Testimony

May 24, 2000

OTS-077 - Testimony on Predatory Lending before the Committee on Banking and Financial Services United States House of Representatives May 24, 2000 Ellen Seidman, Director, Office of Thrift Supervision

Testimony on Predatory Lending

before the

Committee on Banking and Financial Services

United States House of Representatives

May 24, 2000

Ellen Seidman, Director

Office of Thrift Supervision

I. Introduction

Chairman Leach, Ranking Member LaFalce, and Members of the Committee, I appreciate this opportunity to add my voice to those who are raising the alarm about predatory lending practices. These practices are crippling the financial health of too many low- and moderate-income families and elderly persons. Predatory lending is of great concern to me, both as Director of OTS and as Chairman of the Board of the Neighborhood Reinvestment Corporation. Today, I would like to discuss the nature of the problem, the steps OTS is taking to learn more about predatory lending and to fight it, what more we can do as the regulator of federal savings associations, and the role of the institutions we regulate.

While compliance and consumer protection concerns are the primary focus of the Committee at today's hearing, it is important to recognize that predatory lending can present safety and soundness risks, as well as risks to consumers and communities. The most obvious risk, of course, is legal and reputation risk. Once a lender gets a reputation for engaging in predatory practices, it is at serious risk of both public and private legal actions which--even if settled or successfully defended--divert time, energy, and funds. A second major risk is to liquidity. As we saw in late 1998 with respect to high-loan-to-value lending (where there were no serious questions of illegality raised), if the capital markets begin to become concerned that a given lender's securities or loans may not perform as projected, funding, particularly at the expected price, can dry up quickly. The result for a lender with a pipeline of such loans or actual or implied recourse on securities: very quick cash flow, capital, and earnings problems. Finally, there are operational and credit problems. It is extremely difficult to service a loan made without serious expectation that the borrower can repay--and particularly to do it in a manner consistent with the Fair Debt Collection Practices Act.

The scope of the predatory lending problem is illustrated by the wide range of today's witnesses, including lenders and their organizations, consumer organizations, federal and state regulators and other officials, community organizations, and academics. Each one of us has an important role to play.

As I see it, there are three interrelated approaches for combating predatory lending practices--what I call the three "E's": examination for enforcement of applicable laws and regulations, encouragement of responsible subprime lending, and education of consumers and investors. As one step to learn more about this problem and how to combat it, on April 5 OTS published an advance notice of proposed rulemaking, or ANPR, inviting comments from all who are interested in mortgage lending practices. We expect the comments to help us determine whether and how we can strengthen our mortgage lending regulations in this area. While we have no reason to believe there is a significant amount of predatory lending engaged in by the thrift industry, I want to confirm whether that belief is correct and take steps to prevent it from taking root in the future.

It is critical, however, that our efforts to curtail predatory lending do not impede the flow of credit to low- and moderate-income families, elderly individuals, and their communities. Lending to underserved communities and individuals, whether prime or responsibly done subprime lending, provides necessary credit safely and soundly. Insured depository institutions should consider serving this market not just because there is a large, unmet need, but also because it is a good business opportunity for those with proper management controls and sufficient capital. Without responsible and competitive credit, the amount of housing rehabilitation, education, job training, community development, and all the other activities of vital families and neighborhoods will be greatly reduced and a downward spiral of neighborhood decay can be the result. Ironically, this is the very same damage that predatory lenders impose when they strip equity from a large number of homeowners in a community.

In today's testimony, I will discuss the problem of predatory lending in more detail, describe highlights of the ANPR, and discuss the "three E's" for combating predatory lending.

II. The Problem of Predatory Lending

A discussion of predatory lending must start with the frank admission that defining it is not easy. In Deborah Goldstein's predatory lending study, "Understanding Predatory Lending: Moving Towards a Common Definition and Workable Solutions,"[1] the author states that "[p]redatory lending describes a set of loan terms and practices that fall between appropriate risk-based pricing by subprime lenders and blatant fraud." Ms. Goldstein suggests that loans become predatory when they target a particular population (most frequently low-income minorities and the elderly), taking advantage of the borrower's inexperience and lack of information to manipulate a borrower into a loan the borrower cannot afford to pay. Some predatory practices amount to fraud against the borrower, and of course, where that can be proven, there are criminal laws on the books to address it. The practices we are here to discuss today for the most part fall short of fraud but go beyond responsible subprime lending.

