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PREPARED STATEMENT OF THE
FEDERAL TRADE COMMISSION

before the

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

on

Predatory Lending Practices in the Home-Equity Lending Market

September 7, 2000

San Francisco, California

I. INTRODUCTION

I am Peggy Twohig, Assistant Director for Financial Practices, of the Federal Trade Commission's Bureau of Consumer Protection.[(1)] I appreciate the opportunity to appear before you today to discuss the serious problem of abusive lending practices in the subprime lending industry, commonly known as "predatory lending." I will provide an overview of predatory lending practices that are occurring in the growing subprime industry and will discuss the Commission's recent activities in this area. I will also address specific areas about which the Board has sought public comment.[(2)] 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, including jurisdiction over most non-bank lenders.[(3)] 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 in or affecting commerce.[(4)] The Commission also enforces a number of laws specifically governing lending practices, including the Truth in Lending Act ("TILA"),[(5)] which requires disclosures and establishes certain substantive requirements in connection with consumer credit transactions; the Home Ownership and Equity Protection Act ("HOEPA"),[(6)] 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"),[(7)] which prohibits discrimination against applicants for credit on the basis of age, race, sex, marital status, or other prohibited factors. 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 officials, state law enforcement agencies, and the media.[(8)]

II. THE GROWING PREDATORY LENDING PROBLEM

In recent years, subprime lending has grown dramatically. As a percentage of all mortgage originations, the subprime market share increased from less than 5 percent in 1994 to almost 13 percent in 1999.[(9)] In 1999 alone, subprime lenders originated over $160 billion in home equity loans,[(10)] a $35 billion increase from 1997.[(11)] 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 and by 1999, that figure reached almost $60 billion.[(12)] 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.[(13)] 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 practices in the subprime mortgage market that take advantage of the most vulnerable consumers.

Predatory lending practices often exploit lower-income and minority borrowers.[(14)] 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. Subprime loans are three times more likely in low-income neighborhoods than in high-income neighborhoods.[(15)] In predominately black neighborhoods, subprime lending accounted for 51 percent of refinanced loans in 1998 -- compared with only 9 percent in predominately white areas.[(16)] Significantly, these disparities still existed when borrowers in black and white neighborhoods were compared while controlling for the income levels of the neighborhood.[(17)] 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.[(18)] While subprime lenders may expand access to credit for individuals who otherwise would be shut out of the market, unethical lenders may take advantage of consumers in the weakest bargaining position.

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, high-pressure sales tactics, and loan terms, such as prepayment penalties, that inhibit a borrower's ability to go elsewhere for credit. Depending on the particular facts, some of these predatory lending practices may be illegal under various federal or state laws, including the FTC Act, the TILA (including HOEPA's extra protections triggered by high-rate and high-fee loans), or the ECOA.[(19)] 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.[(20)]

III. 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 illegal lending practices engaged in by subprime lenders. At the same time, the Commission has been working with other federal agencies and the states to increase and coordinate enforcement efforts. In addition, the Commission has been participating in the interagency task force convened by the Board to examine the issue of predatory lending. The Commission also is educating consumers to help them avoid predatory lending practices.

In March 2000, the Commission, in conjunction with the United States Department of Justice ("DOJ") and the Department of Housing and Urban Development ("HUD"), announced a settlement with Delta Funding Corporation, a national subprime mortgage lender. In addition to the allegations brought by DOJ and HUD, the Commission alleged that Delta had 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. In these instances, prudent underwriting criteria would have revealed factors such as high debt-to-income ratios with minimal residual income, unverified income, and higher monthly payments for a borrower already in default indicating that the borrower was likely to have difficulty repaying the loan. The settlement, which provided for nationwide injunctive relief, also resolved allegations by DOJ of violations of the ECOA and HUD of violations of the Real Estate Settlement Procedures Act.(21)

In July 1999, as part of "Operation Home Inequity," the Commission settled cases against seven subprime mortgage lenders for violations of HOEPA, the TILA, and Section 5 of the FTC Act. The HOEPA violations alleged 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.(22) More recently, the Commission settled a case of this type against a Washington State lender, Nu West, Inc. That case also included an additional allegation that the lender violated HOEPA by making direct payments to home improvement contractors, and the settlement required the defendants to pay more than $160,000 in consumer redress.(23)

In July 1999, the Commission settled charges that another mortgage lender, Fleet Finance, Inc., had failed to provide accurate, timely disclosures of the costs and terms of home equity loans to consumers and had failed to provide or accurately provide consumers with information about their right to cancel their transactions, in violation of the TILA and Section 5 of the FTC Act. The settlement provides for $1.3 million in consumer redress as well as injunctive relief.(24)

