Testimony of Martin Eakes,
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Before the Senate Committee on Banking, Housing and Urban Affairs
On Predatory Mortgage Lending
July 26, 2001

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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 Self-Help and the Coalition for Responsible Lending the opportunity to testify before you today.

Introduction

Fundamentally, I am a lender. Self-Help (www.self-help.org), the organization for which I serve as President, 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 $1.6 billion dollars of financing to help 23,000 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. **Some would call us a subprime lender. We have 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 $800 million.

I am also spokesperson for the Coalition for Responsible Lending (CRL). CRL (www.responsiblelending.org) is an organization representing over three million people 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 lack of financial sophistication for large numbers of subprime borrowers have created an environment ripe for abuse.

We discovered that too many families in our state – over 50,000 – have been victimized by abusive lenders, losing their homes or a large portion of the wealth they spent a lifetime building. 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" over 10% of Habitat for Humanity borrowers from their 0% first mortgages to high interest and high cost subprime loans.[2] The problem is not anecdotal; it is closer to an epidemic.[3]

The North Carolina Law

The standard industry response at the national level has been to fight against stronger rules and for tighter enforcement of existing laws. We found that those calls rang hollow: people's hard-earned equity was being stolen and their homes being lost through practices that complied with the law. These practices were entirely legal. Since federal law was insufficient, as a second-best solution we decided to try to amend North Carolina's mortgage lending law to prohibit predatory lending practices.

Thus, in 1999, CRL spearheaded an effort that helped enact the North Carolina predatory lending law. The bill was the result of a collaborative effort supported by associations representing the state's large banks, community banks, mortgage bankers, credit unions, mortgage brokers, realtors, the NAACP, and consumer, community development and housing groups. There were two principles we all agreed upon from the beginning. **First, we would not rely on disclosures.** In the blizzard of paper that constitutes a home loan closing, even lawyers can lose track of what they are signing. In addition, 22% of the adult American population is functionally illiterate, unable to fill out an application.[4] In our experience, disclosures often do more harm than good, because unscrupulous lenders use them as a shield for abuse. **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 for 17 years. Loans with higher risk should bear an appropriately higher interest rate in order to compensate lenders for this risk. We believe, however,

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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 Joint HUD/Treasury Report, pp.12-49; Panels I to III at May 24, 2000 House Banking Committee Hearings: http://www.house.gov/banking/52400toc.htm; Unequal Burden: Income and Racial Disparities in Subprime Lending in America, Department of Housing and Urban Development, April 12, 2000; National Training and Information Center, Preying on Neighborhoods: Subprime Mortgage Lenders and Chicagoland Foreclosure (September 21, 1999); Daniel Immergluck & Marti Wiles, Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development (The Woodstock Institute 1999). 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).

[4] "National Adult Literacy Survey," National Center for Education Statistics, 1992. These Level 1 individuals cannot read "well enough to fill out an application, read a food label, or read a simple story to a child." See http://www.nifl.gov/nifl/faqs.html#literacy.

that the risk should primarily be paid for through higher interest rates rather than fees, because a subsequent lender can always refinance a borrower out of a loan with an excessive rate (barring a prepayment penalty). Fees, on the other hand, must be paid in full once agreed to; there is nothing a responsible lender can do to help a borrower whose prior loan financed exorbitant fees.

Because the bill we supported utilized market principles and common sense rather than credit rationing or other extreme measures, it enjoyed widespread support within the North Carolina banking industry and the state's credit unions. Some would say that if the state's credit unions and banks could come to agreement over the bill, it had to be a good idea. Consumer groups did just that. They saw the bill as a credible response to the predatory lending that was harming our communities. As a result of the support of all major groups, the bill passed both chambers almost unanimously in July 1999.

Some say that it is impossible to define predatory lending. I disagree. The North Carolina bill did just that, in the same way that statutes attack any problem: by setting parameters for what is acceptable, that encourage certain actions while discouraging others. The practices that the North Carolina law discourages are exactly the abusive lending practices that we find most harmful to borrowers. Please see the Coalition for Responsible Lending Issue Paper entitled **Quantifying the Economic Cost of Predatory Lending** that is included in the appendix for a discussion of the cost that predatory lending practices imposes on hundreds of thousands of borrowers across the country.