To understand predatory lending, it is important first to understand what responsible subprime lending is. Subprime lending refers to lending to borrowers who do not qualify for the most favorable interest rates and other loan terms because they are not among those with the best credit histories and most stable employment. Responsible subprime lending means making those loans at a price and with terms that appropriately compensate the lender for any enhanced risk, including a reasonable return, and marketing the loan in a manner that is fair to, and understandable by, the borrower.

What is predatory lending? First, let me disagree with those who describe it as a subset of subprime lending. Freddie Mac has estimated that from 10 to 35 percent of borrowers with subprime loans could have qualified for a prime loan, but were steered to a higher-cost loan anyway. A predatory loan typically combines several of the following features:

- interest rates significantly higher than justified by the relative risk profile of the borrower;
- financing of high fees and points and of a single-payment credit life insurance premium, often called "packing";
- a balloon payment;
- negative amortization; and
- prepayment penalties.

But the presence of one or more of these features does not necessarily make a loan predatory. Whether a loan is predatory depends also on factors related to its marketing, the choices available to the borrower, and whether the borrower has sufficient non-housing assets or income to pay off the loan. Thus, if you couple a loan with one or more of the features listed above with one or more of the following practices, a predatory loan is the likely result:

- high pressure marketing targeted to vulnerable populations, such as the elderly, low- and moderate-income families, and those with medical care or other debts;
- steering a borrower who would qualify for a prime loan to a high-cost loan, by taking advantage of the borrower's lack of knowledge or inexperience;
- excessive refinancing of little or no net benefit to the borrower, often called "flipping;"
- underwriting the loan based on the equity in the home without regard to whether the income or other non-housing assets of the borrower are sufficient to pay off the loan;
- making disclosures in a rushed way so the borrower does not understand the nature of the proposed loan; and
- refusing to report complete loan payment experience to credit reporting agencies.

Let me illustrate the point that certain loan features may be reasonable in one circumstance but predatory in another. A financially experienced borrower with substantial assets but uncertain or erratic current cash flow may knowingly and rationally elect an interest-only loan with a balloon payment due in a few years. That same borrower may be wise to accept a prepayment penalty applicable during the first three years of the loan in exchange for an interest rate of 8 percent instead of 8 5/8 percent. But substitute for this example (a) a borrower with few savings and a fixed income; (b) a loan with a prepayment penalty that resulted in lowering the interest rate from 17 ¼ percent to 16 percent; (c) a two-year balloon payment feature that will almost inevitably result in foreclosure; and (d) confusion created by high-pressure sales tactics, and you get what all would agree is a predatory loan.

Take yet another case, where a wealthy mortgagor chooses to purchase a single premium, whole life insurance policy at the time she refinances her home in order to diversify her investment portfolio and protect her family. There is no need to intervene to protect that borrower. But substitute an unsophisticated borrower who is told that he must purchase a credit life insurance policy and finance it by adding the single premium to the amount of the loan, and the warning bells ring loudly.

These are not just hypothetical problems. Let me describe an actual case brought to my attention by Jason Zavala, a housing counselor for a rural Vermont NeighborWorks local nonprofit organization speaking to the board of directors of the Neighborhood Reinvestment Corporation last August. Mr. Zavala told us the story of Janet "G," who is a single mother with limited literacy skills whose partially disabled adult son lives with her at home.[2] She makes $5 an hour as a dishwasher, working about 45 hours a week. An unsolicited window salesman referred her to a home equity mortgage lender that, he told her, could finance the windows and consolidate her personal, unsecured debts into one loan, even though three of the loans would have been paid off in only three, eight, and 13 months, respectively. The lender set up a loan that covered her existing debt, including her 3 percent mortgage, the new windows, and, of course, the fees. The lender charged her 10 points as an origination fee at the closing.