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 various federal laws resulting in serious injury to borrowers, including the loss of their homes.(25) 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 faced foreclosure on their properties, after which the company would allegedly buy the properties at auction for prices much lower than their appraised value. 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.(26)

In the area of loans sold with credit insurance (a practice known as "packing"), the Commission has a long enforcement history. 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, among other things, requires The 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.(27) In 1992, the Commission approved a consent agreement with Tower Loan of Mississippi settling similar charges regarding its consumer loans.(28) These cases, as well as earlier enforcement actions,(29) have provided an important foundation for the Commission in its investigations of potential packing practices in home equity lending. For example, most recently the Commission jointly settled a case, along with HUD, against Action Loan Company, Inc., of Louisville, Kentucky, and its owner and president, requiring the defendants to pay a $350,000 civil penalty and up to a total of $37,000 in consumer redress. The complaint included allegations that the defendants violated the TILA and Regulation Z by failing to include the cost of accident and health insurance in their disclosure of the finance charge and annual percentage rate (APR) of a consumer loan and that they violated Section 5 of the FTC Act by misrepresenting that consumers were purchasing only credit life insurance when, in fact, they were also purchasing accident and health insurance.(30)

In addition to its 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(31) and to share information about recent trends.

The Commission has implemented 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 first 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, including the Board, 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. 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*."(32) In fiscal year 2000, the Commission distributed approximately 200,000 free publications on home equity lending, including over 50,000 online publications.

IV. HOW THE BOARD MIGHT FURTHER ADDRESS PREDATORY LENDING PRACTICES

In the TILA, Congress gave the Board the authority to prescribe regulations to carry out the purposes of the Act and, in doing so, to take such actions "as in the judgment of the Board are necessary or proper to effectuate the purposes of [the TILA], to prevent circumvention or evasion thereof, or to facilitate compliance therewith."[(33)] Pursuant to this authority, the Board enacted Regulation Z, which implements the TILA.[(34)] With the HOEPA amendment to the TILA, Congress gave the Board two types of additional regulatory authority. First, Congress granted the Board the authority to prohibit by regulation or order acts or practices in connection with mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of HOEPA.[(35)] The legislative history of HOEPA indicates that Congress intended that the Board look to the standards employed by the Commission in defining unfair or deceptive acts or practices under the FTC Act.[(36)] Second, Congress gave the Board the authority to prohibit acts or practices in connection with the refinancing of mortgage loans that the Board finds to be associated with abusive lending practices or that are otherwise not in the interest of the borrower.[(37)]

Based on our enforcement experience, the Commission recommends that the Board further restrict certain acts and practices under HOEPA and change the HOEPA triggers to expand HOEPA's coverage. These recommendations are interrelated. As discussed below, a very small percentage of subprime mortgage loans are currently covered by HOEPA and the Commission has observed problem lending practices in subprime loans where the rates or fees fall below the current triggers. As a result, the protections offered by HOEPA, which we strongly support, will help relatively few borrowers unless HOEPA is expanded to cover more loans. In addition, the Board should provide additional clarification of certain HOEPA provisions.

A. Restricting Certain Acts or Practices under HOEPA

1. Credit Insurance and Other "Extra" Products

Recommendation: Prohibit the Financing of Single-Premium Credit Insurance and Other Loan Extras.

As discussed above, the Commission has a long enforcement history in the area of loans sold with credit insurance and other "extras."[(38)] 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, resulting in extra fees and interest.[(39)] Thus, lenders have strong incentives to induce consumers to buy credit insurance as part of the loan.[(40)]

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. However, borrowers are not able to evaluate the costs and benefits of the insurance purchase because it is often included automatically with the loan and its terms are not explained. 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, fully-informed decision about insurance. And, it requires them to finance the premium, and the points on the premium for the life of the loan.