<u>Abusive Lending Practices</u>

- **Financing single premium credit insurance** on home loans.
- **Charging fees**, direct and indirect, over 3% - 5% of the loan amount.
- Levying back-end **prepayment penalties** on subprime loans, which serve as anti-competitive tools to keep responsible lenders from remedying abusive situations.
- "**Flipping**" borrowers through repeated fee-loaded refinancings.
- "**Steering"** borrowers into loans with higher-rates than those for which they qualified.
- **Permitting mortgage broker abuses**, including broker kickbacks.
- **Requiring mandatory arbitration** clauses in any home loans.

I would like to briefly discuss these abusive practice and how the North Carolina law has defined and attempted to correct them.

1. *Financing single premium credit insurance on home loans.* One type of credit insurance, credit life, is paid by the borrower to repay the lender should the borrower die. The product 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. This is why the mortgage industry is disavowing single-premium credit insurance (SPCI) in the face of heavy criticism.

   Fannie Mae and Freddie Mac, U.S. Departments of Treasury and Housing and Urban Development, bills introduced in the Senate and House banking committees, and the

Federal Home Loan Bank of Atlanta have all condemned the practice for all home loans.[5] In addition, **Bank of America, Chase, First Union, Wachovia, Ameriquest, Option One, Citigroup, Household, and just this week, American General, have all decided not to offer SPCI on their subprime loans**.[6] The Federal Reserve has proposed to count SPCI in determining what loans are "high cost," which will further disfavor the practice. Conseco Finance, formerly Greentree, seems to be the last large lender continuing to defend it. Conventional loans almost never include, much less finance, credit insurance. The North Carolina law prohibited the practice for all home loans.

2. *Charging fees greater than 3% - 5% of the loan amount.* 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. Again, subprime lenders can always increase the interest rate. The North Carolina law 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 the consumer's ability to repay; 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.

3. *Charging prepayment penalties on subprime loans (defined by interest rates above conventional).*

- Prepayment penalties trap borrowers in high-rate loans, which too often leads to foreclosure and bankruptcy. The subprime sector serves an important role for borrowers who encounter temporary credit problems that keep them from receiving lower-rate conventional loans. This sector should provide borrowers a bridge to conventional financing as soon as the borrower is ready to make the transition. Prepayment penalties prevent this from happening. Why should any borrower be penalized for doing just what they are supposed to do -- namely, pay off a debt?
- Prepayment penalties are hidden, deferred fees that strip significant equity from over half of subprime borrowers. Prepayment penalties of 5% are common. For a $150,000 loan, this fee is $7,500, more than the total net wealth built up over a lifetime for the median African American family.[7] According to Lehman Brothers'

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[5] See http://www.freddiemac.com/news/archives2000/predatory.htm and http://www.fanniemae.com/news/speeches/speech_116.html; Joint HUD/Treasury Report, page 91; H.R. 4250 (Rep. LaFalce /S. 2415 (Sen. Sarbanes), Sec. 2(b)(3); Federal Home Loan Bank of Atlanta BankTalk, Nov. 27, 2000;

[6] See "Equicredit to Stop Selling Single-Premium Credit Life," Inside B&C Lending, April 2, 2001, p. 3 (Bank of America); Erick Bergquist, "Gloom Turns to Optimism in the Subprime Business," American Banker, May 15, 2001, p. 10 (Chase); "First Union and Wachovia Announce Community Commitment for the New Wachovia," May 24, 2001; statements by officers of Ameriquest and Option One; Jathon Sapsford, "Citigroup Will Halt Home-Loan Product Criticized by Some as Predatory Lending," *Wall Street Journal* (6/29/01); Anitha Reddy, "Household Alters Loan Policy," *Washington Post* (7/12/2001).

[7] According to the 1990 census, median net worth for African-American families was $4,400 compared to $44,000 for white families. Home equity is the primary factor in this disparity.

prepayment assumptions, **over half** of subprime borrowers will be forced to prepay their loans – and pay the 4% to 5% in penalties – during the typical five-year lock-out period. And borrowers in predominantly African-American neighborhoods are **five times** more likely to be subject to wealth-stripping prepayment penalties than borrowers in white neighborhoods. Prepayment penalties are therefore merely deferred fees that investors fully expect to receive and borrowers never expect to pay.

- <u>Borrower choice cannot explain the 80% penetration rate of prepayment penalties in subprime loans</u>. Only 2% of conventional borrowers accept prepayment penalties in the competitive conventional market, while, according to Standard & Poors, 80% of subprime loans had prepayment penalties. The NC law prohibited prepayment penalties on all loans of less than $150,000.

