PREPARED STATEMENT OF THE
FEDERAL TRADE COMMISSION

before the

HOUSE COMMITTEE ON BANKING AND FINANCIAL SERVICES

on

Predatory Lending Practices in the Subprime Industry

May 24, 2000

I. INTRODUCTION

Mr. Chairman and members of the Committee: I am David Medine, Associate Director for Financial Practices, of the Federal Trade Commission's Bureau of Consumer Protection.[(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 lending industry, commonly known as "predatory lending." I will discuss the recent growth of the subprime industry, predatory lending practices that reportedly are occurring in the industry, the Commission's recent activities in this area, and possible statutory changes to enhance consumer protection. First, however, let me briefly speak about the Commission's role in enforcing laws that bear on these problems.

The Commission has wide-ranging responsibilities concerning nearly all segments of the economy. As part of its mandate to protect consumers, the Commission enforces the Federal Trade Commission Act ("FTC Act"), which broadly prohibits unfair or deceptive acts or practices.[(2)] The Commission also enforces a number of laws specifically governing lending practices, including the Truth in Lending Act ("TILA"),[(3)] which requires disclosures and establishes certain substantive requirements in connection with consumer credit transactions, the Home Ownership and Equity Protection Act ("HOEPA"),[(4)] which, as part of the TILA, provides special protections for consumers in certain non-purchase, high-cost loans secured by their homes, and the Equal Credit Opportunity Act ("ECOA"),[(5)] which prohibits discrimination against applicants for credit on the basis of age, race, sex, or other prohibited factors. The Commission has jurisdiction over most non-bank lenders.[(6)] In addition to our enforcement duties, the Commission also responds to many requests for information about credit issues and consumer credit laws from consumers, industry, state law enforcement agencies, and the media.[(7)]

We continue to see problems in the subprime industry, in particular the home equity loan business, and the Commission is working in a number of ways to address them. Commission strategies include law enforcement, often coordinated with other law enforcement officials, and consumer education. It is crucial that as many consumers as possible have access to credit, but, at the same time, this access must not be hindered by unlawful lending practices.

II. THE SUBPRIME MORTGAGE INDUSTRY

Subprime lending refers to the extension of credit to persons who are considered to be higher-risk borrowers, also commonly referred to as "B/C" or "nonconforming" credit.[(8)] Loans to subprime borrowers serve communities that may have been underserved by lenders in the past. In recent years, subprime mortgage lending has grown dramatically. In 1999 alone, subprime lenders originated over $160 billion in home equity loans.[(9)] This is a $35 billion increase from 1997, when subprime lenders originated $125 billion in home equity loans.[(10)] At the same time that subprime loans have become a significant and growing part of the home equity market, 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, including bank holding companies, that operate nationwide.[(11)]

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. Higher rates and points can be appropriate where greater credit risks are involved, as is often the case with subprime loans. Critics assert, however, that the interest rates and fees charged by some subprime lenders are excessive, and much higher than necessary to cover increased risks, particularly since these loans are secured by the value of a home. Some attribute lenders' high rates on first mortgages in part to federal deregulation of certain state interest rate ceilings in 1980.[(12)]

During the last five years, Wall Street investment banks have played an increasingly important role in raising funds for subprime loans. In 1995, $18.5 billion in subprime loans was securitized. In 1999, that figure reached almost $60 billion.[(13)] The secondary market's expansion has, in turn, helped to sustain growth in the industry by enabling lenders to raise funds on the open market to expand their subprime lending activities.[(14)]

The government-sponsored enterprises, Fannie Mae and Freddie Mac, have begun providing a direct source of secondary market funds for certain subprime loans.[(15)] In addition, Fannie Mae and Freddie Mac have recently set guidelines to address concerns about predatory lending. Freddie Mac announced in February 2000 that it would not buy high-cost mortgage loans that are subject to HOEPA.[(16)] The following month, it announced steps to protect borrowers from predatory practices, including a refusal to purchase mortgages with single-premium credit insurance policies.[(17)] In April, Fannie Mae launched its own campaign against predatory lending practices. Among other things, Fannie Mae has said it will not purchase subprime loans that: include single-premium credit life insurance; charge excessive fees; charge prepayment penalties that do not benefit the borrower through, for example, a rate or fee reduction; or steer well-qualified borrowers to high-cost mortgages.[(18)]