The new loan was for $28,000 at 12.9 percent interest for a 15-year term. The new windows only cost $8,500 and the payoff for the existing 3 percent mortgage was $12,000. Although she told the window salesman she could only afford to pay $200-$250, her new monthly payment was $359. The lender did not disclose the amount of the new payment until the closing. Her gross weekly wages were only $225. Although she sensed there was a problem with the loan, she "felt as though I had to go ahead and sign for the loan because I agreed to buy the thermal windows and I had no other way to pay for them." Luckily, she called the NeighborWorks organization, which helped her refinance through the Department of Agriculture's section 502 program. I am happy to report that the state of Vermont revoked the lender's license later that year. While there was a relatively happy ending to Janet G's story, one frequent result of such predatory lending practices is loss of the home due to foreclosure.

You have asked what evidence we have that there is an increasing trend in predatory lending practices such as illustrated by the example of Janet G, as compared to subprime lending. That is one of the main questions we have asked in our ANPR. It will not be easy to get hard data, for as I have illustrated, what may be predatory in one situation may be acceptable in another. Nevertheless, there is growing evidence suggesting that both the amount of predatory lending and the number of foreclosures are accelerating. The National Training and Information Center (NTIC) of Chicago released a study last September on the effect of subprime lending on foreclosures in and around Chicago. In 1993, subprime lenders accounted for only 131 of the 3,814 foreclosures initiated that year, or 3 percent. Six years later, in 1999, the subprime share of foreclosures initiated had skyrocketed to 38 percent (4,958 out of a total of 12,923).[3] More work needs to be done in this area, especially to determine the extent of the problem caused by predatory loans. Comments in response to OTS's ANPR may provide additional data about the extent to which predatory loans go into foreclosure.

Another factor that may be contributing to the growth of predatory lending is the existence of the Alternative Mortgage Transaction Parity Act (Parity Act). Some argue that the Parity Act shields predatory lenders from state laws designed to protect consumers from abusive mortgage lending practices. The ANPR discusses potential problems with the Parity Act, including that the law preempts state laws so state-licensed housing creditors may elect to follow OTS regulations governing alternative mortgage instruments instead of state law, even though they are not subject to OTS examination and supervision. I will discuss potential problems in this area in more detail when I address the problems of enforcement.

We have more to learn about the nature and extent of the problem of predatory lending. In addition to seeking more information through the ANPR process, OTS participates in a federal interagency working group that includes the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Department of Justice (DOJ), the Federal Trade Commission (FTC), the Department of Housing and Urban Development (HUD), the Federal Housing Finance Board (FHFB), the Office of Federal Housing Enterprise Oversight (OFHEO), and the National Credit Union Administration (NCUA). This group is examining the state of the law and determining where we might strengthen its enforcement. As part of this effort, we will be considering how to define and identify predatory practices; which policy, regulatory, and legislative options to pursue; and what consumer education initiatives are appropriate. Again, it is vital that in determining how best to curb predatory practices, we do not limit the availability of the prime and responsible subprime credit to those now targeted by predatory lenders, or the ability of federally insured depository institutions to serve all those in their communities.

III. OTS's Advance Notice of Proposed Rulemaking (ANPR)

Let me brief you on OTS's ANPR in some detail. As concerns intensified about predatory lending practices, OTS decided to review its own regulations to determine their effect in today's market on thrifts and their customers and, under the Parity Act, on state housing creditors. As we state in the ANPR's summary, we are particularly interested in hearing about ways to facilitate thrifts' efforts to address the lending needs of underserved markets in a responsible way--free of predatory practices--and, of course, consistent with safe and sound operation.

