Before joining Self-Help, I founded and led the Far SW-SE Community Development Corporation, which raised almost $2 million of equity for the revitalization of a commercial strip in the District of Columbia community this CDC serves. I have also held government posts, serving as the District's Deputy Mayor for Economic Development and, earlier, as Associate Deputy Assistant Secretary for Neighborhoods with the U.S. Department of Housing and Urban Development. Many years ago, I worked with Bank of America as it developed its community reinvestment program. I speak on behalf of Self-Help and the Coalition for Responsible Lending, but also with deep personal conviction that predatory lending devastates communities and with great certainty that Self-Help's and the Coalition's approaches to the problem are workable and fair.

As a community development financial institution—consisting of a credit union and a nonprofit loan fund—Self-Help is dedicated to helping low-wealth borrowers buy homes, build businesses, and strengthen community resources.[1] Self-Help has provided over $2.6 billion in financing in 48 states since its founding in 1980. Through our loans, we have created or maintained approximately 17,500 jobs, 18,775 child care slots, and 8,000 public charter school spaces. We have also enabled more than 33,400 families to become homeowners for the first time. Because we seek to serve those who have traditionally been denied access to credit, our loans go disproportionately to women, African Americans, Latinos, and rural borrowers. Also, because we lend only to borrowers who cannot access conventional prime home loans, we have a lot in common with subprime lenders. Despite the claims of many in the industry that our borrowers are too risky to serve (or too risky to serve without practices we consider abusive), our overall loan loss rate is less than one-half of one percent per year, and our assets have grown to over $1 billion.

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[1] Self-Help has created an affiliate, the Center for Responsible Lending, to serve as a national research and resource for policymakers and community leaders dedicated to countering predatory lending.

The Coalition for Responsible Lending represents over three million people through eighty organizations, as well as the CEOs of 120 financial institutions. The Coalition was formed in response to the large number of abusive home loans that threatened the most vulnerable members of North Carolina communities. In 1999, the Coalition spearheaded an effort to enact market-based, common sense state legislation that would protect borrowers from predatory lending practices.

In my comments today, I will address three questions. What is the nature of the predatory lending problem? How effective have state efforts, particularly the North Carolina law, been at addressing predatory lending? Finally, how can states and the federal government best work together to deal with this pernicious issue? Before going on at greater length, I'd like to share the short answers that provide direction for Self-Help and the Coalition.

First, we recognize that predatory lending is a widespread problem, one we estimate is costing U.S. families $9.1 billion each year. We know from experience that predatory lenders primarily use exorbitant and anti-competitive fees to rob families of the home equity wealth that could otherwise be used to send children to college, start small businesses, weather crises such as unanticipated medical expenses, and enjoy some measure of security in old age.

Second, we believe that market-based solutions will work best. The North Carolina legislation <u>does</u> <u>not</u> cap interest rates beyond the limits established in the federal Home Ownership and Equity Protection Act of 1994 ("HOEPA"). Rather, it encourages lenders to limit fees. In this way, credit risk is reflected in rates, and loan balances do not become inflated by the financing of fees. We came to this solution out of frustration at our inability to help borrowers who were locked into fee-laden loans.

The problem of excessive fees is two-fold: the fees seem painless at closing and they are forever. They are deceptively costless to many borrowers because when the borrower "pays" them at closing, he or she does not feel the pain of counting out thousands of dollars in cash. The borrower parts with the money only later, when the loan is paid off and the equity remaining in his or her home is reduced by the amount of fees owed. In addition, the fees are forever because, even if another lender refinances a family just one week later, the borrower's wealth is still permanently stripped away.

In short, abusive loans were stripping equity from low-wealth families faster than we were helping them become homeowners in the first place. Consequently, the North Carolina law prohibits or discourages unfair and abusive fees and prohibits the "flipping" of loans for fee generating purposes.

Research shows that North Carolina's approach is working. In the great spirit of cooperative federalism, other states are learning from and improving upon our example. Moreover, North Carolina is learning from the efforts in other states. Following the lead of several other states, our legislature amended the North Carolina law this year to bring open-end loans within its scope.

Finally, we believe the federal government is facing a choice to either continue its partnership with states in the effort to protect the hard-earned wealth of American families or destroy the ability of states to protect their homeowners. We believe that it is crucial that the current partnership be maintained. While the Federal government initially set the floor for home loan protections in the Home Ownership and Equity Protection Act of 1994 (HOEPA), states have built upon that framework. But, perhaps more impressively, federal agencies have learned from states and incorporated new higher standards into the federal floor. Indeed, echoing state actions, the Federal Reserve Board has addressed the harmful practice of financing credit insurance within the rubric of HOEPA and the Office of Thrift Supervision has restored states' ability to regulate prepayment penalties on home loans. These are prime examples of how state and federal efforts can be complementary. At the same time, while a national floor of consumer protections could help many, federal preemption of state laws—the creation of a ceiling above which states may not protect their own citizens--would needlessly cut off states' pioneering efforts to address predatory lending. The ultimate burden of such a loss would be borne by U.S. homeowners left unprotected from predatory lending abuses.