III. THE PROBLEM OF PREDATORY 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. The Commission is aware, however, of predatory lending practices in the subprime mortgage market that affect the most vulnerable consumers. These predatory lending practices often involve lower-income and minority borrowers.[(19)] Elderly homeowners, in particular, are frequent targets of some subprime home equity lenders, because they often have substantial equity in their homes, yet have fixed or declining incomes.[(20)] 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 whether they would qualify for less expensive loans. While subprime lenders may expand access to credit to individuals who otherwise would be shut out of the market, unethical lenders are in a position to take advantage of consumers in the weakest bargaining position.

It is critically important for consumers, especially those who live in lower-income communities, to have access to credit. However, this access should not be based on predatory lending practices that take advantage of borrowers. Predatory 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. Predatory 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.

Predatory lending in the subprime mortgage market covers a wide range of practices. While the 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. This is often accomplished through a combination of aggressive marketing practices, high-pressure sales tactics, and loan terms, such as prepayment penalties, that inhibit a borrower's ability to go elsewhere for credit.

Among the most harmful of these practices is "equity-stripping."[(21)] 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." 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.[(22)]

Another practice of serious concern is "packing," which is the practice of adding credit insurance or other "extras" to increase the lender's profit on a loan.[(23)] 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.[(24)]

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 [(25)] 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 often are not in a position to negotiate loan terms. They often need to close the loan quickly, due to high debt, limited financial resources, and limited financing options. 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 not prohibited by federal law from requiring 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. As described above, however, sometimes 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.[(26)] 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.[(27)]

Another practice that has received attention is "flipping," the practice of inducing[(28)] a consumer to refinance a loan, repeatedly, often within a short time frame, charging high points and fees each time.[(29)] This causes the borrower's debt to increase steadily. Although a consumer's debt may be on the rise anyway if she borrows money in connection with the refinancing, in some cases, the amount of cash received may be smaller than the additional costs and fees charged for the refinancing. While a consumer's option to refinance is an integral part of a functioning mortgage market, subprime lenders engaged in "flipping" may misrepresent to the borrower the terms and ultimate benefits of the transaction, or induce the borrower to take on more debt than she can handle. By taking advantage of its unequal relationship with a particularly vulnerable consumer, an unscrupulous lender can compromise a borrower's ability to make an informed choice about financing options.

Another reported abuse in the subprime mortgage industry is the targeting of consumers by home improvement contractors who are effectively working as agents of lenders.[(30)] One alleged abuse involves contractors who may obtain the borrower's consent for a loan with high rates and fees through the use of deception or coercion. For example, the contractor and homeowner may agree on a price for certain work. The contractor, after beginning work on the home, may then present the homeowner with loan documents from the lender indicating higher rates and fees than those that were agreed upon. The consumer is then pressured to sign the papers as drafted -- especially when faced with the untenable prospect of leaving the improvements unfinished. In another reported scenario, the contractor may receive the loan proceeds directly or indirectly from the lender without providing any services to the homeowner, or without providing services commensurate with the amount of the payment. Nevertheless, the lender may still demand full payment from the homeowner.

Predatory practices by home improvement contractors and their affiliated lenders(31) are particularly problematic because the targeted homeowners often start out with no mortgage at all or a market-rate first mortgage that they later are induced to refinance. Because of the home improvement scheme, however, a homeowner with an affordable mortgage or no mortgage, and who is seeking aluminum siding or new windows, may suddenly find herself with a high-cost home equity loan.(32)

After a loan is closed, consumers may be subject to loan servicing practices that extract monies not owed under the loan terms or that inhibit refinancing options with another lender.(33) A lender may provide inaccurate monthly-payment demands, adding fees and charges that are not owed. Because of the complexities of loan terms, it is difficult for the borrower to know whether the lender's payment demands are accurate. A lender also may fail to provide the consumer with full or accurate pay-off information, and at the same time aggressively solicit the borrower to refinance with the lender. Consequently, the borrower becomes tied to a lender without a means of escape.(34)