Six Goals

The ANPR sets forth six goals that we will balance in our decisions on whether changes to OTS's lending regulations are appropriate once the comment period closes on July 5. The goals are to--

1. Encourage safe and sound lending. Whatever the type of mortgage lending or market, the loans a thrift makes must be prudently underwritten. That means, among other things, that the borrower must have the ability to repay the loan. Because the equity in the home is pledged to repayment of the loan and the loan fees and charges are paid to the lender at or before loan closing, predatory lenders may feel free to ignore whether the loan can be repaid.
2. Encourage innovation in identifying potential customers and meeting their needs. We must make room for the development of new underwriting approaches and new procedures and marketing strategies as we encourage thrifts to find new ways to meet the needs of qualified subprime borrowers and earn reasonable profits.
3. Discourage lending that preys upon customers' lack of knowledge or limited options.
4. Enable thrifts to compete with other types of lenders. I would reject any suggestion that this means they must have the flexibility to compete with predatory lenders by "fighting fire with fire." Instead, we must give them the tools and flexibility to fight predatory lending practices with responsible loan products and education of consumers so the business of responsible sound lending to prime and subprime borrowers will flow to thrifts and other ethical lenders.
5. Maintain the uniform system of regulation that applies to federal thrifts. This will keep costs down and help simplify the confusing array of options for consumers.
6. Minimize regulatory burden on thrifts. If we give thrifts and other lenders appropriate guidance and flexibility, we believe we can achieve the goal of driving predatory lending off the map of home lending without imposing undue regulatory compliance burdens, with their associated higher costs that flow through to homebuyers.

Parity Act

The ANPR focuses much of its attention on the Alternative Mortgage Transaction Parity Act of 1982. The period from the late 1970s to the early 1980s was a time of high interest rates, when housing credit was relatively unaffordable to many. Congress's purpose in enacting the Parity Act was to give state-chartered housing creditors, which are entities that regularly make mortgage loans, parity with federally chartered institutions by giving them the authority to make, purchase, and enforce alternative mortgage loans. Alternative mortgage loans are loans with any alternative payment features, such as variable interest rates, balloon payments, or call features. The Parity Act does not apply to other types of mortgages or other loan transactions.

State housing creditors have the choice to comply with either OTS regulations or state laws for alternative mortgage instruments. The Parity Act does not, however, give federal agencies supervisory authority over state housing creditors, which remains with the states. This is not a unique situation. In the federal arena, for example, the Federal Reserve Board issues regulations implementing the Truth in Lending Act, but OTS and other agencies have the responsibility to enforce them.

For purposes of the Parity Act's preemption, OTS has designated certain regulations over time as appropriate and applicable to alternative mortgage transactions engaged in by state housing creditors. The earliest approach taken by OTS's predecessor agency in 1982 was to limit the list of regulations to those that apply exclusively to alternative mortgage transactions. This included (a) the authority to make partially or non-amortizing loans and to adjust the interest rate payment, balance, or term of maturity; (b) limits on adjustments on loans secured by property occupied by the borrower; and (c) requirements for disclosures on loans that are not fixed-rate and fully amortized and that are secured by property occupied by the borrower. This approach was possible because, at that time, OTS's lending regulations were highly detailed and "design-oriented." In the early 1990s, however, OTS streamlined its lending regulations--both those that apply only to alternative mortgage transactions and those that apply to all mortgages--to provide flexibility, reduce regulatory burden, and encourage innovations to stimulate credit. To protect consumers, OTS has relied on consumer disclosures. Based on these new more "performance-based" regulations, in 1996 OTS reevaluated and revised its approach to the Parity Act preemption. Since by then the same broad regulation applied to all types of home mortgage loans, no longer distinguishing between traditional fixed-rate and alternative types of loans, some have argued that OTS, in effect, expanded preemption available under the Parity Act.