## I. PREDATORY LENDING IS PERVASIVE, (USUALLY) PERFECTLY LEGAL, AND DEVASTATING TO FAMILIES AND COMMUNITIES.

Subprime lending generally describes loans made to individuals who do not meet the criteria for mainstream (also called "prime") loans. Lending in the subprime market has exploded in the past decade[2], increasing from $34 billion in 1994 to $213 billion in 2002.[3] While by no means are all subprime loans predatory, almost all predatory loans are subprime. As a result of the growth of subprime lending, the pressing issue today is no longer the availability of credit in America's communities. Rather, the debate has shifted to the terms on which credit is offered.

Predatory lending is a term used to describe a set of abusive home lending practices that deprive homeowners of hard-earned equity. The combination of tremendous growth in subprime lending, the lack of standards for this rapidly growing industry, and subprime borrowers' frequent lack of financial sophistication has created an

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[2] The rise in subprime lending far exceeds the rise in homeownership by those in the subprime market, as most subprime loans are made to refinance debt. Some subprime lenders actively market refinancing to families who have significant equity in their homes; some market new loans to families who own their homes outright. Borrowers are encouraged to put their driveways and living rooms at risk in order to buy or hold onto cars and furniture.

[3] The substantial growth in the subprime market has had a disproportionate impact on low-income homeowners, particularly members of minority groups. After analyzing almost one million mortgages reported to HMDA in 1998, HUD found that subprime loans are five times more likely in black neighborhoods than in white neighborhoods. Homeowners in high-income black neighborhoods are twice as likely as homeowners in low-income white neighborhoods to have subprime loans. "Unequal Burden: Income & Racial Disparities in Subprime Lending in America," U.S. Department of Housing and Urban Development (April 2000).

environment ripe for abuse. The headlines from business pages around the country speak of those who have taken advantage of this environment. For example, in August 2003, Household International, Inc. agreed to settle claims of predatory lending practices brought by state attorneys general and financial regulators. The monetary settlement was $484 million nationwide.

While large, collaborative enforcement actions have been met with well-deserved cheers, we cannot be complacent. Cases such as Household are both remarkable and, relative to the scope of the predatory lending problem and the human toll it exacts, insufficient. (Certainly, receiving modest monetary relief of approximately $1,500 per loan years after losing one's home is better than nothing—but such an outcome does not exactly represent an ideal solution.) Current federal law does not address many widespread abuses, such as fee-packed refinancing loans that offer no benefit to the borrower (flipping) and exorbitant prepayment penalties for repaying the balance of a subprime home loan early—and state laws have just begun to address these issues. Indeed, many victims of predatory lending lose equity in their homes every day without the slightest public attention to their plight. Moreover, even where laws protect homeowners, many subprime lenders have sought to preclude private legal action through pre-dispute mandatory arbitration clauses designed to frustrate such efforts.

The stories of individuals who have been callously preyed upon by predatory lenders could fill volumes. For instance, a borrower from Wilmington, North Carolina, an African American widow who worked as an elementary school janitor, has lost title to her home to a predatory lender. Her husband had bought a house with a low-rate Veterans Affairs loan with generous forgiveness features. He later died of complications from injuries sustained in Vietnam. In 1997, Chase Mortgage Brokers (no relation to JP Morgan Chase) refinanced this woman's loan at 13 percent interest, charging 10 percent in fees. Six months later, the same company flipped her, refinancing the loan and accumulating more fees, which then totaled $17,000. In 1999, the woman faced foreclosure. She now rents the same house from the foreclosure buyer at above-market rent because it's her daughter's only connection to her father. I wish I could tell you that this story is an isolated example, but we have seen the dynamic play out time and time again—and the United States Departments of Treasury and Housing and Urban Development have documented these abuses in a joint report.[4]

Because predatory lenders are known to target certain neighborhoods, the odds are good that one victim of predatory lending lives down the street or around the corner from another. In this way, whole communities are affected, especially when foreclosures become rampant. For instance, according to the Mortgage Bankers Association, nearly 16 percent of Ohio's subprime loans were in foreclosure earlier this year. This was thirteen times the rate of foreclosure in conventional loans.[5] While we might expect some elevation of default rates in the subprime market, the statistics documenting Self-

[4] U.S. Department of Housing and Urban Development & U.S Department of the Treasury, "Curbing Predatory Lending" (June 2000) (available at: http://www.hud.gov/library/bookshelf18/pressrel/treasrpt.pdf).

[5] *See*, "Pace Quickens on Home Foreclosures in Ohio", The Columbus Dispatch (March 25, 2003).