Some of these predatory lending practices may be illegal under various federal or state laws, including a number of laws enforced by the Commission. Depending on the particular facts, some of the practices may constitute deceptive or unfair practices in violation of Section 5 of the FTC Act or a comparable state statute. In addition, some of these practices may constitute violations of the TILA, as well as violations of the protections for high-rate and high-fee loans under HOEPA. If a lender charges similarly-qualified borrowers higher prices based on age, race, and/or sex, such a practice would constitute pricing discrimination in violation of the ECOA.(35) Additionally, if a lender targets borrowers for predatory practices based on age, race and/or sex, such targeting, depending on the facts, also could violate the ECOA.(36)

IV. THE COMMISSION'S RESPONSE

Given this background, the Commission is taking a variety of steps to address abuses in the subprime market. First, the Commission is increasing its enforcement activities to halt subprime lenders who are engaged in predatory lending practices. At the same time, the Commission has been working with federal agencies and states to increase and coordinate enforcement efforts. In addition, the Commission has been participating in an interagency task force convened by the Federal Reserve Board to examine the issue of predatory lending. The Commission also is educating consumers in order to help them avoid predatory lending practices.

In March 2000, the Commission announced a settlement, along with the United States

Department of Justice ("DOJ") and the Department of Housing and Urban Development ("HUD"), with Delta Funding Corporation, a national subprime mortgage lender. The Commission alleged that Delta engaged in a pattern or practice of asset-based lending, and other practices, in violation of HOEPA. Specifically, Delta allegedly extended high-cost loans to borrowers based on the borrower's collateral rather than considering the borrower's current and expected income, current obligations, and employment status to determine whether the borrower was able to make the scheduled payments to repay the obligation. In these instances, prudent underwriting criteria, such as debt-to-income ratios, residual income, and repayment history, would have indicated that the borrower likely would have had difficulty repaying the loan. The settlement, which provided for nationwide injunctive relief, also resolved claims by DOJ for violations of the ECOA and by HUD for violations of the Real Estate Settlement Procedures Act.[(37)]

In July 1999, as part of "Operation Home Inequity," the Commission settled cases against seven subprime mortgage lenders for violations of HOEPA, TILA, and Section 5 of the FTC Act. The alleged HOEPA violations included failure to provide required disclosures, asset-based lending, and use of prohibited terms (such as balloon payments on loans with less than five-year terms, increased interest rates after default, and prohibited prepayment penalties). The settlement agreements provide for substantial remedies and protections for past and future borrowers, including consumer redress totaling $572,500, and, in the case of one lender, a ban against any future involvement with high-cost loans secured by consumers' homes.[(38)]

Also in July 1999, the Commission settled charges that another mortgage lender, Fleet Finance, Inc., failed to provide accurate, timely disclosures of the costs and terms of home equity loans to consumers, and failed to provide or accurately provide consumers with information about their right to cancel their credit transaction, in violation of TILA and Section 5 of the FTC Act. The settlement provides for $1.3 million in consumer redress as well as injunctive relief.[(39)]

In January 1998, the Commission filed a complaint in the United States District Court for the District of Columbia against Capital City Mortgage Corporation, a Washington, DC-area mortgage lender, and its owner, alleging numerous violations of a number of federal laws resulting in serious injury to borrowers, including the loss of their homes.[(40)] The company allegedly made home equity loans to minority, elderly, and low-income borrowers at interest rates as high as 20-24 percent. Many borrowers allegedly faced foreclosure on their properties, after which the company would buy the properties at auction for prices much lower than the appraised value of the properties. The Commission's complaint in this matter, which remains in litigation, alleges violations of the FTC Act, the TILA, the ECOA, and the Fair Debt Collection Practices Act.[(41)]

