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The Problem of Predatory Lending

The evidence we have about predatory lending is essentially anecdotal.

encompasses a variety of practices – there is no means for measuring how prevalent it is

HOEPA was enacted in 1994 in response to similar anecdotal evidence of “reverse redlining” -- credit offers being targeted to residents in certain communities, particularly the elderly, women and minorities

Frequently they are consumers who are not out looking for credit—but who are solicited by phone or door-to-door

The loans carry high interest rates and up front fees;
As a result, the repayment terms may be unaffordable

When homeowners have trouble repaying—they are often “flipped” into another loan that strips more equity with additional loan fees.

There may be fraud or misrepresentations.

Existing Regulatory Framework of HOEPA

HOEPA uses 2 price triggers to identify a class of high cost loans

Adds disclosures and substantive limitations

Triggers

A home-secured loan (other than purchase-money loan)
is covered by HOEPA if

1. The APR exceeds the rate for treasury securities having a comparable maturity, by more than 10 percentage points; or
2. The points and fees paid by the consumer at or before closing exceed 8% of the loan amount.
(smaller loans, under \$5,000, covered by HOEPA only if fees exceed \$450—even though it would be more than 8%).

HOEPA seeks to deter predatory practices in two ways:

- Consumers get simplified cost disclosures at least 3 days before the loan closing.
- For HOEPA loans the following are prohibited:
 - Balloon payments for short term loans (less than five years)
 - Non-amortizing payment schedules
 - Higher default interest rates
 - Prepayment penalties are strictly limited
 - no penalties after 5 years
 - within 5 years; if d-t-i ratio not over 50%, and refi by different creditor
 - Engaging in a pattern/practice of lending based on the collateral without considering consumers' repayment ability

There is one significant predatory practice that HOEPA does not address—

- the practice of loan flipping where loans are repeatedly refinanced and the only purpose is to produce more fees to the broker or lender

There may be other practices that are unfair, deceptive, used to evade HOEPA, or otherwise associated with abusive transactions.

The Congress instructed the Board to hold periodic hearings and delegated to the Board broad rulemaking authority to prohibit such practices

BACKGROUND

The Board held hearings in 1997, and concluded that changes to HOEPA would be premature because HOEPA had been in effect less than 2 years. (much of the hearing testimony about abuses was about loans made before HOEPA's enactment)

In July 1998, the Board and HUD submitted a report to Congress on mortgage reform; that report concluded that improved disclosures alone were unlikely to protect vulnerable consumers from unscrupulous creditors.

The report recommended that Congress consider the need for additional legislation

The report made several recommendations for possible amendments to HOEPA (such as, further restricting balloon notes; regulating the sale of single-premium credit insurance; minimum standards for foreclosure)

Mortgage reform did not progress through Congress during 1999, and concerns about predatory lending persisted.

--FTC brought several legal actions

--States began to consider legislation and regs (N.C. passed a tough law in 7/99, effective 7/00, NY/Illinois regs)

--Near the end of 1999 –Board convened an interagency task force to study ways to strengthen compliance with existing laws

By 2000:

Several bills had been introduced in the Congress to amend HOEPA

House held hearings in May – criticism from Chairman Leach and the Democrats that the Board hadn't tried to do more by regulation (Leach: would limit the need to enact new laws)

HUD/Treasury held hearings that resulted in a report containing recommendations to Congress and to the Board

Board held 4 hearing this summer focused on how the Board might use its regulatory authority under HOEPA

PROPOSED RULES

Based on the staff's study of this issue--beginning with the 1997 hearings and through this summer's hearing's staff has drafted proposed amendments to HOEPA that would be issued for public comment

In drafting the proposal, the staff has continued to keep in mind what was stated in the Board's 1998 report to Congress -- that is--the importance of targeting abusive practices:

--without unduly interfering with the flow of credit;

--without creating unnecessary creditor burden, or;

--without narrowing consumers' options in legitimate transactions.

A. Expanding the Number of Loans Protected under HOEPA by Adjusting the Price triggers

APR Trigger -- The Board has the authority to lower the APR trigger by 2 percentage points.

Advocates' arguments in favor lowering the trigger:

Would broaden the HOEPA net, so the current disclosures and prohibitions (and any new restrictions) would apply to more transactions

Little or no precise data on how many loans are covered now.

Estimates of the percentage of subprime loans covered by HOEPA now are in the range of 1% to 10%

If the APR Trigger is lowering by 2 points—estimates for the number of loans that would then be covered range from 5% to 25% of subprime loans.

Arguments against lowering the trigger:

Some lenders testified that they made a business decision to not make HOEPA loans because of:

Compliance risk – HOEPA rules are complicated, there's no tolerance for errors; Board not authorized to provide relief.