Help's experience with lending to borrowers with "credit risks" (including our loss rate of no more than 0.5 percent per year) suggest that foreclosures in the subprime market cannot be explained solely by borrower behavior. Rather, we must recognize that abusive lending pushes borrowers past their limits. In fact, we estimated that predatory lending costs American families $9.1 billion each year in lost homeowner equity, back-end penalties, and excess interest paid.[6]

## II. STATE EFFORTS ARE BEGINNING TO REDUCE PREDATORY LENDING WITHOUT REDUCING ACCESS TO CREDIT.

### *A. The North Carolina legislature was the first to adopt an anti-predatory lending bill.*

As I have stated, the Coalition for Responsible Lending was formed about five years ago to respond to the prevalence of predatory lending in North Carolina. Ultimately, the Coalition worked with associations representing the state's large banks, community banks, mortgage bankers, credit unions, mortgage brokers, and realtors to support a moderate bill that passed both legislative chambers nearly unanimously. In 2001, the North Carolina General Assembly, with the endorsement of the banking industry, passed companion legislation to license mortgage brokers and to spell out their affirmative duties. During the 2003 legislative session, the North Carolina legislature demonstrated its continuing support for the 1999 and 2001 reforms by extending their reach to open-end loans, closing what may have become a significant loophole. Clearly, state legislators view the North Carolina law as a great success.

From the beginning, Coalition members all agreed on two principles. First, we would not rely on disclosures. In the blizzard of paper generated for a home loan closing, even lawyers can lose track of what they are signing. Most college graduates probably do not understand terms such as discount rates, home equity, net present value, and annual percentage rate. In addition, 22 percent of the adult American population is functionally illiterate and therefore unable to read disclosures independently. Disclosures often offer nothing more than a defense for unscrupulous lenders.

Second, we would not ration credit by attempting to cap interest rates. We believe in risk-based pricing; in fact, Self-Help has engaged in it since we started making subprime loans almost 20 years ago. Loans with higher risk should bear an appropriately higher interest rate to compensate lenders for this risk. We believe, however, that the risk should primarily be paid for through higher interest rates rather than fees. Barring a prepayment penalty, a subsequent lender can always refinance a borrower out of a loan that no longer reflects that borrower's risk, assuming it ever did. However, no one can rescue a borrower from a loan that has been inflated through the financing of exorbitant fees.

[6] Stein, Eric. "Quantifying the Economic Cost of Predatory Lending", Coalition for Responsible Lending (2001) (available at http://www.predatorylending.org/pdfs/Quant10-01.PDF).

From these principles came a fairly simple solution: deter exorbitant fees and encourage lenders to garner compensation in interest rates, over which lenders can compete to arrive at a price that is a true reflection of risk. Therefore, the North Carolina law prohibits the most blatantly abusive practices (all of which involve the accumulation of fees) and establishes special protections for borrowers entering into "high-cost" loans. Practices that are prohibited across-the-board include the selling of financed credit insurance; penalizing early repayment of a first-lien home loan of less than $150,000; and "flipping," or refinancing a loan primarily for fee generation without providing the borrower with a "reasonable tangible net benefit."[7] For loans in the high-cost category, the law prohibits balloon payments and negative amortization, both of which are used to obscure the cost of equity-stripping fees. (Monthly payments are kept low, but a large payment is owed at the end of the loan's term (balloon) or the payments are not reducing the loan balance (negative amortization).)

The law provides other protections as well. Special attention is paid to identifying the fees that count toward categorizing a loan as "high-cost" in the first place. Furthermore, high-cost home lenders must look beyond the value of the collateral used to secure a loan when assessing borrowers' ability to repay. Because financed fees are often invisible fees, lenders may not finance fees in high-cost loans. (This provision was meant to encourage lenders to reflect risk in interest rates rather than fees, in keeping with our generally agreed-upon principles.) In an effort that has been endorsed by the North Carolina Housing Finance Agency,[8] counseling is required before a borrower enters a high-cost loan.[9] Finally, legislators later adopted the North Carolina Mortgage Lending Act, which has allowed state regulators to remove unscrupulous mortgage lenders from the system entirely.

A more specific explanations of the practices regulated in North Carolina may be of interest:

1. **Single-premium credit insurance**. Credit life insurance is paid by the borrower to repay the lender in the event the borrower dies. When paid for up-front, this insurance does nothing more than strip equity from

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[7] The tangible net benefit standard is similar to flexible standards applied in other financial industry contexts. For example, the doctrine of suitability has been applied by the securities industry since the 1930s and has since been adopted by the commodities and insurance industries. Like the North Carolina flipping standard, suitability standards are intentionally broad and adaptable to the wide range of fact patterns giving rise to the abuse, allowing industry flexibility to develop compliance solutions that fit their customer base. See Kathleen C. Engel and Patricia A. McCoy, A Tale of Three Markets: The Law and Economics of Predatory Lending, 80 Tex. L. Rev. 1255, 1321-22 (2002) (the paper can be found in its entirety at http://www.law.csuohio.edu/handbook/engel.html). For example, Rule 2310 of the NASD's Rules of Fair Practice sets a broad "reasonable grounds" and "reasonable efforts" standard in determining the suitability of a broker's recommendation to a customer and puts the obligation on the broker or company to evaluate the transaction. Id.

[8] N.C. Housing Finance Agency, A. Robert Kucab letter to Governor Roy Barnes (February 26, 2002) (available on request).