We recommend that the Board use its authority under HOEPA to prohibit the practice of financing lump-sum credit insurance (as well as other loan "extras") for HOEPA loans. The Commission has recommended that Congress adopt this same prohibition.[(41)] The Board could prohibit this practice in connection with the "refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are not otherwise in the best interest of the borrower."[(42)] In the alternative, the Board should consider prohibiting the financing of single-premium credit insurance and extras pursuant to its authority under HOEPA to regulate unfair or deceptive acts or practices.[(43)]

A prohibition on the practice of financing single-premium credit insurance would prevent the abusive practice of packing by regulating the method for collecting credit insurance premiums in connection with HOEPA loans. A prohibition on the financing of premiums would not prohibit the sale of credit insurance; the insurance could be sold on a cash basis with premiums paid periodically over the course of the loan. We believe, however, for any sale of credit insurance in HOEPA loans (even if paid over the term of the loan), there should be a further requirement: the Board should require that each billing statement disclose the cost of credit insurance, and that the insurance is optional and can be canceled at any time.[(44)]

The Departments of Treasury and Housing and Urban Development, in *Curbing Predatory Home Mortgage Lending: A Joint Report, United States Department of the Treasury and United States Department of Housing and Urban Development*, June 2000 ("HUD/Treasury Report"), support a prohibition on the financing of single-premium credit insurance in mortgage transactions. When making this recommendation, the agencies stated that lump-sum products that are paid for in advance and financed over the life of the loan,[(45)] such as single-premium credit insurance, "provide the borrower no net benefit," and for that reason, "are almost always not in the interest of the borrower."[(46)] As the HUD/Treasury Report also states, the sale of such products at closing is arguably inherently deceptive "because so many borrowers conclude that they must purchase the products in order to close the loan, or fail at all to notice the products among the lengthy settlement documents."[(47)] Similarly, the Commission's enforcement experience is that single-premium credit insurance and other extras are often marketed deceptively or unfairly, through the packing of credit insurance with the credit extension.

A prohibition on this practice is necessary to protect consumers, and disclosures alone would not be adequate. Typically the bargaining positions of the lender and borrower in these transactions are highly unequal. Borrowers are presented with a multitude of documents to sign in a high-pressure atmosphere with little opportunity to read and comprehend all of the information contained in the documents. Borrowers may feel that the terms are not negotiable in any event. In analogous situations, the Commission has concluded that the nature of the transaction does not permit free and informed consumer choice, that disclosure alone would not cure the violative practice, and that only restrictions on the practice itself would be sufficient.[(48)]

Recommendation: If the Board Does Not Prohibit the Financing of Single-Premium Credit Insurance, It Should Separate the Sale of Credit Insurance from the Credit Transaction.

The Board asks whether, if the practice is not prohibited, the Board should regulate the conditions under which single-premium credit insurance is sold or financed. It states that such regulation might include prohibiting creditors from selling single-premium credit insurance until after loan closing. If the Board does not prohibit the financing of single-premium credit insurance and other extra products sold with loans, the Board should adopt regulations that unpack the two transactions in HOEPA loans as much as possible.[(49)]

The Board should require that the offer and sale of credit insurance and extras be separated from the credit transaction. The most effective and simplest way to do that would be to prohibit creditors from selling single-premium credit insurance until after closing a HOEPA loan. Alternatively, if the Board does not prohibit the sale of single-premium credit insurance until after loan closing, the Board should, with regard to HOEPA loans: (1) declare it to be an unfair or deceptive act or practice for a creditor to quote loan terms (such as the amount of the monthly payment) to a consumer with the cost of credit-related insurance or other extras automatically included; (2) require that the creditor notify the consumer that she has been approved for credit prior to marketing credit insurance and extras in order to dispel any impression on the part of the consumer that the purchase of credit insurance or extras are required for loan approval;[(50)] (3) specify that information about the cost and terms of credit insurance and extras must be separate from the credit cost information; and (4) if the credit insurance and extras are financed, require the creditor to provide separate documentation relating only to that transaction. Alternatively, the Board could require that two cost disclosures, one with and one without the cost of credit insurance and extras, be provided as part of the HOEPA disclosures given to the borrowers three days in advance, if it has not been prohibited as discussed previously.

2. Mandatory Arbitration Agreements in HOEPA Loans

Recommendation: The Board Should Ban 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. In many contexts, alternative dispute resolution, including arbitration, may benefit consumers. However, the Commission is troubled by the use of mandatory arbitration in the context of HOEPA loans. 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. 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.[(51)] 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.[(52)] In fact, arbitration may be more costly and inconvenient for the borrower and thus be a disincentive to pursuing legal rights.[(53)]

Moreover, there are significant procedural and substantive distinctions between arbitration proceedings and litigation that might have an adverse effect on a consumer's ability to pursue her remedies for HOEPA violations. 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.[(54)] 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.[(55)] 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)]

Further, as the HUD/Treasury Report states in recommending that mandatory arbitration clauses be prohibited for high-cost loans:

The most vulnerable borrowers in the subprime market may be the least likely to understand adequately the implications of agreeing to mandatory arbitration. Since they may also be the most likely borrowers to default or be foreclosed upon, it is especially important that they retain the rights afforded them under federal fair lending and consumer protection laws. In the high-cost market, the difference in bargaining power between lenders and borrowers is particularly acute, making pre-dispute arbitration an unwise option for these consumers.[(57)]