4. *"Flipping" borrowers through repeated fee-loaded refinancings.* One of the worst practices is for lenders to refinance subprime loans over and over, taking out home equity wealth in the form of high fees each time, without providing significant borrower benefit. Some lenders originate balloon or adjustable rate mortgages only to inform the borrowers of this fact soon after closing to convince them to get a new loan that will pay off the entire balance at a fixed rate. Others require borrowers to refinance in order to catch up if the loan goes delinquent. The NC law prohibits refinancings that do not provide the borrower with a net tangible benefit, considering all of the circumstances; this standard is similar to the "suitability" standard applicable to the securities industry.

5. *Mortgage broker abuses, including broker kickbacks.* Brokers originate over half of all mortgage loans and a relatively small number of brokers are responsible for a large percentage of predatory loans. Lenders should identify -- and avoid -- these brokers through comprehensive due diligence. In addition, lenders should refuse to pay kickbacks (yield-spread premiums) to brokers. These are fees lenders rebate to brokers in exchange for placing a borrower in a higher interest rate than that for which the borrower qualifies. These lender kickbacks violate fair lending principles since they provide brokers with a direct economic incentive to steer borrowers into costly loans. While we decided to focus on lenders and not brokers in the bill, we are working in collaboration with the brokers' association in North Carolina on a mortgage broker licensing bill this session to crack down on abusive brokers.

6. *"Steering" borrowers into higher cost loans than that for which they qualify.* As Fannie Mae and Freddie Mac have shown, subprime lenders charge borrowers with prime credit who meet conventional underwriting standards higher rates than justified by the risk incurred. This is particularly troubling for lenders with prime affiliates -- the very same "A" borrower who would receive the lender's lowest-rate loan from its prime affiliate pays substantially more from the subprime affiliate. HUD has shown that steering has a racial impact since borrowers in African-American neighborhoods are five times more likely to get a loan from a subprime lender -- and therefore pay extra -- than borrowers in white neighborhoods. A minority borrower with the same credit profile as a white borrower simply should not pay more for the same loan. Therefore, lenders should either offer "A" borrowers loans with "A" rates, or refer

such borrowers to an affiliated or outside lender that offers these rates. This is not a problem we were able to address in the NC bill.

7. *Imposing mandatory arbitration clauses in home loans*. Increasingly, lenders are placing pre-dispute, mandatory binding arbitration clauses in their loan contracts. **While many lenders' mantra has been the need to enforce current laws, many of these same lenders are making this goal impossible by denying borrowers the right to have their grievances heard.** These clauses burden consumers because they increase the costs of disputing unfair and deceptive trade practices, limit available remedies and prevent consumers from having their day in court. Mandatory arbitration imposes high costs on consumers in terms of filing fees and the costs of arbitration proceedings.[8] Arbitration also limits the availability of counsel, cuts off traditional procedural protections such as rules of discovery and evidence, slows dispute resolution, and restricts judicial review.[9] Lenders benefit unfairly from arbitration as repeat players, and in some cases, have used the mandatory arbitration clause to designate an arbiter within the industry, producing biased decisions. Further, lenders are able to use arbitration to handle disputes in secret, avoiding open and public trials which would expose unfair lending practices to the public at large.[10]

   Lenders have used mandatory arbitration to close the courtroom door for millions of consumers and have forced borrowers to waive their constitutional right to a civil jury trial. This situation has only been made worse as many mandatory arbitration clauses have been expanded to also contain provisions that waive the consumers' right to participate in class action suits against the lender, making it more difficult for smaller claims to prevail. For these reasons, mandatory arbitration clauses are unfair to consumers who do not know what they are giving up or do not have a choice but to sign adhesion contracts. If an informed consumer thinks that arbitration is a helpful step in resolving a dispute with a lender, the consumer and lender should be permitted to agree to arbitration at that time. Because the Federal Arbitration Act preempts state regulation of mandatory arbitration clauses, we were unable to get any language prohibiting mandatory arbitration in the North Carolina bill.

And what are the results of North Carolina's law? The only significant data to date about the law's effects are comforting. The Residential Funding Corp., the nation's largest issuer of subprime mortgage securities, reported that North Carolina's share of subprime mortgages issued nationwide actually <u>increased</u> in 2000. And we have publicly and repeatedly challenged lenders to show us a single responsible loan made impossible under the law. No one has accepted our challenge to date.