[9] This provision is similar to Congressional standards applied to reverse mortgage transactions and Community Reinvestment Act loan products developed by lenders across the nation.

homeowners.[10] After North Carolina banned this practice, the industry largely eliminated single-premium credit insurance.

2. **Charging fees greater than 5 percent of the loan amount**. Conventional borrowers generally pay, at most, a 1 percent origination fee. The North Carolina law sets a fee threshold for "high-cost" loans at 5 percent. Because these loans should be exceedingly rare, the law provides a number of incentives for lenders to garner revenues in rates rather than fees.[11]

3. **Charging prepayment penalties on subprime loans**. Prepayment penalties trap borrowers in high-rate loans, often leading to foreclosure and bankruptcy. Prepayment penalties prevent borrowers from using the subprime market as a bridge to conventional financing as the borrowers' credit improves. While prepayment penalties are almost unheard of in the conventional market, a large majority of subprime loans contain these terms.

4. **Flipping borrowers through fee-loaded refinancings**. Abusive lenders refinance subprime loans over and over, each time charging fees that reduce home equity. Some lenders set borrowers up for refinancing by selling them bad loans packed with unexplained terms in the first instance. North Carolina research found that abusive lenders flip one in ten Habitat for Humanity borrowers from their interest-free first mortgages into high interest loans.[12] These examples and more motivated the General Assembly to provide for a back-up protection to the law's general high-cost provisions that ensures that no lender may intentionally refinance a homeowner without providing a "reasonable, tangible net benefit" even if the loan falls below high-cost thresholds.

### *B. The North Carolina law has reduced predatory lending while preserving access to credit.*

Contrary to claims by subprime lending associations, recent research clearly shows that the North Carolina law is having its intended effects. Borrowers continue to have access to a wide variety of competitively priced loans from a wide variety of lenders. At the same time, North Carolina has reduced predatory lending.

Industry data attests to the robust subprime market in North Carolina. An analysis by a leading industry trade journal, <u>Inside B&C Lending</u>, found that top North Carolina

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[10] Fannie Mae and Freddie Mac, U.S. Departments of Treasury and Housing and Urban Development, and the Federal Home Loan Bank of Atlanta have all condemned the practice for all home loans. Bank of America, Chase, First Union, Wachovia, Ameriquest, Option One, Citigroup, Household, and American General have all decided not to offer single-premium credit insurance on their subprime loans.

[11] Under various definitions, major subprime lenders (including Household International, Citifinancial, Washington Mutual), the secondary market (including Fannie Mae and Freddie Mac), and many states have subsequently adopted 5 percent or less in points and fees as an appropriate standard.

[12] See "Overview of Habitat for Humanities Refinances" (Coalition for Responsible Lending, Dec. 9, 1999), under Studies at http://www.responsiblelending.org.

subprime lenders continue to offer a full array of products for borrowers in North Carolina—with little or no variation in rate compared to other states.[13] In addition, a Morgan Stanley & Co. survey of 280 subprime branch managers and brokers found that tougher predatory lending laws have not reduced subprime residential lending volumes in any significant way.[14]

Our own analysis of home loans reported to federal regulators as originated under the Home Mortgage Disclosure Act (HMDA) shows that subprime lending continues to thrive in North Carolina.[15] In 2000, North Carolina was still the sixth most active state for subprime lending, with North Carolina borrowers 20 percent more likely to receive a subprime loan than borrowers in the rest of the nation. One in every three loans to low-income North Carolina families (annual incomes of $25,000 or less) was subprime, the highest such proportion in the country. In addition, the study finds that the North Carolina law saved homeowners $100 million in its first year.

The best research in the field was recently completed by the Center for Community Capitalism at the Kenan-Flagler Business School of the University of North Carolina in June 2003.[16] The University of North Carolina study concluded that the North Carolina law succeeded in reducing the incidence of loans with predatory terms, perhaps most notably leading to a 72% drop in subprime prepayment penalties with terms of three years or longer.

On the crucial issue of credit availability, the report found that loans to North Carolina borrowers with substantially impaired credit actually increased by 31 percent after implementation of the North Carolina law. In a corollary finding, researchers noted that subprime loans to borrowers with credit scores above 660—those who could more easily qualify for low-cost conventional loans—declined by 28%, while, according to HMDA data, overall loans by primarily prime lenders increased by 40% in the state from 2000 to 2001. This finding suggests a reduction in "steering" of borrowers to loans with a higher price than that justified by their credit history. In addition, researchers noted that subprime home purchase loans overall increased by 43 percent following passage of the law.