For these reasons, the Commission has recommended to Congress a prohibition of mandatory arbitration clauses in HOEPA loans.[(58)] While the Commission recognizes the benefits of alternative dispute resolution, it does not support <u>mandatory</u> arbitration agreements imposed in HOEPA loans where consumers and their homes are most vulnerable. With regard to Board action in this area, the Commission recommends that the Board consider using its authority to prohibit the use of mandatory arbitration clauses in HOEPA loans under the Board's authority to prohibit acts or practices in connection with the "refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are not otherwise in the best interest of the borrower."[(59)]

3. Asset-Based Lending

Asset-based lending, where a loan is based on equity in a property rather than on a borrower's ability to repay the loan, is among the most harmful of predatory lending practices. Studies conducted in several metropolitan communities reveal that as subprime lending has increased, foreclosure rates have increased even more. In Chicago, the subprime share of the mortgage origination market rose from 3 percent to 24 percent between 1991 and 1997. However, between 1993 and 1998, the subprime market's share of foreclosures increased from 1.3 percent to 35.7 percent.[(60)] Among lenders in Atlanta that report HMDA data, the overall share of foreclosures attributable to subprime lending increased from 5 percent in 1996 to 16 percent in 1999.[(61)] In Baltimore, the subprime share of foreclosures is much higher than the subprime share of mortgage originations; while subprime loans accounted for 45 percent of the foreclosure petitions, the subprime share of mortgage originations was 21 percent in 1998.[(62)]

Under HOEPA, a creditor may not engage in a "pattern or practice" of extending credit based on the consumer's collateral without regard to the consumer's repayment ability (including the consumer's current and expected income, current obligations, and employment status).[(63)] Regulation Z, implementing this provision, prohibits such extensions of credit if the consumer will be unable to make the scheduled loan payments.[(64)] The Board asks whether additional interpretive guidance on the "pattern or practice" requirement would be useful, and, if so, what elements of the requirement the guidance should address. The Board also asks what regulatory standard it could adopt for determining whether a creditor has actually considered the consumer's ability to repay the loan.

Recommendation: The Board Should Adopt the Fair Housing Act Standard for Defining "Pattern or Practice."

Additional guidance on the meaning of "pattern or practice" is needed. We believe that the appropriate "pattern or practice" standard should be the same as that under the Fair Housing Act ("FHA").[(65)] The FHA, as amended, authorizes the Attorney General of the United States to bring an enforcement action if she has reasonable cause to believe that a person or group of persons is engaged in a "pattern or practice" of resistance to the full enjoyment of any of the rights granted by the FHA.[(66)] To fulfill the "pattern or practice" requirement, the discrimination must result from more than a mere isolated, accidental or peculiar event.[(67)] However, no minimum number of incidents is required,[(68)] and courts have awarded relief based on as few as six incidents of discrimination.[(69)] Moreover, the construction adopted by the Courts suggests that a wide range of evidence may be used to prove a "pattern or practice" of discrimination under the FHA.[(70)] Similar latitude should be available to agencies seeking to establish that a creditor has engaged in a pattern or practice of asset-based lending in violation of HOEPA.[(71)]

For a variety of reasons, it may not always be possible to prove a pattern or practice of asset-based lending through an "empirical analysis of a representative sample of all of the lender's loans."[(72)] There are often other ways, however, to establish a practice of a lender, such as through the lender's marketing materials or other documents or testimony from the lender's employees and borrowers. The Board should clarify that the "pattern or practice" requirement under HOEPA has the same meaning as the "pattern or practice" requirement under the Fair Housing Act.

Recommendation: The Board Should Adopt Standards Regarding the Determination of the Consumer's Ability to Pay Without a Definitive Safe Harbor and Should Require Creditors to Document Information Considered in Determining Ability to Repay.

The Board has also asked for comment as to what regulatory standard it could adopt for determining whether a creditor has considered a consumer's ability to repay. The Commission has brought a number of enforcement actions in which it has alleged that creditors have not met this legal requirement. In these cases, the Commission has based allegations of HOEPA violations on a variety of facts that established the creditor's failure to consider ability to repay.