In the area of loans sold with credit insurance, the Commission has a long enforcement history. Most recently, the Commission settled a case in 1997 against The Money Tree, a Georgia-based consumer finance lender, and its president. The case involved, in part, allegations that the company required consumers to purchase credit-related insurance and other "extras" along with their loans, without disclosing to consumers the true cost of their credit. The settlement, in part, requires Money Tree to offer refunds of certain insurance premiums to customers whose loans were open at the time the settlement became final. It also mandates that the company approve borrowers' loan applications prior to any discussion with the borrower regarding credit insurance and requires that the company provide expanded disclosures.[(42)] In 1992, the Commission approved a consent agreement with Tower Loan of Mississippi settling similar charges regarding its consumer loans.[(43)] The Commission is using the knowledge it has developed through the Money Tree and Tower Loan cases, as well as earlier enforcement actions,[(44)] to investigate potential insurance problems in home equity lending.

In addition to its casework and ongoing investigations, the Commission is sharing its knowledge and experience with other enforcement agencies and with consumers. In 1997, the Commission's Bureau of Consumer Protection held joint law enforcement sessions on home equity lending abuses with state regulators and law enforcers in six cities around the country. These training sessions were conducted to assist states in exercising their relatively new enforcement authority under HOEPA[(45)] and to share information about recent trends.

The Commission also has an aggressive consumer education program and has published a series of free publications specifically for homeowners and potential home buyers. For example, in 1996, the Commission produced "*High-Rate, High-Fee Loans (Section 32 Mortgages)*" to alert homeowners about their rights under HOEPA. In 1998, in conjunction with the filing of the Capital City complaint, the Commission issued two publications to help consumers recognize and avoid home equity scams and abuses: "*Avoiding Home Equity Scams"* and "*Home Equity Loans: Borrowers Beware*." In January 1999, the Commission, along with ten other federal agencies, produced "*Looking for the BEST Mortgage - Shop, Compare, Negotiate*" to help consumers shop for home loans. During the first annual National Consumer Protection Week in February 1999, which highlighted credit fraud and abusive lending practices, the Commission distributed more than 500,000 credit-related publications. And most recently, as part of "Operation Home Inequity" in July 1999, the Commission partnered with AARP to produce "*Need a Loan? Think Twice About Using Your Home as Collateral*."[(46)]

V. LEGISLATIVE CONSIDERATIONS

The Commission recognizes that predatory lending practices are a serious national problem. While some of these practices can be addressed through current laws and regulations, additional statutory changes would enhance consumer protection in this area. The Commission urges the Committee to consider expansion of HOEPA to: (A) prohibit the financing of single-premium, or "lump-sum," credit insurance premiums (as well as other loan "extras") in loans covered by HOEPA; (B) count lump-sum financed credit insurance premiums (and other extras) toward HOEPA's fees-based trigger; (C) provide the Commission and other law enforcers with the power to impose civil penalties for HOEPA violations; and (D) prohibit mandatory arbitration clauses in loans covered by HOEPA. At this time, the Commission recommends only these changes to HOEPA, although it is continuing to examine the problem of predatory lending and may have additional recommendations in the future.[47]

A. Prohibit the Financing of Single-Premium "Lump-Sum" Credit Insurance and Other "Extras" in Loans Covered By HOEPA

As discussed above, the Commission has a long enforcement history in the area of loans sold with credit insurance and other "extras."[48] Predatory lenders stand to make significant profits from credit insurance, not only because the premium itself is very profitable but also because the premium is typically financed as part of the loan, adding to the cost of fees and interest. Typically, credit insurance is sold for all or a substantial part of the loan term with a single premium, payable up front and financed as part of the loan. Thus, lenders have strong incentives to induce consumers to buy credit insurance as part of the loan.[49] However, because credit insurance often is automatically included with the loan and not explained, borrowers are not in a position to evaluate the insurance purchase. As a result, consumers may spend thousands of dollars for credit insurance in connection with loans without having made an independent decision to buy the insurance. A single-premium payment scheme that commits consumers up front to long-term credit insurance precludes them from ever making a separate decision about insurance. And it requires them to finance, and thus pay points and interest on, that single premium for the life of the loan.