While the number of subprime home purchase loans in North Carolina increased, the number of subprime refinance loans with predatory terms did drop significantly. The UNC study notes that the reduction in originations can be attributed to subprime

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[13] Inside B&C Lending. 2001. Lenders Will Try to Pin Down Effects of NC Mortgage Law. March 5.
[14] Morgan Stanley. 2002. Channel Check: Surprisingly Strong Subprime Growth. Diversified Financials. August 1.
[15] Ernst, Keith, John Farris, and Eric Stein, "North Carolina's Subprime Home Loan Market After Predatory Lending Reform", Center for Responsible Lending (August 2002) (available at http://www.mbaa.org/state_update/2002/nc/nc_study_0814.pdf).
[16] Quercia, R.G., Stegman, M.A., and Davis, W.R. 2003. "The Impact of North Carolina's Anti-Predatory Lending Law: A Descriptive Assessment." Center for Community Capitalism, University of North Carolina at Chapel Hill (available at http://www.kenan-flagler.unc.edu/assets/documents/CC_NC_Anti_Predatory_Law_Impact.pdf). Note: As acknowledged in the study, the Center for Responsible Lending provided financial support to enable the research.

refinance originations that contain at least one predatory lending characteristic: prepayment penalty terms that exceed three years, subprime balloon payments, and loan-to-value ratios of 110 percent or more. UNC considers these loans as proxies for refinance loans that provided little or no benefit to the borrower, but likely resulted in increased fees to the lender, or abusive, unnecessary originations. **In short, the study suggests that the reduction of subprime refinances is consistent with a "weeding out" of bad loans since passage of the law.**

Surprisingly, even though the North Carolina law significantly limited fees, the UNC study also found that, after the law was fully implemented, North Carolina's mean origination interest rates were consistent with corresponding national rates and actually increased slightly less than the national average increase. This result implies that the fees being charged before the implementation of the law were not genuinely priced to borrower risk, but represented excessive fees extracted from North Carolina's most vulnerable populations. In other words, as Professor Michael Stegman, one of the study's authors reported, "[t]he study shows that since the North Carolina law went into full effect, the subprime market has behaved just as the law intended. The number of loans with predatory characteristics has fallen without either restricting access to loans to borrowers with blemished credit or increasing the cost of these loans."[17]

Although an industry-sponsored Credit Research Center (CRC) study claimed that the North Carolina law led to a decrease in access to credit for low-income borrowers, that conclusion should be viewed with suspicion. The CRC study contradicts other industry reports and the weight of available evidence. The CRC study relies upon a limited data set from nine anonymous lenders that has not been made available for independent verification.[18] The CRC study examines data from a period ending June 30, 2000, the day before most of the North Carolina law's provisions took effect. Moreover, the data omits all open-end home loans from those lenders. Finally, the CRC study ignores the problem of "flipping" and consequently assumes that any reduction in subprime originations is evidence of harm. However, any successful anti-predatory lending law would curb the practice of flipping (refinancing loans with no benefit to the borrowers) and thus would tend to reduce the number of subprime refinance originations.

For example, think of the woman from Wilmington, North Carolina, whom I described earlier. Her lender made two refinancing loans in just six months, but—as demonstrated by her eventual foreclosure--the borrower would have been far better off had she not refinanced at all. An effective law, one that prohibited flipping and restricted fees, would have prevented the two loans that led to this woman's foreclosure. This observation shows how an effective law may reduce originations, while still improving

[17] "STUDY: NC Predatory Lending Law Cuts Abuses, Does Not Dry Up Credit for Borrowers", Center for Community Capitalism June 25, 2003 press release (available at http://www.kenan-flagler.unc.edu/News/DetailsNewsPage.cfm?id=466&menu=ki).

[18] The CRC study started with a pool of 1.4 million loans made by nine anonymous members of an industry trade group (that funds CRC) in four states chosen by the authors. The researchers then analyzed one-tenth of these loans. By contrast, the UNC study analyzed 3.3 million loans made by more than twenty lenders in all fifty states. The Loan Performance data set used for the UNC study is the most comprehensive data available on the subprime mortgage market.

the quality of lending in a state. As the UNC study recognized, if the number of loans decreases after the enactment of an anti-predatory loan law, one needs to examine which loans are not being made in order to know whether to worry or celebrate.

Those who claim that North Carolina has a liquidity crisis because of our anti-predatory lending laws are far divorced from the North Carolina mortgage market. Those who live and work in the state know that loans remain widely available. Joseph Smith, North Carolina's Banking Commissioner, has commented that "[d]uring the last twelve months, over seventy-five percent of formal complaints to [his office] … have involved mortgage lending activities [but] …. [n]ot one of these complaints has involved the inability of a North Carolina citizen to obtain residential mortgage credit."[19]

North Carolina legislators—who have every reason to follow this issue closely—have revisited the law only to strengthen it. A representative of Self-Help recently spoke at a press conference with North Carolina's Governor, Attorney General, and the head of the North Carolina's Bankers Association, celebrating the anti-predatory lending law's success.

### *C. Other states have built upon North Carolina's successes.*

While North Carolina was the first state in the nation to pass strong anti-predatory lending legislation, others have followed and identified appropriate solutions for their particular context.[20] As this Committee examines how the federal government can improve upon the existing federal standards on predatory lending, it is important to recognize that states have served as laboratories of democracy with respect to predatory lending by helping to refine solutions for such issues as assignee liability, the appropriate definition and threshold for points and fees, and the scope of loans included under the law's protections.

Any reforms that attempt to check predatory lending must be mindful of providing meaningful remedies for aggrieved homeowners. Building from existing federal law's provision of assignee liability on high-cost home loans, several states have recognized that balanced assignee liability is essential to protect consumers and responsible lenders.