In some cases, the lenders were not considering income at all, were not verifying income or employment, or were not even obtaining credit reports to determine and verify current obligations. The Commission also alleged HOEPA violations where other factors demonstrated that the lender did not sufficiently consider ability to repay, such as loans where the borrower's debt payments left her with insufficient income for living expenses, or loans that caused monthly debt payments to increase, even though the borrower was already in default and there was no change in financial circumstances.[(73)]

Further clarification by the Board of the standards creditors should meet would ensure that they are adequately considering ability to repay. However, since we are still learning about the various ways lenders have not adequately considered ability to repay, we encourage the Board not to carve out an absolute safe harbor at this time, but to leave room for proof of overall failure to consider ability to repay.

Further, we have encountered extremely poor documentation by lenders regarding what factors were considered in determining ability to pay. While Regulation B, which implements the ECOA, requires a creditor to retain "written or recorded information used in evaluating the application," it does not generally require that such information be created in the first instance.[(74)] Requiring such documentation would assist the Commission and others in their efforts to evaluate the occurrence of unlawful asset-based lending.

4. Refinancing Lower Rate Loans

Recommendation: The Board Should Prohibit Creditors from Representing Falsely or Without Substantiation That a Loan Will Save the Consumer Money.

The Board notes that, when a consumer seeks a second mortgage to consolidate debts or finance home improvements, some creditors require the existing first mortgage to be paid off as a condition of providing the new funds. Requiring a lower rate first mortgage to be paid off in connection with a higher rate debt consolidation or home improvement loan, increases substantially the cost to the borrower. The Board asks what regulatory action is appropriate to protect consumers from refinancing abuses without restricting legitimate transactions.

The Commission would likely regard it as a deceptive practice in violation of the Federal Trade Commission Act for a creditor to represent falsely or without substantiation that refinancing will save the consumer money. The Commission recently announced a settlement with a lender who, in advertising debt consolidation loans, allegedly made such representations in violation of the FTC Act.[(75)] The Commission urges the Board to consider using its authority under HOEPA to prohibit such false or unsubstantiated representations as deceptive or unfair. This approach would help to prevent abuse by providing an added remedy without restricting the types of transactions available to consumers.

B. Adjusting the HOEPA Triggers

1. APR Trigger

Recommendation: The Board Should Lower the HOEPA APR Trigger to 8 %.

One measure of whether a loan is a HOEPA loan is whether it has an APR of ten percentage points or more above Treasury rates for securities with comparable maturities ("the APR trigger"). The Board has the authority under HOEPA to reset the APR trigger as high as twelve percent and as low as eight percent. According to the HUD/Treasury Report, due to the high thresholds that a loan must exceed for HOEPA to apply, very few consumers in the subprime market benefit from the law's provisions.(76) According to the Report, anecdotal evidence suggests that abuses often occur in loans priced just below the HOEPA triggers.(77) Based on these findings, the HUD/Treasury Report recommends that Congress lower the HOEPA APR trigger to 6 percentage points above Treasury securities for first liens and 8 percentage points above Treasury securities for second liens. The Report also recommends that the Board lower the APR trigger to 8%.(78) Lowering the APR trigger below 8 percentage points would require a statutory change.

Based on the Commission's experience to date in investigating predatory lending practices, only a small portion of subprime loans are HOEPA loans. Many lenders price their loans just below the HOEPA triggers, yet we have found abusive lending practices often occur in loans that fall below the triggers. Thus, we recommend that the Board exercise its authority to lower the APR trigger to 8 percentage points to ensure maximum consumer protection.(79)

2. The Points and Fees Trigger

Recommendation: Credit Insurance Premiums Should be Included in the HOEPA Points and Fees Trigger.

The Commission has recommended to Congress that credit insurance premiums be included in the HOEPA points and fees trigger.(80) Similarly, the Commission recommends to the Board that lump-sum financed credit insurance premiums (and other loan extras) be included in HOEPA's fees-based trigger.(81) 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. Including all lump-sum financed credit insurance premiums and loan extras in HOEPA's fees-based trigger will prevent predatory lenders from avoiding HOEPA's requirements simply by shifting loan costs to credit insurance.

C. Other Issues On Which the Board Has Requested Comment

1. HOEPA Disclosures

The Board seeks comments as to how to make the HOEPA-required advance disclosures more effective. The Commission generally supports any change to the HOEPA notice that would increase its effectiveness in notifying consumers three days before closing of certain critical terms.

Recommendation: The Board Should Require Disclosure of Prepayment Penalty Terms in the HOEPA Disclosure.