The ANPR solicits comments on how to clarify the interaction between the federal and state regulatory schemes affecting state housing creditors. We may hear from state housing creditors and others that more regulations should be designated as applying to state housing creditors electing to be subject to OTS regulations with respect to alternative mortgage transactions and from the states and consumer groups that fewer should be. In any case, we must keep the overall congressional goal of parity in mind. Thrifts are subject to a comprehensive regime of regular examination, supervision, and enforcement to assure their compliance with applicable laws and regulations. Some non-depository institution state housing creditors are as well, but others are not. How should these differences be taken into account so alternative mortgage transactions by state housing creditors are treated neither more harshly nor more leniently than similar transactions by thrifts? Frankly, we don't yet know. The degree of participation in such practices by housing creditors that have used the Parity Act and OTS's implementing regulations instead of state law has not been studied in a focused manner. The ANPR therefore asks the following questions:

1. To what extent are housing creditors engaging in predatory or abusive mortgage lending practices that would be contrary to existing state law but for the provisions of the Parity Act and OTS's implementation?
2. To what extent are state housing creditors engaging in predatory or abusive lending practices that are contrary to applicable laws (such as state laws against fraud) but are not being prosecuted by state authorities whose power is specifically reserved by the Parity Act for that purpose?

Some have argued that the ability of state housing creditors to rely on OTS's regulations may have resulted in abuses in markets where there are fewer competitive pressures and no regular state oversight. To explore whether this has occurred, we have invited comments on these questions:

1. To what extent do housing creditors lending under the Parity Act use different practices and impose more onerous loan terms in underserved or financially unsophisticated markets than they or their affiliates use in more mainstream markets?
2. To what extent do housing creditors lending under the Parity Act provide credit to persons with good or excellent credit records at rates and with terms significantly above those for conventional prime mortgages?
3. To what extent does the use or terms of prepayment penalties, the financing of prepaid credit life insurance or loan fees, or the frequency of partially amortizing, non-amortizing, or negative amortizing loans vary among state housing creditors

or between them and insured depository institutions? Do variations relate to characteristics of the borrower (such as race or age) or the neighborhood, or to the relative creditworthiness of the borrower? Do variations result in returns that compensate lenders in excess of risk-adjusted prices or loan terms?

4. Do state housing creditors refinance mortgage loans (including fees) that they or an affiliate have made at rates equal to or greater than the rates on the existing loans? Does this occur at insured depository institutions?
5. How, if at all, do the answers to these questions differ for housing creditors who do not make alternative mortgage transactions under the Parity Act but rely instead upon state law?

It is not clear that we will be able to get complete information on all, or even any, of these questions. But we believe it is important to gather what is available before taking any action.

Should OTS Adopt Regulations on High-Cost Mortgage Loans?

The ANPR also seeks advice on whether OTS should adopt regulations on high-cost mortgage loans. The Home Ownership and Equity Protection Act of 1994 (HOEPA) amended the Truth in Lending Act to require certain protections for home equity borrowers if either the annual percentage rate exceeds by more than 10 percent the yield on Treasury securities of comparable maturities or the total of points and fees the borrower must pay exceeds the greater of 8 percent of the loan amount or, currently, $451 (adjusted for inflation).

Representative LaFalce and Senator Sarbanes have recently introduced companion predatory lending bills, H.R. 4250 and S. 2415, the "Predatory Lending Consumer Protection Act of 2000." This legislation would expand the reach of HOEPA to cover more high-cost mortgage loans, cover open-end credit as well as closed-end, lower the 10 percent interest rate trigger to 6 percent in the case of a first mortgage and to 8 percent for subordinate mortgages, tighten the cap on total points and fees, and prohibit or restrict certain practices. Representatives Schakowsky and Ney have also introduced predatory lending bills (H.R. 3901, the "Anti-Predatory Lending Act of 2000," and H.R. 4213, the "Consumer Mortgage Protection Act of 2000," respectively). Senator Schumer introduced S. 2405, the "Predatory Lending Deterrence Act." I am glad to see so much attention being paid to this problem. We hope to contribute to the discussion, and plan to share with you what we learn from public comments submitted in response to the ANPR.