Assignee liability is essential since most mortgage loans are assigned shortly after origination, so the party collecting and enforcing the note is routinely neither the party that the borrower dealt with nor who originated the loan. Under current commercial law, once a home loan is sold to a third person, homeowners lose virtually all of their rights to defend their homes in court when threatened by the illegal actions of a broker or

[19] North Carolina Office of the Commissioner of Banks, Joseph A. Smith, Jr. letter to Comptroller John D. Hawke, Jr. (October 2, 2003) (available on request).

[20] Perhaps the most notable states in this regard include New Mexico, New York, and New Jersey—however, Illinois, Massachusetts, California, South Carolina, Arkansas, and Georgia have all made contributions to the pioneering efforts of states to identify solutions that protect homeowners and promote a thriving market.

originator. For years, homeowners found they could live with this arrangement, since the market was closely regulated and loans were largely brokered and originated by a relatively small number of responsible institutions.

Predatory lending, however, changed the equilibrium by introducing unscrupulous brokers and loan originators that lacked the responsible and stable nature of those previously in the market. As a result, homeowners have found themselves without a marketplace they can depend on to deliver loans that are not abusive.

Under current law, homeowners are frequently left unprotected when they seek help from the courts after their home is threatened by loans with illegal terms. Without assignee liability, a family that has been the victim of a predatory loan cannot stop the foreclosure of their home. Instead, they end up losing their home, and then must bring a separate action against the original lender in order to pursue any claims of abusive or illegal practices. This separate action can take years, and the home is long gone before the homeowner even has a chance of recovery against a bad actor. Worse, very often the party that originated the loan is no longer in business and has no assets from which to recover.[21]

Assignee liability corrects a flaw in the home lending market and serves to protect responsible lenders and their customers by encouraging the market to police itself. If there is no assignee liability, an unscrupulous lender can increase the value of the loans it sells by engaging in predatory practices and packing the loan with unnecessary fees, excessive interest rates and large prepayment penalties. Without assignee liability, purchasers of these loans have no incentive to determine if the loans were abusive, and indeed, the loan purchasers reward unscrupulous lenders by paying more for these predatory loans.

In fact, while investors may benefit from some of these abusive terms (i.e. interest rates or prepayment penalty streams), other fees may be extracted by the originator without the investor's knowledge, and may in fact detract from the borrower's eventual ability to maintain payments on the loan. As such, assignee liability serves to ensure that homeowners' rights are more than symbolic. It at once denies capital to support predatory lending and allows homeowners to defend their homes directly.

Even as states have taken action to realize these goals, they have, however, recognized that there are instances when a secondary market purchaser of home loans unintentionally acquires a high-cost home loan despite its intentions and best efforts to refrain from purchasing such risky and abusive loans. In these circumstances, states have

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[21] Borrowers seeking a remedy find that brokers typically have substantially fewer assets than lenders (one recent study put the average size of brokerages at ten employees) and are more likely to go out of business and be judgment-proof. *See* Wholesale Access, "New Research About Mortgage Brokers Published," (August 6, 2003) (available at: http://www.wholesaleaccess.com/8.6.03.mb.shtml) and Eggert, Kurt, "Held Up in Due Course: Predatory Lending , Securitization, and the Holder in Due Course Doctrine," Creighton Law Review, v35, n3 (April 2002), 507-640.

recognized that the market has a legitimate interest in the certainty presented by capping damages that may be awarded against an assignee.

Assignee liability is not a new concept or unique to state anti-predatory lending laws. It exists elsewhere in federal and state law, and secondary markets have performed well in those contexts.[22] Since 1976, under the Federal Trade Commission Act, a rule known as the FTC "Holder Rule" has provided for assignee liability for many home improvement and mobile home mortgages that are nevertheless regularly securitized. Many state anti-predatory lending laws have adopted this model with regard to such loans and sought to tighten loopholes regarding the application of the Holder Rule. The key provisions of anti-predatory lending laws build on the example of the federal Home Ownership and Equity Protection Act (HOEPA), which provides for broad assignee liability for high-cost home loans (HOEPA loans), where the investor could tell that the loan was a HOEPA loan, as well as liability under the Truth In Lending Act for rescission claims. Some states also impose assignee liability for usury violations, including on mortgage loans. Car loans also widely carry assignee liability into the securitization market.

The experiences in New Jersey and Georgia show that assignee liability issues can readily be resolved. After rating agencies raised questions about a Georgia law, a resolution was quickly reached that capped the liability of loan purchasers and provided additional protections for loan purchasers who engaged in due diligence. Georgia eventually chose not to enact this provision, and instead adopted a provision that cut off almost all assignee liability. In New Jersey, the Department of Banking and Insurance has taken the lead in addressing concerns with the Garden State's assignee liability provisions. The point is not that either of these states has the perfect solution for predatory lending, but rather that each proved capable of adjusting its standard and, in doing so, may help define which policies protect and which fail to protect homeowners and lenders alike.