Specifically, we believe that the effect of any prepayment penalty, where permitted, should be added to the HOEPA disclosure. This is an additional item of information that could significantly affect a consumer's judgment as to whether to proceed with the loan. Creditors sometimes make high cost loans palatable to a consumer experiencing financial difficulty by promising that the consumer will be able to refinance the loan on more favorable terms within a short period of time.[(82)] Such representations without corresponding disclosure of the prepayment penalty terms on the consumer's ability to refinance are likely to mislead consumers. For that reason, the Board should require that the HOEPA disclosure contain the following in plain language: (1) that the loan contract contains a prepayment penalty; (2) the number of years for which any prepayment penalty applies; and (3) the conditions under which it will be imposed.

2. Open-End Home Equity Lines

The Board notes that HOEPA does not cover home equity lines of credit and asks if there is evidence that lenders are using open-end credit lines to evade HOEPA. If so, the Board asks what benefit might be derived from prohibiting the practice of structuring a loan as open-end credit in order to evade HOEPA. The Board asks how such practices might be identified and what limitations on these practices would be appropriate to effect the purposes of HOEPA.

Recommendation: There is Evidence that Lenders Are Using Open-End Credit Lines to Evade HOEPA, But Current Law Appears to Provide Adequate Remedies.

The Commission has brought two enforcement actions -- as a part of "Operation Home Inequity" -- that included allegations that lenders, in the course of offering and making HOEPA mortgage loans, represented to consumers that the credit offered and extended to them was open-end credit. The complaints state that the lenders made such representations when, in fact, the credit extended was closed-end credit subject to HOEPA, and that, by making such false representations, lenders engaged in deceptive acts and practices in violation of the FTC Act.[(83)] The complaints also alleged, because the loans were, in fact, HOEPA loans, that the creditors failed to comply with HOEPA.

These cases provide evidence that lenders are using spurious open-end credit lines to evade HOEPA. They also demonstrate that the practice can successfully be attacked, at a minimum, as a violation of HOEPA. Thus, it is not clear that it is necessary to prohibit such a practice expressly because, in our experience, we have been successful in asserting that the practice is already prohibited.

V. CONCLUSION

The Commission is continuing to examine and take appropriate law enforcement action regarding the problem of predatory lending. 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. The Commission supports the Board's efforts to expand HOEPA's protections to increase consumer protection in this important area.

ENDNOTES

1. This comment represents the views of the Federal Trade Commission. Responses to any questions you have are my own and do not necessarily reflect the Commission's views or the views of any individual Commissioner.

2. See 65 Fed. Reg. 42,889 (2000).

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

4. See 15 U.S.C. § 45(a).

5. See 15 U.S.C. § 1601-1667(f).

6. See 15 U.S.C. § 1639.

7. See 15 U.S.C. § 1691.

8. 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 officials.

9. See *Curbing Predatory Home Mortgage Lending: A Joint Report, United States Department of the Treasury and United States Department of Housing and Urban Development*, June 2000 ("HUD/Treasury Report") at 27-28.

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

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

12. See HUD/Treasury Report, supra note 9, at 40.

13. See Martin Wahl and Craig Focardi, *The Stampede*, Mortgage Banking, Oct. 1997,

at 26, 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.

14. See Complaint, 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.

15. See HUD/Treasury Report, supra note 9, at 45.

16. Id. Home Mortgage Disclosure Act (HMDA) data indicate that borrowers in black neighborhoods are five times as likely to refinance in the subprime market than borrowers in white neighborhoods. Id. at 45.

17. Id. at 45-46.

18. 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).

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

20. See Brief of the United States As Amicus Curiae, Hargraves v. Capital City Mortgage Corp., Civ. Action No. 98-1021 (D.D.C. 1998).

21. The complaint alleged that higher broker fees were charged to African American females than to white males in violation of the ECOA and the Fair Housing Act, 42 U.S.C. § § 3601-3619, and that few or no services were performed in exchange for certain broker charges in violation of the Real Estate Settlement Procedures Act, 12 U.S.C. § 2607. See United States v. Delta Funding Corp. and Delta Financial Corp. Civ. Action No. 00 1872 (E.D.N.Y.) (April 2000).

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

23. See Federal Trade Commission, *Sub-prime Lender Agrees to Settle FTC Charges of Violating Federal Lending and Consumer Protection Laws*, Press Release, July 18, 2000.

24. See FTC v. Fleet Fin., Inc., C3899 (F.T.C. Oct. 5, 1999).

25. See Complaint, Capital City Mortgage, supra note 14.

26. See 15 U.S.C. § 1692.

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

28. See Tower Loan of Miss., 115 F.T.C. 140 (1992).

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

30. See Federal Trade Commission, *Sub-prime Lender Agrees to Pay $350,000 Civil Penalty to Settle Charges of Violating Federal Lending Laws,* Press Release, Aug. 24, 2000.

