Prepared Statement of the
Federal Trade Commission

by
Jodie Bernstein, Director
Bureau of Consumer Protection

before the
SENATE SPECIAL COMMITTEE ON AGING

on
Home Equity Lending Abuses in the Subprime Mortgage Industry

March 16, 1998

I. INTRODUCTION

Mr. Chairman and members of the Committee: I am Jodie Bernstein, Director of the Bureau of Consumer Protection of the Federal Trade Commission.[(1)] I appreciate the opportunity to appear before you today on behalf of the Commission to discuss the serious problem of abusive lending practices in the subprime mortgage lending industry. These comments do not address those lenders within the subprime mortgage industry who play

capital, but, at the same time, this access must not be hindered by deceptive or other unlawful lending practices.

II. THE SUBPRIME MORTGAGE INDUSTRY

Subprime lending refers to the extension of credit to higher risk borrowers, a practice also commonly referred to as "B/C" or "nonconforming" credit.[(7)] Loans to subprime borrowers serve communities that may have been underserved by other lenders in the past. In recent years, subprime mortgage lending has grown dramatically, with over 90% of all subprime mortgage loans made in or after 1993.[(8)] By the end of 1996, the total value of outstanding subprime mortgage loans exceeded $350 billion.[(9)] In 1997 alone, subprime lenders originated over $125 billion in home equity loans.[(10)] Subprime loans have become a significant and growing part of the home equity market. Subprime originations constituted 11.5% of the total home equity lending market in 1996; by the first half of 1997, they had grown to 15.5% of this market.[(11)] At the same time, the composition of companies involved in the subprime market is evolving. One of the dramatic changes in this market has been the growth in subprime mortgage lending by large corporations that operate nationwide.[(12)]

The subprime mortgage market has flourished because such lending has been profitable, demand from borrowers has increased, and secondary market opportunities are growing. Lenders typically price subprime loans to consumers at rates of interest and fees higher than conventional loans.[(13)] Higher rates and points can be appropriate where greater credit risks are involved, as is often the case with subprime loans.[(14)]

home equity loans due to the change in the tax code limiting allowable interest deduc
to those on a first mortgage.

III. THE PROBLEM OF ABUSIVE LENDING PRACTICES

The enormous growth of the subprime mortgage industry has enabled many consumers to obtain home loans who previously would have had much more limited access to the credit market.[(22)] Questions increasingly are being raised, however, about certain lending practices, often referred to as predatory lending, that reportedly are occurring in the subprime mortgage market and about their effect on the most vulnerable consumers.[(23)] These abusive lending practices often involve lower-income and minority borrowers.[(24)] Elderly homeowners, in particular, are frequent targets of some subprime home equity lenders, because they often have substantial equity in their homes, yet have reduced incomes.[(25)] In many cases, those living in lower-income and minority neighborhoods -- where traditional banking services continue to be in short supply -- tend to turn to subprime lenders regardless of their credit history.[(26)] While subprime lenders point out that they are expanding access to credit to individuals who otherwise would be shut out of the market and consumers whose credit histories make them too risky for conventional loans, such lenders are in a position to take advantage of the consumers in the weakest bargaining position.

It is critically important for all consumers, especially those who live in lower-income communities, to have access to capital. Access that is based on deceptive mortgage lending, however, is false access. Deceptive lending practices hide from consumers essential information they need to make decisions about their single greatest asset -- their home -- and the equity they have spent years building.[(27)] Deceptive lending practices are particularly devastating because these loans usually are sought at a time of great need, when borrowers are most susceptible to practices that can strip them of substantial sums of money and, ultimately, their homes.

Reported abusive lending practices in the subprime mortgage market cover a wide range. We will mention here a few highlighted in recent reports. While the reported practices are quite varied, there are common traits. They generally aim either to extract excessive fees and costs from the borrower or to obtain outright the equity in the borrower's home.