Beyond assignee liability, the states that passed laws after North Carolina have developed new definitions of points and fees that expand on the North Carolina definition by including back-end payments to brokers for placing borrowers in loans with higher interest rates than those for which they qualify (yield spread premiums), expanded the scope of loans provided with new protections by ensuring that open-end loans (including home equity lines of credit) are covered, and taken other steps, such as imposing fiduciary duties on mortgage brokers. Each of these steps represent meaningful advances in the evolving debate over how best to solve the predatory lending problem.

## III. FEDERAL PREEMPTION OF STATE ANTI-PREDATORY LENDING LAWS WOULD BE MISGUIDED, AS THE CURRENT FRAMEWORK OF COOPERATIVE FEDERALISM IS WORKING.

[22] In virtually every sale, loan purchasers protect themselves through representations and warranties that require the seller of the loans to indemnify the purchaser for all liabilities arising from the loans. Purchasers also have other tools such as net worth requirements for sellers or ongoing quality control checks to ensure that their investment is protected.

Federal preemption of state anti-predatory lending laws would be misguided—and harmful to homeowners. As the framers of our Constitution anticipated, the states and the federal government each have a role to play through "cooperative federalism." As Justice O'Connor has noted,[23]

> The Constitution does not protect the sovereignty of States for the benefit of the States or state governments as abstract political entities, or even for the benefit of the public officials governing the States. To the contrary, the Constitution divides authority between federal and state governments for the protection of individuals. State sovereignty is not just an end in itself: "Rather, federalism secures to citizens the liberties that derive from the diffusion of sovereign power." …. "Just as the separation and independence of the coordinate branches of the Federal Government serves to prevent the accumulation of excessive power in any one branch, a healthy balance of power between the States and the Federal Government will reduce the risk of tyranny and abuse from either front."

Similarly, Justice Rehnquist renews a warning from earlier cases when he writes,[24]

> the scope of the interstate commerce power "must be considered in the light of our dual system of government and may not be extended so as to embrace effects upon interstate commerce so indirect and remote that to embrace them, in view of our complex society, would effectually obliterate the distinction between what is national and what is local and create a completely centralized government."

In practical terms relating to home lending, cooperative federalism means that while the federal government first legislated against predatory home lending through the HOEPA floor, states were free to go further. This dynamic has served the nation well, leading federal regulators to adopt and enable state-developed solutions. Moreover, the states' have moved with caution and have adopted and refined laws with which lenders can comply. Given the benefits and the dearth of evidence to support wholesale changes to the country's respectful approach to cooperative federalism, it is disappointing that one federal agency, the Office of the Comptroller of the Currency (OCC), previously chastised by Congress for being "overly aggressive" in preempting state laws, is once again undermining this process.

### *A. Federal agencies have learned from state-based efforts to address predatory lending.*

In at least two cases, federal agencies have learned from and acted upon lessons developed at the state level. In adopting changes to their regulatory framework, the Federal Reserve Board and the Office of Thrift Supervision each exemplified the best ideals of federalism.

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[23] New York v. U.S., 112 S.Ct. 2408, 2431 (1992) (citations omitted).
[24] U.S. v. Morrison, 120 S. Ct. 1740, 1749 (2000) (citations omitted).

The Federal Reserve Board took important action in 2001 when it moved to incorporate financed credit insurance within the scope of charges evaluated as a point of fee under HOEPA. But, the Federal Reserve did not arrive at this conclusion in a vacuum. Indeed, the first jurisdiction to reach such a conclusion was the state of North Carolina, which adopted a similar provision in its 1999 law. Even as North Carolina reached the conclusion that such products were harming consumers, it recognized that legitimate forms of credit insurance, calculated and paid on a monthly basis, did not have harmful equity stripping effects and should not be subject to the same scrutiny. Following the law's effective date, many lenders publicly disclaimed such products and the market appears to have successfully transitioned to the monthly product. Consequently, the Federal Reserve acted responsibly when it saw that similar benefits could be extended through the federal HOEPA floor to borrowers in all states.

Similarly, some 35 states currently have statutory provisions relating to prepayment penalties on home loans. Yet, federal law had been interpreted to preclude them from enforcing those laws against state-chartered finance companies and mortgage brokers in adjustable rate mortgages (ARMs) and other alternative mortgage transactions. Increasingly, prepayment penalties in home loans have come under scrutiny and a number of states have moved to prohibit them outright or to limit their application. In recognition of these developments, the Office of Thrift Supervision took commendable action when it revised federal regulations in a way that promoted cooperative federalism by restoring the states' rights to apply their laws to these state-chartered institutions.

### *B. States are best equipped to respond to abuses in their particular markets.*

We urge you today to continue in this vein and partner with states to provide protections for the nation's homeowners. In addition to losing the opportunity for synergy with state efforts, federal preemption of state law is not a practical response to predatory lending because states are in the best position to respond to many of the challenges presented by predatory lending, for at least three reasons: (1) many of the bad actors involved in predatory lending are state-chartered entities with minimal capitalization, (2) regional variations in real estate markets require different solutions to predatory lending, and (3) irresponsible lenders can invent new abusive practices virtually overnight, and the federal government is ill-equipped to react quickly to these changes.