Thus, the Commission recommends the expansion of HOEPA to prohibit the financing of lump-sum credit insurance (as well as other loan "extras"). This approach -- which has also been recommended by the Federal Reserve Board and the Department of Housing and Urban Development [50] -- would prevent the abusive practice of loan packing by regulating the method for collecting credit insurance premiums in connection with HOEPA loans. Credit insurance could still be sold with premiums paid (not financed) monthly, along with loan payments, as long as each billing statement discloses the cost of credit insurance, and that the insurance is optional and can be canceled at any time.

B. Count Lump-Sum Financed Credit Insurance Premiums (and Other Extras) Towards HOEPA's Fees-Based Trigger

In addition, the Commission recommends that lump-sum financed credit insurance premiums (and other loan extras) be included in HOEPA's fees-based trigger. Under current law, credit insurance costs, unless required, are not included in calculating whether a loan is covered by HOEPA. A creditor can use the means described above to effectively bundle the insurance with the loan, and still exclude the insurance costs from the fee calculation. A creditor can thereby keep the interest rate and closing fees just below HOEPA's triggers for coverage but achieve a higher total return, and consumers will pay costs that, in practice, are above HOEPA's triggers. By including all lump-sum financed credit insurance premiums and loan extras in HOEPA's fees-based trigger, predatory lenders will not be able to avoid HOEPA's requirements simply by shifting costs of the loan to credit insurance.

C. Increase Deterrence By Giving Law Enforcers the Power to Impose Civil Penalties for

HOEPA Violations

Under current law, if a lender fails to comply with HOEPA, it is liable under HOEPA for the sum of all finance charges and fees paid by the consumer, unless the lender demonstrates that the failure to comply is not material.[(51)] In the absence of a specific civil penalty provision under HOEPA, merely having to pay these amounts back, and any other damages, may be viewed as simply a cost of doing business. To provide a more effective deterrent, the Commission recommends amendment of HOEPA to give law enforcement agencies the power to impose civil penalties for HOEPA violations. Inclusion of a specific civil penalty provision has established a compliance incentive and strong enforcement tool in other credit statutes, like the ECOA, and would also be beneficial in HOEPA.

D. Prohibit Mandatory Arbitration Agreements in HOEPA Loans

Over the last few years, there has been a significant increase in the use of mandatory arbitration clauses in consumer credit contracts, in particular in the subprime industry. Mandatory arbitration clauses require, as a condition of receiving the loan, that the borrower agree to resolve any dispute arising out of the loan through mandatory arbitration, rather than litigation. In the Commission's enforcement experience, consumers may be presented with an arbitration agreement for the first time at loan closing, with no prior notice of the requirement, and among a stack of other complicated loan documents. At that time, even if consumers have an opportunity to read the agreement, consumers are unlikely to inquire about it out of fear they will lose the loan.[(52)] Consumers are focused on getting a loan, and not on the unanticipated event of default. In addition, borrowers may not understand the significance of agreeing to arbitration and various associated terms, such as cost allocation.[(53)] In fact, arbitration may be more costly and inconvenient for the borrower and thus be a disincentive to pursuing legal rights.[(54)]

Moreover, there are significant procedural and substantive distinctions between arbitration proceedings and litigation. By signing a mandatory arbitration agreement, borrowers waive their right to a jury trial, and the ability to pursue claims through class action litigation. In arbitration, there is also limited factual discovery, and remedies such as punitive damages and injunctive relief are typically unavailable.[(55)] A decision by an arbitrator in one case has no precedential value; indeed, there is no requirement that the decision-maker give any reasons for the decision. Thus, predatory lenders can shield their abusive practices from public scrutiny. Perhaps most importantly, mandatory arbitration agreements undermine consumers' ability to exercise statutory rights conferred by the TILA, HOEPA, ECOA, and other laws which were passed to protect consumers in the credit marketplace. Review of arbitration awards is very limited. "Arbitrators can misconstrue contracts, make erroneous decisions of fact, and misapply law, all without having their awards vacated."[(56)]

For these reasons, the Commission recommends the prohibition of mandatory arbitration clauses in HOEPA loans. While the Commission recognizes the benefits of alternative dispute resolution, it does not support mandatory arbitration agreements imposed in high cost loans where consumers and their homes are most vulnerable.