31. State Attorneys General also have authority to enforce HOEPA. See 15 U.S.C. § 1640 (e).

32. 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*.

33. See 15 U.S.C. § 1604(a).

34. See 12 C.F.R. § 226.

35. See 15 U.S.C. § 1639(l)(2)(A).

36. See H.R. Conf. Rep. No. 103-652, at 365 (1994). This history is consistent with Section 18 of the FTC Act, which, in order to prevent unfair or deceptive acts or practices by banks not subject to the FTC's jurisdiction, directs the Board to prescribe "regulations defining with specificity such unfair or deceptive acts or practices." Section 18 requires the Board, whenever the FTC issues a trade regulation rule pursuant to its authority to prohibit unfair or deceptive acts or practices, to promulgate substantially similar regulations for banks. The Board is not required to prescribe such similar regulations only if the Board determines that such acts or practices by banks are not unfair or deceptive or that the implementation of such a regulation with respect to banks would seriously conflict with essential monetary and payments systems policies of the Board. The Board must publish any such determination, and the reason for it, in the Federal Register. See 15 U.S.C. § 18(f)(1).

37. See 15 U.S.C. § 1639(l)(2)(B).

38. Loan "extras" can be any products added to the cost of a loan, for example the cost of insurance that is not related to the credit or membership in an automobile or shopping club. See Money Tree, supra note 27 (complaint alleged that Money Tree required consumers to purchase credit-related insurance, non-credit-related insurance and auto club memberships but failed to disclose to consumers the true cost of credit).

39. 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.

40. 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.

41. See Predatory Lending Practices in the Subprime Industry: Hearings before the House Comm. on Banking and Fin. Servs., 106th Cong. 16-17 (2000) (statement of David Medine, Associate Director for Financial Practices, Bureau of Consumer Protection, Federal Trade Commission). 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. See also HUD/Treasury Report, supra note 9, at 88.

42. See 15 U.S.C. § 1639(l)(2)(B).

43. See 15 U.S.C. § 1639(l)(2)(A).

44. The HUD/Treasury Report recommends that the Board "also require lenders to disclose to consumers any right they may have to cancel [credit] insurance." See HUD/Treasury Report, supra note 9, at 88.

45. Any such product, the cost of which is paid in advance in connection with a subprime mortgage loan, will inevitably be financed as consumers who obtain subprime loans will unlikely be able to afford paying the high cost of such products in cash.

46. See HUD/Treasury Report, supra note 9, at 88. Not surprisingly, the Commission in its investigations has not seen credit insurance offered as a way to lower the loan's interest rate.

47. Id.

48. See FTC Trade Regulation Rule on Credit Practices, 16 C.F.R. § 444 (1995) and accompanying Statement of Basis and Purpose and Regulatory Analysis, 49 Fed. Reg. 7740, 7787-7788 (1984). See also FTC Trade Regulation Rule on Funeral Industry Practices, 16 C.F.R § 453 (1994) and accompanying Statement of Basis and Purpose 47 Fed. Reg. 42260 (1982).

49. To that end, the HUD/Treasury Report recommends that the sale of non-mortgage products such as credit insurance be restricted to post-closing. See HUD/Treasury Report, supra note 9, at 88.

50. Creditors are free to require the purchase of credit insurance as a condition of loan approval. If they do, however, the TILA and Regulation Z require that the cost of the insurance be included in the finance charge and APR disclosed to the consumer. See 12 C.F.R. § 226.4(d).

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

52. 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 Fin., 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., 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).

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

54. 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).

55. This principle is similar to the Commission's determination that Spiegel's policy of using state long-arm statutes to sue distant mail order customers in Illinois was an unfair practice. Spiegel, Inc. v. F.T.C., 540 F.2d 287, 293 (7th Cir. 1976). In that case, the Commission determined that Spiegel's practice was "contrary to clearly articulated public policy, intended to guarantee all citizens a meaningful opportunity to defend themselves in court." Id.

56. See 4 Ian R. Macneil et al., Federal Arbitration Law: Agreements, Awards & Remedies Under the Federal Arbitration Act § 40.61 (1994).

57. See HUD/Treasury Report, supra note 9, at 96.

58. See Predatory Lending Practices in the Subprime Industry: Hearings before the House Comm. on Banking and Fin. Servs., 106th Cong. 16-17 (2000) (statement of David Medine, Associate Director for Financial Practices, Bureau of Consumer Protection, Federal Trade Commission).