In the context of asking whether OTS should amend its lending regulations to impose high-cost mortgage loan limits stricter than the current HOEPA approach without waiting for new legislation, the ANPR invites comments in response to the following questions:

1. What loans should be covered?
2. Should OTS impose limits on financing of certain fees or charges?
3. Are limits on refinancing appropriate?
4. Are prepayment penalties appropriate for high-cost loans?
5. What limits on balloon payments, negative amortization, post-default interest rates, and mandatory arbitration clauses would be appropriate for high-cost loans?
6. Should OTS require lenders to determine the suitability of a mortgage loan product for particular borrowers?
7. Should OTS require institutions to notify applicants for high-cost loans of the availability of home loan counseling programs before closing?
8. Is differential regulation appropriate?

We have considered the work done by North Carolina in its recently enacted legislation and by New York in its proposed regulations, and want to give them credit for taking leadership roles and to acknowledge our debt to this leadership in helping us formulate our questions about the nature and extent of predatory lending.

How Should OTS Deal with Potential Lending Issues Raised by Entities Related to Thrifts?

Some believe that entities related to insured depository institutions engage in lending practices that may disadvantage potentially vulnerable customers. OTS is looking into the extent to which this is a problem, and the ANPR invites comments on various aspects of this issue. Thrift operating subsidiaries may only engage in activities permissible for a thrift, and OTS must receive notice before a thrift creates an operating subsidiary or an operating subsidiary initiates a new activity. These subsidiaries are already subject to OTS examination and supervision, and we act promptly if a problem arises. If we determine subsidiaries pose different or higher risks than the parent thrifts, we would modify our subordinate organizations regulations to address these risks or take other appropriate action. With respect to other affiliates of thrifts--that are subsidiaries of a thrift holding company but not of a thrift and are often under the jurisdiction of other state or federal regulatory authorities--our concern is limited to the effect of affiliates on the safety and soundness of thrifts. If we determine an affiliate is placing a thrift at risk, we take appropriate steps to protect the thrift, including full cooperation with the responsible state authorities.

IV. WHAT IS BEING DONE AND WHAT ELSE CAN BE DONE: ENFORCEMENT, ENCOURAGEMENT OF RESPONSIBLE SUBPRIME LENDING, AND EDUCATION

I alluded earlier to a three-pronged approach that we at OTS are already pursuing as our share of the fight against abusive predatory lending practices:

- Examination for enforcement of applicable laws and regulations.
- Encouragement of responsible subprime lending.
- Education of consumers and investors.

Examination for Enforcement of Applicable Laws and Regulations

Vigorous enforcement of applicable laws and regulations can help curtail abusive loan terms and practices. Federal and state regulators, and law enforcement agencies, need to become more aggressive with lenders engaged in risky, abusive, and unlawful predatory lending practices. There are several federal enforcement options and assorted new state remedies available for pursuing unscrupulous lenders, including under North Carolina's new law.

You have asked about any weaknesses we have identified in current law and regulations and for suggestions for changes in these or other areas. I have already described to you the ANPR we are using to seek advice from all interested parties on possible changes to our lending regulations. To the extent the comments recommend legislative reforms, such as to the Parity Act or to HOEPA, OTS will bring them to your attention. I think it is quite possible that at least some regulatory reform will result from the ANPR, and if that is the case, the preamble to the proposed regulation will describe the comments we received and the steps we are proposing in response. There will then be another opportunity for public comment on the specific standards proposed for change.

For federal banking agencies, assuring enforcement of applicable laws governing predatory practices begins with fulfilling our supervisory role, including regular and special examinations. Consumer compliance examinations are a standard part of OTS oversight. Examiners follow the interagency procedures established by the Federal Financial Institutions Examination Council (FFIEC) to ascertain the record of an institution's compliance with federal consumer protection laws and regulations. We implement these procedures by following a risk-focused, top-down approach that emphasizes the need for institutions to establish proper policies and maintain internal controls appropriate to their particular business operations. Once an examiner has focused the examination on the risks presented by the institution's operations and evaluated the policies and controls established by the institution, he or she probes for areas of weakness by examining sample transactions for compliance with specific regulations.