VI. CONCLUSION

The Commission recognizes that predatory lending practices are a serious national problem. Due to sharp growth in the subprime mortgage industry, it appears that predatory lending practices are also on the rise. As a result of unfair and deceptive practices, and other federal law violations by certain lenders, vulnerable borrowers are facing the possibility of paying significant and unnecessary fees and, in some cases, losing their homes. Using its enforcement authority, the Commission continues to work to protect consumers from these abuses. In addition, the Commission supports the expansion of HOEPA protections to enhance consumer protection in this area.

ENDNOTES

1. The views expressed in this statement represent the views of the Commission. Responses to any questions you have are my own, however, and do not necessarily reflect the Commission's views or the views of any individual Commissioner.

2. See 15 U.S.C. § 45(a).

3. See 15 U.S.C. § 1601 et seq.

4. See 15 U.S.C. § 1639.

5. See 15 U.S.C. § 1691.

6. See, e.g., 15 U.S.C. § 45(a); 15 U.S.C. § 1607.

7. A number of the remarks in this testimony are based on the Commission's administrative and enforcement experience in the area of home equity lending, including consultations with individual consumers, consumer groups, and industry.

8. Credit to "prime" borrowers, borrowers generally with good credit histories, is referred to as "A" credit. "A" mortgage loans are those that conform to the secondary market standards for purchase by the government-sponsored entities, Fannie Mae and Freddie Mac (although Fannie Mae and Freddie Mac recently began purchasing "A minus" subprime loans).

9. See *Top 25 B & C Lenders in 1999,* Inside B & C Lending, Feb. 14, 2000, at 2.

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

11. See Kathleen Day, *'Subprime' Mortgage Practices by Banks and Finance Firms Draw Federal, State Scrutiny*, Wash. Post, February 6, 2000, at H1, 6.

12. See, e.g., Norma Paz Garcia, Dirty Deeds: Abuses and Fraudulent Practices in Los Angeles' Home Equity Market, Consumers Union, October 1995, at 25; Mike Hudson, *Stealing Home*, Wash. Monthly, June 1992, at 23, 26. Congress preempted many state usury laws on first lien mortgages with passage of

the Depository Institutions Deregulation and Monetary Control Act of 1980, 12 U.S.C. § 1735f-7.

13. See Inside B & C Lending, Jan. 17, 2000, at 3. As part of Wall Street's expansion in this area, firms are exploring new approaches to securitization that further shield investors from risks associated with subprime asset-backed securities. See *New Subprime ABS Structure Helps Subordinate Tranches*, Inside B & C Lending, Mar. 27, 2000, at 9.

14. See Martin Wahl and Craig Focardi, *The Stampede*, Mortgage Banking, Oct. 1997, at 29. Growth in subprime originations also has been aided somewhat by the increasing availability of warehouse lines of credit, which provide short-term funding to lenders for the purpose of loan financing. See *Warehouse Lines of Credit: Limited for B & C Lenders?*, Inside B & C Lending, Feb. 17, 1997, at 9.

15. It appears that the GSEs already are actively investing in subprime securitizations. See *Countrywide Does Mega ABS Deal, Includes Rate Reduction*, Inside B & C Lending, Mar. 13, 2000, at 7.

16. See *Freddie Mac Just Says "No" to HOEPA Mortgage Loans*, Inside B & C Lending, Feb. 28, 2000, at 11.

17. See Press Release, *Freddie Mac Announces Steps to Protect Borrowers from Predatory Lending Practices,* Freddie Mac (Mar. 24, 2000).

18. See *Fannie Mae Sets Campaign to Improve Lending,* Wall Street Journal, Apr. 11, 2000, at A28.

19. See Complaint at 6, F.T.C. v. Capital City Mortgage Corp., No. 1:98-CV-00237 (D.D.C. filed Jan. 29, 1998); Anastasia Hendrix, *Oakland Widow: They Stole My House*, S.F. Examiner, Apr. 13, 1997, at A-1; Kay Stewart & David Heath, *High-Cost Loans Trap Those Least Able To Afford It*, Louisville Courier-Journal, Feb. 16, 1997, at 16-17; Lucille Renwick, *Wolf at the Door*, L.A. Times, Mar. 14, 1993, at 16.