Among the most harmful of these reported practices is "equity-stripping." This often begins with a loan that is based on equity in a property rather than on a borrower's ability to repay the loan -- a practice known as "asset-based lending."[(28)] As a general rule, loans made to individuals who do not have the income to repay such loans usually are designed to fail; they frequently result in the lender acquiring the borrower's home equity. The borrower is likely to default, and then ultimately lose her home through foreclosure or by signing over the deed to the lender in lieu of foreclosure. Such a scheme is particularly damaging because these vulnerable borrowers often have no significant assets except the equity in their homes.[(29)]

Another practice of serious concern is "packing," the practice of adding credit insura

other "extras" to increase the lender's profit on a loan.[30] Lenders often stand to make significant profits from credit insurance, and therefore have strong incentives to induce consumers to buy it as part of the loan.[31] At the same time, observers have questioned the value to consumers who obtain the insurance in conjunction with their loans, given the high premium cost and comparatively low claims rate.[32]

Typically, the insurance or other extra is included automatically as part of the loan package presented to the borrower at closing, and the premium is financed as part of the loan. The lender often fails to provide the borrower with prior notice about the insurance product[33] and then rushes the borrower through the closing. Sometimes, the lender represents that the insurance "comes with the loan," perhaps implying that it is free. Other times, the lender simply may include the insurance in the loan closing papers with no explanation. In such a case, the borrower may not understand that the insurance is included or exactly what extra costs this product adds to the loan. Even if the borrower understands and questions the inclusion of the insurance in the loan, subprime borrowers are not in a position to negotiate loan terms. They often need to close the loan quickly, due to high debt and limited financial resources. Therefore, they generally will not challenge the loan at closing if they believe or are told that any changes may cause a problem or delay in getting the loan.

Lenders are permitted to require the purchase of credit insurance with a loan, as long as they include the price of the premium in the finance charge and annual percentage rate. In some instances, however, the lender effectively requires the purchase of credit insurance with the loan, but fails to include the premium in disclosures of the finance charge and annual percentage rate, as mandated under the Truth in Lending Act.[34] When the lender excludes the required insurance premium from the borrower's disclosures, the cost of credit may appear significantly lower than the true cost of the credit. As a result, the consumer cannot make an informed decision about the cost of the loan.

work on the home, may then present the homeowner with loan documents from the ler indicating higher rates and fees than those that were agreed upon. The consumer is then pressured to sign the papers as drafted --

enforcers in six cities around the country. These training sessions were conducted to a
states in exercising their relatively new enforcement authority under HOEPA[(52)] and to
share information about recent trends.

In the area of consumer education, the Commission has developed a brochure focusing on consumer rights under HOEPA, for high-rate, high-fee loans covered by that law. In conjunction with the filing of the Capital City complaint, the Commission began distributing a Consumer Alert, advising consumers on how to avoid home equity scams. The Commission today is releasing a new consumer education brochure with additional advice for consumers on home equity abuses.

V. CONCLUSION

The Commission recognizes that abuses in the home equity lending market are a serious national problem. Due to sharp growth in the subprime mortgage industry, it appears that the abuses by subprime lenders are on the rise. As a result of unfair and deceptive practices, and other federal law violations by certain lenders, vulnerable borrowers --

stands in contrast with an increase of 61% in the prime mortgage market for approximately the same period.

9. . See Wahl and Focardi, supra note 7, at 31.

10. . See Top 25 B & C Lenders in 1997, Inside B & C Lending, Feb. 16, 1998, at 2.

11. . See Wahl & Focardi, supra note 7, at 29. The number of mortgage brokers in this market skyrocketed from 500 in1985 to 20,000 in 1996. See The Two Faces of B&C Lending, Am. Banker, May 6, 1997, at 2A.

12. . See Home Loan Leaders,

v. Inland Mortgage, 132 F.3d 692 (11th Cir. 1998); Barbosa v. Target Mortgage Corp., 968 F. Supp. 1548 (S.D. Fla. 1997); Mentecki v. Saxon Mortgage, Inc., Civ. No. 96-1629-A, U.S. Dist. LEXIS 1197 (E.D. Va. January 10, 1997); see also Carol M. Cropper, Even With Mortgage Brokers, Let the Borrower Beware, N.Y. Times, Sept. 8, 1996, § 3, at 8.

24. . See Complaint at 6, F.T.C. v. Capital City Mortgage Corp., No. 1:98-CV-00237 (D.D.C. filed Jan. 29, 1998); Goetz, supra note 20, at 33; Anastasia Hendrix, Oakland Widow: They Stole My House, S.F. Examiner, Apr. 13, 1997, at A1; O'Brien, supra note 11, at B3; Kay Stewart & David Heath, High-Cost Loans Trap Those Least Able To Afford It, Louisville Courier-Journal, Feb. 16, 1997, at 1A, 16; Lucille Renwick, Wolf at the Door, L.A. Times, Mar. 14, 1993, at 16.