This basic approach has a sound track record. As insured depository institutions, including thrifts, expand their product lines and operations into subprime markets, they must face consumer protection risks that are different from those they face in conventional lending markets. For example, fees out of line with even the higher costs of originating and servicing low-balance subprime loans may be inconsistent with the Real Estate Settlement Procedures Act requirement for reasonable compensation for services delivered in connection with mortgage transactions. Focusing subprime products to largely minority markets increases the risk of discriminatory pricing or steering in violation of the Equal Credit Opportunity and Fair Housing Acts. OTS is developing additional guidance for its examiners to help them better recognize the challenges that subprime market business plans and products hold for the institutions we regulate. This guidance will enable examiners to identify the types of lending practices that move beyond responsible to predatory and, therefore, that thrifts should avoid. Even before we issue the new guidance, if an examination were to identify management deficiencies that allow illegal predatory lending practices to develop, OTS can require a thrift to cease the offending practices, implement improved policies and controls, and provide remedies for past conduct.

Some believe that the problem of predatory lending can be sufficiently controlled by beefing up disclosures. While I am not sure about all the steps we need to curtail predatory lending, I am convinced that disclosures alone are not enough. Those targeted by predatory lenders often do not have the background to understand the real world impact of adjustable rate mortgages, balloon mortgages, negative amortization, prepayment penalties, points, insurance premiums, and all the rest. Moreover, pressure tactics that dissuade borrowers from taking the time to ask for help from an independent source are part and parcel of predatory practices. Take, for example, the following section from the variable-rate mortgage sample disclosure form from the Federal Reserve Board's TILA regulation (12 CFR part 226, appendix H (form H-14)). This disclosure is a good example of plain English that nevertheless includes concepts, such as "securities adjusted to a constant maturity of 1 year," that may be too complex for the average consumer to understand fully:

How Your Interest Rate and Payment are Determined

- Your interest rate will be based on an index rate plus a margin.
- Your payment will be based on the interest rate, loan balance, and loan term.

  --The interest rate will be based on the weekly average yield on United States Treasury securities adjusted to a constant maturity of 1 year (your index), plus our margin. Ask us for our current interest rate and margin.

  --Information about the index rate is published weekly in the Wall Street Journal.

- Your interest rate will equal the index rate plus our margin unless your interest rate "caps" limit the amount of change in the interest rate.

Enforcement is a piece of the solution, but I believe it is only one piece of the puzzle. It is generally after-the-fact and limited in scope. At best it provides restitution, not restoration of ownership of the lost home, and functions as a preemptive warning to those already in the business and those considering entering it. If we are to have systemic reform that reaches into every community, we must focus our attention on the two other "E's": encouragement of responsible subprime lending and education of consumers and investors.

Encouragement of Responsible Subprime Lending

The most important place to fight predatory lending is in the marketplace itself. We still have communities that are not adequately served by insured depository institutions. One of the reasons predatory lenders are so successful is the absence of competition. Some conventional lenders believe that the risk of lending in certain communities is unacceptable and that there are too few business opportunities in those markets. They therefore unwittingly cede this business to the unscrupulous. We need to create an environment that encourages responsible competition in underserved markets typically targeted by predatory lenders.

As has become apparent to many commercial retailers, many markets have been mistakenly undervalued in terms of business opportunity and over-estimated in terms of risk. More and more retailers are opening business outlets in profitable markets in both inner-city neighborhoods like Harlem, the South Bronx, South Central L.A., and Little Village in Chicago and other similar markets in close-in suburbs. In fact, the opportunities seem to be expanding, fueled by a robust economy, low unemployment, special programs designed to move people from welfare to work, and rapidly changing demographics due to migration patterns.

Seeking business in these underserved markets is a matter of enlightened self-interest. Millions of unbanked or untraditionally banked Americans want and need the quality of financial services you and I take for granted. Too often these potential banking customers are being left to finance companies and check cashing businesses. When they need a loan, they think of payday loans and car title loans, not personal loans or home equity loans from an insured depository institution. We are encouraging thrifts to look hard at their changing marketplace and to think about their future strategically. Thrifts must figure out who their customers are today and who they will be tomorrow, what products and services they need, and how to meet the demand for those services.