20. 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).

21. See United States of America v. Delta Funding Corporation and Delta Financial Corporation, Civ. Action No. 00 1872 (E.D.N.Y.) (April 2000) (settling FTC allegations that Delta engaged in a pattern or practice of asset-based lending, in violation of HOEPA).

22. While HOEPA 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.

23. See The Money Tree, 123 F.T.C. 1187 (1997) (settling allegations that credit insurance and auto club memberships 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).

24. 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 premium payments paid out for claims. In most states, however, lenders and insurers retain more than 40% of premium monies; in some states, they keep up to 70% or 80% of the proceeds. See Jane Bryant Quinn,

Credit Life Insurance Often Overpriced, Wash. Post, Feb. 9, 1997, at H2.

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

26. 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).

27. 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 or HOEPA triggers, which it may in actuality be exceeding.

28. 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.

29. 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 W. Artz & R. Neihengen, Jr., *Analysis of Finance Company Ratios in 1994*, 78 J. Commercial Lending 33, 37 (Sept. 1995) (showing that, from 1990 to 1992, companies refinanced existing loans to present borrowers in a range of 63% to 66.8% of the cases); Report of the Presiding Officer on Proposed Trade Regulation Rule: Credit Practices, Federal Trade Commission, Aug. 1978, at 43-44 (creditors self-reported refinancing loans for existing customers in a range of 35% to 75% of accounts, with an average of 56.5%).

30. See Complaint, Newton v. United Cos. Fin. Corp., Civ. No. 97-CV-5400 (E.D. Pa. filed Sept. 2, 1997) (class action suit on behalf of low-income borrowers who paid fees and charges of up to 50% of the cost of the home improvements); Complaint, Harris v. Green Tree Fin. Corp., Civ. No. 97-CV-1128 (E.D. Pa. filed Feb. 14, 1997) (class action suit challenging deceptive home improvement loan contracts); see also Stuart L. Ditzen, *From Home Loans to Lawsuits*, Phila. Inquirer, Dec. 17, 1997, at B1.

31. Although a consumer targeted by a home improvement contractor often has no direct contact with the lender, the consumer generally still can bring an action against the lender. The contractor, pursuant to the Commission's Trade Regulation Rule on Preservation of Consumer Claims and Defenses, known as the Holder Rule, is obligated to include in the consumer's loan documents a provision stating, in part, that "any holder of [that] consumer credit contract is subject to all claims and defenses which the debtor could assert against the seller of goods or services . . . ." See 16 C.F.R. § 433.2. Therefore, depending on the facts of a particular case, the lender could be subject to any claims that the borrower could have brought against the contractor. If the contractor omits this language from the loan documents, the omission itself would constitute a violation of the Holder Rule.

32. Lenders have several incentives to refinance a homeowner's existing mortgage rather than to merely originate a new loan for the home improvements. First, lenders generally seek to originate one combined loan 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 position because of the benefits that would accrue to them in the event of a borrower's bankruptcy.

Third, under current federal law, state usury caps do not apply to first liens. See 12 U.S.C. § 1735f-7.

33. See Complaint at 11-13, F.T.C. v. Capital City Mortgage Corp., No. 1:98-CV-00237 (D.D.C. filed Jan. 29, 1998). See infra note 39 and accompanying text for a discussion of this case.

34. A borrower also may be tied to a lender if the lender's appraisal intentionally and significantly overvalues the property because the borrower's loan-to-value ratio may be too high for refinancing. This is known as a "bumped appraisal."

35. See supra note 19 for a discussion of the Department of Justice's settlement with Long Beach Mortgage.

36. See Brief of the United States As Amicus Curiae, dated March 10, 2000, in Hargraves v. Capital City Mortgage Corp., Civ. Action No. 98-1021 (JHG/AK).

37. See United States of America v. Delta Funding Corporation and Delta Financial Corporation, Civ. Action No. 00 1872 (E.D.N.Y.) (April 2000).