25. . For example, the Department of Justice announced a settlement in September 1996 with Long Beach Mortgage Company addressing allegations, inter alia, that the company discriminated against the elderly, African Americans, Latinos, and women by charging higher rates than were offered to other similarly qualified borrowers. The combination of these factors was alleged to be crucial. For example, African American females over the age of 55 were 2.6 times more likely than white males under age 56 to be charged fees and points that amounted to 6% or more of the loan amount. See Complaint, United States v. Long Beach Mortgage, Civ. No. 96-6159DT (CWX) (C.D. Cal. filed Sept. 5, 1996).

26. . See Goetz, supra note 20, at 34.

27. . Fifty-eight percent of seniors living below the federal poverty level own their own homes. Derived from U.S. Dept. of Commerce & U.S. Dept. of Housing and Urban Development, American Housing Survey of the United States, 1993. Thirty-nine percent of all families below the federal poverty level own their own homes. Derived from U.S. Dept. of Commerce & U.S. Dept. of Housing and Urban Development, American Housing Survey for Selected Metropolitan Areas, 1991-94.

28. . Hearings Before the Federal Reserve Board on the Effect of Truth in Lending Act Provisions Enac 1994 on the Home Equity Loan Market, June 17, 1997 (testimony of Elizabeth Renuart, National Consumer Law Center).

29.. While the TILA, as amended by the Home Ownership and Equity Protection Act, prohibits a pattern or practice of asset-based lending, this proscription only applies to the narrow set of high-rate and high-fee loans covered by the statute and does not apply at all to purchase-money loans. See 15 U.S.C. §1639; 12 C.F.R. §226.32. For a discussion of HOEPA's requirements, see infra note 43.

30. . See The Money Tree, No. C3735 (F.T.C. Apr. 28, 1997) (settling allegations that credit insurance and other "extras" were required but not included in finance charge and APR disclosures in violation of the TILA and, in certain instances, the FTC Act); Tower Loan of Mississippi, 115 F.T.C. 140 (1992) (same).

31. . The guidelines established by the National Association of Insurance Commissioners suggest that lenders and insurers may retain up to 40 cents on the dollar from premiums paid by borrowers, with 60% of p payments paid out for claims. In most states, however, lenders and insurers retain more than 40% of p

overcharged a total of $615 million in 1973).

33. . This scenario is known as "bait and switch," because the closing papers differ from the loan package previously discussed with the borrower.

34. . See 12 C.F.R. §226.4(b)(7). Typically, lenders can easily induce borrowers to sign a line in the thick package of complex loan closing papers indicating that the purchase of insurance is voluntary when, in fact, they have little choice if they want to close the loan at that time. Whether credit insurance is in fact required or optional is a factual question. See Federal Reserve Board, Official Staff Commentary to Regulation Z, § 226.4(d)(5).

35. . Lenders have incentives to omit required credit insurance premiums from the disclosures of the annual percentage rate and finance charge. First, the appearance of a lower rate may induce the borrower to follow through on the transaction. Second, the lower figure may cause the lender's annual percentage rate to appear to fall below state rate ceilings, which it may in actuality be exceeding.

36. . One method of inducing a borrower to refinance is by issuing a balloon note -- particularly one in which the borrower is paying only interest -- where the note comes due in a relatively short period of time. When the note comes due and the borrower owes a substantial lump sum -- sometimes equal to the entire principal of the original loan -- the borrower must again obtain a loan in order to finance the balloon payment that is due at that time.

37. . See, e.g. Kay Stewart, Widow Sold Her House To Pay Loan She'd Hoped Would Ease Her Debts, Louisville Courier-Journal, Feb. 16, 1997, at 16 (lender refinanced borrower's loan four times in nine months). Lenders in the consumer finance industry have long relied on refinancing, and sometimes repeated refinancing, as a source of business. See

originate a new loan for the home improvements. First, lenders generally seek to originate one comb
rather than only a second mortgage for the smaller cost of the improvements. This allows the lenders to
maximize fees that are obtained based on the loan principal. Second, lenders generally prefer the initial lien

52. . States also have authority to enforce HOEPA. See 15 U.S.C. §1640 (e).