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[8] *See* Victoria Nugent, *Arbitration Clauses that Require Individuals to Pay Excessive Fees are Unconscionable*, THE CONSUMER ADVOCATE 8, 9-10 (Sept./Oct. 1999).

[9] Paul D. Carrington and Paul H. Haagen, *Contract and Jurisdiction*, 1996 SUP. CT. REV. 331, 346-9 (1996).

[10] *See* John Vail, *Defeating Mandatory Arbitration Clauses*, TRIAL 70 (Jan. 2000).

Congress Should Address the Weaknesses in Federal Law that the NC Law Identified

The fact that so many people went to so much trouble to help enact NC's law is an indictment of current federal law. While mortgage lending in our state conforms to reasonable rules, balancing consumer protections and lenders' need to make a profit, families in the rest of the country have no such protection. Ideally, therefore, Congress should pass a federal statute that would address the seven predatory lending practices identified above in ways similar to what we accomplished in North Carolina.

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. Strengthening the law is important to protect homeowners from abuse. I recommend for the Committee's consideration two excellent HOEPA bills: legislation introduced last session by Chairman Sarbanes and Senator Schumer.

Looking at our definition of abusive lending practices, while I would go a bit further, the bill Chairman Sarbanes introduced is very strong. Specifically, it prohibits the financing of single premium credit insurance, reduces the HOEPA points and fees trigger to 5% from the current 8%, imposes significant limits on prepayment penalties for high cost loans, disfavors broker kickbacks by including them in the definition of points and fees, and prohibits mandatory arbitration for HOEPA loans.

The Federal Reserve Board Should Promptly Issue Strong Predatory Lending Regulations

It is important that regulators take advantage of the authority that current laws have provided them to address predatory lending. The Federal Reserve Board (the "Board") is the regulatory agency with by far the most existing authority to address predatory lending practices. In December of last year, the Board proposed substantial regulations on HOEPA and the Home Mortgage Disclosure Act (HMDA). While modest, the Board's proposed HOEPA and HMDA changes are a very constructive step forward.

HOEPA Regulation Proposal

The proposed HOEPA regulations would broaden the scope of loans subject to its protections by, most significantly, including single-premium credit insurance and similar products in its fee-based trigger, as well as by reducing its rate-based trigger by two percentage points. In addition, the Board suggested a modest flipping prohibition that would restrict creditors from engaging in repeated refinancing of their own HOEPA loans over a short time period when the transactions are not in the borrower's interest and similarly restrict refinancing subsidized-rate nonprofit and governmental loans.

The Board's HOEPA proposal to include SPCI would be an extraordinarily important move against predatory lending. In 1994, the Board stated that "The legislative history [of HOEPA] includes credit insurance premiums as an example of fees that could be included, if evidence showed that the premiums were being used to circumvent the statute."[11] It has become clear in the seven succeeding years that unscrupulous lenders have indeed used the exclusion of credit insurance from "points and fees" to circumvent the application of HOEPA to loans that really are "high cost". Financed credit insurance *alone* exceeds the HOEPA limits in many cases – up to 20% of the loan amount – yet the borrowers do not qualify for HOEPA protections.

The Board should address this evasion, as proposed, by including these fees in the definition of "points and fees". Since including SPCI in a loan in most cases will make it a HOEPA loan, and HOEPA imposes certain duties on lenders and has a stigma attached, lenders will have the incentive to provide credit insurance on a monthly basis, a form that does not strip borrower equity. This is exactly what has happened in North Carolina: lenders have uniformly switched from SPCI to monthly outstanding basis (except for CUNA Mutual, which has always done almost exclusively monthly outstanding balance credit insurance), and borrowers have benefited enormously.

The Board's proposal to reduce the APR trigger is welcome also, since at present only 2% of subprime loans are estimated to meet the very high HOEPA triggers. Finally, the restriction on refinancing subsidized loans would benefit thousands of borrowers and avoid what we experienced in North Carolina, where Habitat for Humanity borrowers were flipped from 0% loans to 12% and 14% loans.

HMDA Regulation Proposal
The Board's proposed changes to HMDA would enhance the public's understanding of the home mortgage market generally, and the subprime market in particular, as well as to further fair lending analysis. At the same time, the Board has attempted to minimize the increase in data collection and reporting burden. Most significantly, the Board would require lenders to report the annual percentage rate of the loan. The lender also would have to report whether the loan is subject to HOEPA and whether the loan involves a manufactured home. In addition, it would require reporting by additional nondepository lenders by adding a dollar-volume threshold of $50 million to the current loan-percentage test.