First, federal enforcement of financial services laws depends largely on periodic examinations of the practices of large institutions. The broker who just hung a shingle from his door, however, can originate abusive loans without much fear of federal oversight—as can a state-chartered affiliate of a bank that is not likely to affect its larger parent's overall safety and soundness. State attorneys general and bank regulators have been instrumental in investigating abusive practices and in demanding redress for their citizens. They are also the primary regulators of non-depository finance companies, which dominate the subprime market. The federal government simply cannot be everywhere at once to monitor local real estate transactions.

Second, predatory lending laws should address the special characteristics of each state's underlying real estate regime and market. For example, the mechanism for ensuring that a borrower can raise defenses to foreclosure on predatory home loans may depend on whether a state has judicial or non-judicial foreclosure procedures. The appropriate loan-size threshold for when to prohibit prepayment penalties may depend on the real estate values in a given state. North Carolina prohibits prepayment penalties in fist-lien home loans of less than $150,000. In Maryland or Virginia, the most reasonable threshold would perhaps be considerably higher.

Third, new financial services products are developed every day, frequently to exploit loopholes in laws against abuse. In North Carolina, the legislature prohibited the sale of financed credit insurance. Within two years, the similar "but-not-insurance" product of "debt cancellation agreements" was born. State legislatures are better suited than Congress for responding quickly to such changes.

### *C. Lenders have experience complying with a variety of state laws that affect their business practices, and complying with state-based homeowner protection laws (which prohibit activities that they should not be engaged in anyway) presents no heavier a burden.*

Given the evidence of success at the state level, Congress would do harm to homeowners by imposing a uniform standard in lieu of state protections. Every day, lenders deal with tremendous variety in state real estate laws and practices, including consumer protection laws.[25] The laws concerning who may act as a settlement agent differ from state to state. Foreclosure law differs from state to state. States have their own fraud and deceptive practices acts, interpreted by state court judges in accordance with state-specific common law. Just as lenders find tools for complying with these and other variations, we believe that they are capable of complying with state-based homeowner protection statutes as well. The market has responded by producing computer products that claim to assist lenders in their compliance obligations across state borders.[26] In fact, the variation in these statutes is actually quite small, and we can expect states to move even closer to a consensus approach as regulation of predatory lending improves in its ability to curb abuses.

## IV. CONCLUSION

For all the reasons just stated, Self-Help and the Coalition strongly oppose federal preemption of states' anti-predatory loan laws whether through regulatory[27] or legislative

[25] Significantly, federal laws such as the Fair Housing Act and the Equal Credit Opportunity Act regulate the real estate finance market without broadly preempting comparable state regulations.
[26] *See* Bergquist, Eric, "Some Lenders Turning to Compliance Software", American Banker, v168, n62 (April 1, 2003).
[27] Recently, we submitted a detailed letter explaining our primary objections to the Office of the Comptroller of the Currency's proposed rulemaking on preemption, an agency that has previously been taken to task by Congress for being "overly aggressive" in this regard (*See* legislative history to the

means. In doing so, we stand beside every single state's Attorney General and the Conference of State Bank Supervisors which have similarly objected to federal preemption of state anti-predatory lending laws.[28] Indeed, our federalist system of government provides for both state and federal government to play a role in protecting borrowers. The dual banking system provides for positive competition that is the envy of the world. Operating as laboratories of democracy, the states have developed increasingly effective approaches to eradicating predatory lending without drying up access to reasonably priced subprime mortgage credit. This is federalism at its best.

At the end of the day, however, whether legislator, lender, or advocate, it is incumbent on all of us to stay focused on the important goal that we all share: namely, the provision of a safe mortgage market that American families can trust with effective protections and remedies for those homeowners who fall prey to unscrupulous lenders. Thank you for the opportunity to speak to you today, I am happy to answer any questions you may have for me.

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Interstate Bank Branching and Efficiency Act of 1994). The OCC proposal is misguided for two reasons especially relevant to the instant discussion.

First, the analysis underlying the proposed rulemaking is obviously outcome-driven. The OCC's factual foundation for deciding that state laws interfere with the operation of national banks is based in significant part on an uncritical reading of the CRC study. The OCC also focuses its analysis on subprime mortgage interest rates, ignoring evidence of abuse though excessive fees and the states' focus on this problem. The weight of available research certainly does not support the OCC's conclusion that state anti-predatory lending laws are harmful.

Second, the OCC's proposed rulemaking fails to include meaningful protections for borrowers. Rather, the OCC proposal would substitute a single provision (against loans made without regard to a borrower's ability to pay) for the comprehensive state laws it would preempt.

[28] National Association of Attorneys General letter to the Office of the Comptroller of the Currency (October 6, 2003) (available on request); and Conference of State Bank Supervisors letter to Comptroller Jonathan D. Hawke, Jr. (September 26, 2003) (available at http://www.csbs.org/government/regulatory/comment_ltrs/cl_09.29.03.pdf).