We also urge community groups to help bridge the gap between bankers and financially underserved families as part of a strategy to eliminate the opportunity predatory lenders use to drive a wedge between legitimate needs and community stability. These groups can help lenders identify real risks and real opportunities in underserved markets, learn how to successfully market products and services in low-income and minority communities, and create strategies to help banks and thrifts develop successful and responsible lending programs targeted to underserved communities.

Education of Consumers and Investors

We have now reached the last--but not least--element of the solution: education of both consumers who are potential victims of predatory lenders and of investors in subprime mortgage loans and securities backed by subprime loans. Giving consumers information about their options for obtaining credit from responsible lenders and about the abuses of those who prey on the vulnerable can be a strong bulwark against the predatory lender.

In addition to the role of community-based organizations in helping bridge the gap between financial institutions and communities vulnerable to predatory lending, they are a logical starting point for educating consumers. Many already work with homebuyer education and counseling and can expand into post-purchase counseling to teach clients about how to be discerning homeowners and how to avoid potential home equity scams. Learning what questions to ask and how to evaluate the answers--or where to find help--is critical to making informed choices. So is developing the discipline to say "no" to deals that are just too good to be true.

Reaching community residents who already own their own homes and are not involved in existing homeowner education and counseling programs is a trickier issue. Community-based organizations and financial institutions with respect to their elderly account or safe deposit box holders and others likely to be targeted by predatory lenders need to reach out aggressively to potential borrowers and arm them with valuable information to give them a shield against the lies and deceit of predatory lenders. For example, community groups can:

- Identify reliable home improvement contractors and home equity lenders.
- Establish early warning networks and intervention game plans for implementation when unscrupulous contractors or lenders invade a neighborhood.
- Encourage community members to build broad-based banking relationships with federally insured depository institutions, including, for example, electronic benefits transfer programs and first-time investor programs.
- Work with local schools, faith-based organizations, and seniors groups to get out the word about predatory lending scams--how to avoid them, where to report them, and how to get answers to questions.

As for investors, they must be more discerning in their purchase of securities backed by high-cost loans to avoid providing liquidity to the unscrupulous. The activities of large predatory lenders will quickly shrivel if they are denied financing. Participants in the secondary market are beginning to recognize that predatory loans are not good business--not just because they are unethical but also because they can damage their reputation and hurt their stock price.

It is critical, however, not to pursue this in a manner that threatens the viability of responsible subprime markets. There will still be a vital and large market for securities backed by subprime loans. The well-oiled machine of loan securitization will not seize up when it ceases to accept fraudulent or abusive loans. Fannie Mae and Freddie Mac have responded not as regulators, but as market savvy investors who recognize the hazards predatory loans bring to their loan portfolios. So far, we have heard from Fannie and Freddie; I hope the other securitizers step up to the plate also, rather than seeing Fannie's and Freddie's refusal to buy mortgages that reflect predatory practices as a new business opportunity for themselves.

V. CONCLUSION

The American dream of homeownership is at the heart of the progress we have made as a nation toward the goal of giving all citizens the opportunity to earn their share of our prosperity. During the first quarter of this year, we achieved a new record: 67.1 percent of all families own their own homes. In the last few years, the pride we have all taken in the steady increase in homeownership levels has been tempered by the stories about some lenders that have preyed on homeowners who are least able to defend themselves. Let us look back on this year as the turning point in the fight against predatory lending, knowing that future homeownership records will be even more impressive because fewer new and existing homeowners will be at risk of losing what they've always dreamed of.

---

[1] This study was written under the support of the Neighborhood Reinvestment Corporation's Emerging Leaders in Community Economic Development Fellowship and was issued in October 1999.

[2] Janet G's affidavit is attached.

[3] "Preying on Neighborhoods: Subprime Mortgage Lenders and Chicagoland Foreclosures," September 21, 1999, issued by the National Training and Information Center of Chicago.