The Board's proposal to require lenders to report the APR on loans is crucial. It is currently impossible to obtain any pricing data on loans and therefore to determine which loans are subprime and which are not, or to draw any conclusions about the cost of credit that borrowers undertake. **The most important fair lending issues today are no longer the denial of credit, but the terms of credit.** Providing the APR is a good start in providing information on terms. Requiring additional nondepository lenders to report is also important; Household Finance, the nation's second largest subprime lender, does not currently report HMDA information because of a quirk in the rule that the Board rightly proposes to fix.

Because these proposed changes would significantly help in the battle to combat predatory lending, I would urge the Board not to backtrack on any of these suggestions and to finalize these regulations as soon as possible.

[11] 59 Fed Reg. 61,832, 61834 (Dec 2, 1994).

Notwithstanding our support for these proposals, I believe that each should be strengthened. For HOEPA, first, *the Board should count authorized prepayment penalties in the new loan in the points and fees threshold*. When a borrower pays a 5% prepayment penalty on the back-end, that 5% is stripped directly out of the family's accumulated home equity wealth exactly the same as if it were a fee that was financed on the front end. This fee should therefore also be counted in determining which loans are high cost. Some mortgage industry representatives will argue that a prepayment penalty should not be counted because it is a contingent fee. When 50% of borrowers actually pay the fee, it is hardly a speculative contingency. If the contingent nature of an authorized prepayment penalty is persuasive to the Board, however, then the Board at minimum should include the authorized prepayment penalty discounted by the frequency with which it is paid.

Second, the Board should *hold the initial purchaser of a brokered loan responsible for the broker's actions, so the marketplace will self-police equity-stripping practices by mortgage brokers*. When these activities occur, borrowers are often left with no remedy because many brokers are thinly capitalized and transitory, leaving no assets for the borrower to recover against. The borrower generally cannot recover against the lender who benefited from the broker's actions because the broker is considered an independent contractor under the law. In addition, many times the holder-in-due-course doctrine prevents the borrower from raising these defenses against the note holder, even in a foreclosure action.

The Board should address the problem of brokers by making the original lender funding the loan responsible for the broker's acts and omissions, for all loans. To accomplish this goal, the Board should prohibit a lender from funding a loan where the broker violates state or federal law in arranging the loan unless the lender exercised reasonable supervision over the broker transaction**.** In addition, the Board should prohibit lenders from funding a loan arranged by a broker who is not certified or licensed under state law.

For HMDA, the Board should *replace the HOEPA yes-no field with "points and fees"*. Loan pricing is the most important issue in understanding the fairness of mortgage markets. Although in the popular mind, abusive lending is primarily associated with high interest rates, the primary issue is actually the high fee total charged to borrowers. Lenders should use the HOEPA definition of "points and fees", since lenders already count these fees to determine whether the loan is subject to HOEPA. HOEPA also provides the most comprehensive, and therefore descriptive, catalogue of charges available. It is a very simple calculation. Reporting APR does not lessen the need for reporting points and fees, because the APR understates the true cost of fees since the APR amortizes fees over the original term of the loan, and almost all loans are paid off well before the term expires.

At a Minimum, Weak Federal Law Should not Preempt State Consumer Protections

Little is as frustrating or disheartening than to observe specific predatory lending abuses happening to real people; work successfully to get a state law or regulation passed to address the problem; and then find that federal law has been interpreted to preempt this state consumer protection. Congress has not acted in a substantial manner against predatory lending practices since it enacted HOEPA in 1994. Since then, however, subprime lending has increased 1,000%, and abusive lending is up commensurately. Rather than acting as a sword in the fight against abusive practices, federal law has functioned instead as a shield, enabling the continuation of abusive lending at the expense of entire neighborhoods.

I already discussed the problem of mandatory arbitration restrictions being preempted by the *Federal Arbitration Act*. The FAA was originally enacted in 1925 to overturn a common law rule that prevented enforcement of agreements to arbitrate between commercial entities. Ironically, it was intended to lower the costs of dispute resolution within the business community, but today is used to raise the costs of vindicating consumer rights. The states are unable to respond to this problem, because the Supreme Court has held that state laws that impose any restrictions specific to arbitration clauses are incompatible with the FAA. Preemption even applies to basic disclosure requirements such as a Montana law that required notice of an arbitration requirement to be "typed in underlined capital letters on the first page of the contract" in order to make the agreement enforceable.