59. See 15 U.S.C. § 1639(l)(2)(B).

60. See HUD/Treasury Report at 47.

61. Id. at 48.

62. Id. at 48-49.

63. See 15 U.S.C. § 1639(h).

64. See 12 C.F.R. § 226.32(e)(1).

65. See 42 U.S.C. § 3601. The HUD/Treasury Report also recommends that the Board adopt the Fair Housing Act standard for interpreting the "pattern or practice" requirement." See HUD Treasury Report, supra note 9, at 75-76. Further, the Report recommends that Congress repeal the "pattern or practice" standard under HOEPA and create a safe harbor. See HUD/Treasury Report at 75.

66. 42 U.S.C.A. § 3614 (1994).

67. See United States v. Pelzer Realty Co., 484 F.2d 438, 444-45 (5th Cir. 1973), cert denied, 416 U.S. 936 (1974); United States v. Balistrieri, 981 F.2d 916, 929 (7th Cir. 1992), cert denied, 510 U.S. 812 (1993) ("isolated or sporadic acts of discrimination [do] not suffice to prove a pattern or practice").

68. United States v. West Peachtree Tenth Corp., 437 F.2d 221, 227 (5th Cir. 1971); United States v. Real Estate Dev. Corp., 347 F. Supp. 776, 783 (D.Miss. 1972); cf. United States v. Hunter, 459 F.2d 205, 217 (4th Cir. 1972), cert denied, 409 U.S. 934 (1972) (where only two allegedly discriminatory advertisements appeared in a newspaper, the first being published before the Act and the second in error, no "pattern or practice" was shown through these sporadic and unintentional violations of the Act); United States v, Saroff, 377 F. Supp. 352, 362 (E.D. Tenn. 1974) (no "pattern or practice" where very few agents of a realtor made isolated remarks about the race of prospective buyers).

69. See Balistrieri, supra note 67, at 929.

70. See, e.g., United States v. Reddoch, 467 F.2d 897, 898-99 (5th Cir. 1972) (court found the existence of a discriminatory "pattern or practice" on the basis of the testimony of the resident manager, two former assistant resident managers, and former and prospective black and white tenants); United States v. Big D Enterprises., 184 F.3d 924, 930 (8th Cir. 1999) (court found "pattern or practice" based on the testimony of several apartment managers).

71. It is troubling that the one court to address the "pattern or practice" requirement under HOEPA has held that it requires an "empirical analysis of a representative sample of all of the lender's loans." Newton v. United Cos. Fin. Corp., 24 F. Supp. 2d 444, 457 (E.D. Pa. 1998). In the Commission's view, this court ignored the well-established analogous case law under the FHA, and imposed an unreasonably high burden to prove "pattern or practice" for HOEPA violations.

72. See Newton, supra, note 71, at 457.

73. See Complaint, Delta Funding Corp., supra note 21.

74. See 12 C.F.R. § 202.12(b)(1)(i). Regulation B does require that creditors take written applications for credit to be secured by the applicant's residence, but does not require that other information such as that relating to credit history or income verification be in writing. See 12 C.F.R. § 202.5(e).

75. See Federal Trade Commission, *FirstPlus Financial Group, Inc. Agrees to Settle FTC Charges that Ads for Debt Consolidation Loans were False and Misleading*, Press Release, August 17, 2000.

76. The Report estimates that, during the period July through September 1999, only "0.7% of subprime loans . . . would have met the HOEPA APR threshold." The estimate is derived from calculations using the note rate, rather than the APR, so the actual number may be higher. See HUD/Treasury Report, supra note 9, at 82.

77. Id. at 82.

78. Id. at 83.

79. It is estimated that an additional 5% of subprime mortgage loans would come under HOEPA if the Board lowered the APR trigger to 8%. The estimate is derived from calculations using the note rate, rather than the APR, so the actual number may be higher. Id. at 84.

80. See Predatory Lending Practices in the Subprime Industry: Hearings before the House Comm. on Banking and Fin. Servs., 106th Cong. 16-17 (2000) (statement of David Medine, Associate Director for Financial Practices, Bureau of Consumer Protection, Federal Trade Commission).

81. The HUD/Treasury report recommends to Congress and the Board that single-premium credit insurance, if it is not prohibited, should be included in the points-and-fees trigger under HOEPA. See HUD/Treasury Report, supra note 9, at 84.

82. See Complaint, Hargraves, supra note 20.

83. See Complaints, F.T.C. v. CLS Fin. Servs., Inc., Civ. No.C99-1215Z (W.D. Wash. 1999); and F.T.C. v. Wasatch Credit Corp., Civ No.2-99 CV579G (D. Utah 1999).