38. See Press Release, *Home Equity Lenders Settle Charges That They Engaged in Abusive Lending Practices; Over Half Million Dollars To Be Returned to Consumers*, Federal Trade Commission, July 29, 1999.

39. See Fleet Finance, Inc., C3899 (F.T.C. Oct. 5, 1999).

40. See Complaint, F.T.C. v. Capital City Mortgage Corp., No. 1:98-CV-00237 (D.D.C. filed Jan. 29, 1998).

41. See 15 U.S.C. § 1692.

42. See The Money Tree, 123 F.T.C. 1187 (1997).

43. See Tower Loan of Mississippi, 115 F.T.C. 140 (1992).

44. See, e.g, Commercial Credit Co., 82 F.T.C. 1841 (1973), *order reopened and modified*, 98 F.T.C. 783 (1981).

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

46. Additional housing-related brochures issued by the Commission include: *After a Disaster: Hiring a Contractor; Reverse Mortgages: Cashing in on Home Ownership;* and *Home Equity Loans: The Three Day Cancellation Rule*.

47. In the Commission's experience, some subprime lenders have lowered their rate and closing fees to just below the HOEPA cost triggers, so as not to be covered by HOEPA, although they may still be engaged in predatory lending practices. The Committee may want to consider lowering HOEPA's cost triggers to bring more subprime loans under the protections of HOEPA.

48. Loan "extras" can be any products added to the cost of a loan, for example the cost of membership in an automobile or shopping club. See The Money Tree, 123 F.T.C. 1187 (1997) (complaint alleged that Money Tree required consumers to purchase credit-related insurance and auto club memberships but failed to disclose to consumers the true cost of credit).

49. The National Consumer Law Center recently recited the experience of one borrower who paid $2,200 for a credit life insurance policy sold to her in connection with a home-secured loan with a principal of $40,606.26. The cost of this insurance added over 5% to the cost of the loan. The National Consumer Law Center proposes prohibiting the lump-sum financing of credit insurance premiums. See National Consumer Law Center, *Proposal For Predatory Mortgage Reform*, March 20, 2000.

50. In their TILA/RESPA report, the Federal Reserve Board and the Department of Housing and Urban Development also recommended prohibiting the advance collection of lump-sum credit insurance premiums for HOEPA loans. See *Joint Report to the Congress Concerning Reform to the Truth and Lending Act and the Real Estate Settlement Procedures Act*, July 1998.

51. See 15 U.S.C. § 1640(a)(4).

52. Cf. American Financial Services v. FTC, 767 F.2d 957 (D.C. Cir. 1985), cert. denied, 475 U.S. 1011 (1986) (describing a number factors in credit transactions that hinder consumer ability to compare and bargain over remedial provisions in standard form contracts).

53. The Supreme Court has granted certiorari in a case in which the lower court declared a mandatory arbitration clause unenforceable "because it fails to provide the minimum guarantees required to ensure [the borrower's] ability to vindicate her statutory rights will not be undone by steep filing fees, steep arbitrators' fees, or other high costs of arbitration." Randolph v. Green Tree Financial, 178 F.3d 1149, 1158 (11th Cir. 1999), cert. granted, 68 U.S.L.W. 3629 (U.S. April 3, 2000) (No. 99-1235). See also Johnson v. Tele-Cash Inc., et al., 82 F. Supp. 2d 264, 271 (D. Del. 1999) (order denying motion to compel arbitration citing an "inherent conflict" between compelling arbitration and the underlying purposes of TILA).

54. See Jean R. Sternlight, *Panacea or Corporate Tool?: Debunking the Supreme Court's Preference for Binding Arbitration*, 74 Wash. L.Q. 637 (1996).

55. See Overview of Contractual Mandatory Binding Arbitration: Hearings Before the Senate Subcommittee on Administrative Oversight and the Courts of the Senate Judiciary Committee, 106th Cong. (2000) (Statement of Patricia Sturdevant, Executive Director and General Counsel, National Association of Consumer Advocates).

56. See generally IV Federal Arbitration Law, ch. 40.