The states are unable to protect their consumers from mandatory arbitration as long as the FAA preempts even requiring disclosure of arbitration clauses. We propose the prohibition of mandatory arbitration clauses in consumer loan contracts and amending the FAA to allow state regulation of consumer arbitration agreements. Of course, these changes would not affect the ability of consumers to voluntarily agree to submit a dispute with a lender to arbitration after the dispute had occurred. These changes would only protect consumers from signing away their rights before they knew the consequences.

A second important example is the Alternative Mortgage Transaction Parity Act (the "*Parity Act*"). Passed during the high interest rate crisis of the early 1980's, the Parity Act enabled state depository institutions and "other housing creditors" (unregulated finance companies) to make adjustable rate mortgages without complying with state laws prohibiting such mortgages. For thirteen years, this federal preemption did not pose a significant problem to consumers. However, in 1996, the OTS "reexamined" the purposes of the Parity Act and "reevaluated" its regulations. This "reinterpretation" occurred 10 years after states lost the ability to opt out of the law. At that time, the OTS concluded the Parity Act required it to extend federal preemption to restrictions on prepayment penalties and late fees.

Since this novel interpretation, predatory lending by unregulated finance companies has exploded, based in part on these companies' ability to avoid compliance with state laws, especially those state laws limiting prepayment penalties. In fact, the Illinois Association of Mortgage Brokers has filed suit asserting that the Parity Act preempts the state of Illinois' predatory lending regulations in their entirety for all alternative mortgages, including even the common sense requirement that lenders verify borrower ability to repay the loan. The OTS's definition of "alternative mortgage" is so loose, that nearly any loan could be made to fall under this category. CRL estimates that up to 460,000 families across the country have $1.2 billion stripped from their home equity each year directly as a result of the Parity Act.

Forty-six state Attorneys General, both Republican and Democrat, have urged the Office of Thrift Supervision (OTS) to reduce the scope of Parity Act preemption,[12] but without Congressional action, OTS feels constrained to act. 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 many unregulated non-depository institutions are taking advantage of federal preemption in ways that are abusive to borrowers without any corresponding regulatory obligations. If the Parity Act were repealed, finance companies would not be able to use the federal law to avoid meaningful regulation by states. A less preferable, although still extremely helpful, solution would be to simply delete reference to finance companies in the act. This would still allow state-chartered depository institutions to piggyback on the preemption authority that federally-chartered institutions have. At a minimum, given that the Act's broad effect goes far beyond what was understood when it was enacted, Congress should reopen the opt-out period for states that did not initially opt out (only six states did).

Finally, although it does not involve mortgage lending, we have been active in North Carolina attempting to reform *payday lending*. This relatively new industry has grown rapidly to 10,000 outlets and provides desperate borrowers with a two-week loan, often at 500% annualized interest rates, secured by a deferred check. However, with such a short term, borrowers invariably lack the time to solve the problems that led them to take such a high fee loan in the first place. They therefore get stuck paying a $45 fee every two weeks just to keep same $255 loan outstanding; in fact, 90% of total payday loans come from customers caught on flipping treadmill (5 or more payday loans per year). Reforming this industry is made much more difficult by the payday lenders engaging in a "rent a charter" partnership arrangement to enable them to take advantage of the federal preemption of usury limits available to regulated depository institutions. For example, Eagle National Bank (1% of payday fee) claims preemption on behalf of its "agent" Dollar Financial (99% of payday fee).

Conclusion

Fundamentally, I am a lender. Attempting to make loans to borrowers stuck in predatory loans taught me what lender practices were abusive. Finding out that these practices were legal under federal law made me angry. And so, on behalf of thousands of borrowers who face losing their homes and all the wealth they accumulated through a lifetime of hard work, I would ask the following: pass the bill that Chairman Sarbanes introduced last session, urge the Federal Reserve Board expeditiously to adopt the predatory lending rules it has proposed, and remove the obstacles placed on states in protecting their citizens by revising the Federal Arbitration Act, the Parity Act, and laws potentially allowing payday lending "rent a charters." If Congress could take these steps,

[12] See OTS comments of National Association of Attorneys General at http://www.ots.treas.gov/docs/48197.pdf.

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.

Appendix: Coalition for Responsible Lending Issue Paper, **Quantifying the Economic Cost of Predatory Lending**