Reputational risk – HOEPA associated with predatory lending.

Thus they claim that lowering the trigger will impair credit availability .

They say legitimate loans are made at these rates now (8 or 9 points above Treasury rates).

If those loans become HOEPA loans due to lower APR trigger, they will avoid these risks by not making the loans.

Extent to which lowering HOEPA APR trigger may affect availability of credit is difficult to ascertain

Some creditors may withdraw—others who make HOEPA loans may may fill in the void

Some may have flexibility to lower rates to avoid HOEPA's coverage

Borrowers only benefit from availability of subprime credit if its not based on predatory terms—

Lowering triggers is intended to ensure that the need for credit is filled more often by loans that are subject to HOEPA's protections

Some creditors may be deterred by HOEPA from making subprime loans but there is no evidence to date that the impact on credit availability would be significant,

Points and Fees Trigger --Adding fees to the test would effectively lower the trigger.

1. Adding premiums paid for credit insurance premiums at or before closing (whether paid in cash at closing or financed) -- (also fees similar debt cancellation coverage, even if its not regulated insurance)

Concerns about deceptive sales tactics and “packing” of insurance

The insurance cost is significant—significant fee income to creditor
And creditor/account is the beneficiary of the coverage

Legislative history suggests Bd should consider.

Staff: Insur premiums should be be considered in defining what is high-cost loan

—appropriate to give those consumers HOEPA disclosures/
warnings 3 days before closing.

May deter some packing by those that want to avoid HOEPA coverage

Creditors – oppose including insurance premiums in pts and fees test

They argue:

B/c its optional and not a required F.C. – not the test under HOEPA (all f.c already included when congress gave us the authority to add other charges)

Loans that are not D or C- credits based on interest rates or points should not be covered by HOEPA just b/c of insurance premiums. (they focus on credit quality and not high-cost of transaction which is HOEPA’s basis)

It would deter creditors from offering a product consumers want/need to avoid HOEPA coverage (other vehicles exist—some recently started offering choice of monthly pay as you go insurance instead of up-front premium.)

2. Yield spread premiums – back end points paid by investor to originator outside of closing; consumer pays in the form of higher interest rate over life of the loan.

HOEPA fees test includes all broker compensation

But also must be “payable by the consumer at or before closing”

Staff is not recommending -- issue of legal authority to include yield spread premiums that are paid by consumer over life of loan instead of at closing—

Other fees – points or prepayment penalties paid on earlier loan (made by same creditor) – (treat them all like one loan)

B. “Flipping”

Flipping is the practice of repeatedly refinancing a loan to enable the broker or lender to charge additional fees (which reduce the homeowners’ equity), even though the new loan provides no additional benefit to the borrower.

Discussions at the hearings focused on two basic approaches:

1. First approach is to issue rule that regulates refinancings by imposing objective guidelines to determine that there are sufficient benefits to the borrower. Some of the suggestions include :

----Limiting refinancing fees to a fixed percentage of the loan amount

----Requiring fees to be based only on new funds

----Prohibiting all up front fees so creditors build costs into the interest rate

(Board’s authority to restrict fees is questionable – not an “act or practice,” any limit could be viewed as arbitrary)

2. Second approach -- a subjective test (like North Carolina statute) that prohibits “flipping” and defines the practice

any refinancing (within a certain period, say 12 or 18 months) when the new loan is not in the borrower’s interest, or does not result in a “net tangible benefit” to the borrower

Creditor arguments : too subjective; not clear guidance could deter legitimate loans as well

Staff is recommending a proposed rule is based on a narrower version of the “benefits test”

The most egregious flipping occurs when a creditor

- makes unaffordable loans

- then in a very short time targets those same customers who are having difficulty—by pressuring them into a refinancing that results in more fees and a higher loan balance—with little or no benefit to the borrower

- prohibit refinancing by same creditor within first 12 months unless creditor can show its in the borrower's interest

 - prevents the most flagrant abuses, but creates some uncertainty about whether there is a benefit in some marginal cases

 - creditors could not evade the rule by arranging with other creditors to refinance their own loans

 - consumers would be free to refinance at any time with a different creditor

3. Habitat loans -- another category of abusive refinancings where consumers with affordable, low-rate loans subsidized through a government program or non-profit – are refinanced into higher-rate loan.

Consumer may need a small amount of new money and the advantageous first mortgage is refinanced instead of getting a small second mortgage (sometimes the first mortgage is replaced even if the first lien-holder would be willing to subordinate their interest)

Recommending a rule that would presume its not in borrower's interest to replace a loan by a govt agency or nonprofit org with a higher rate loan (if part of a program to aid low- or moderate- income borrowers)

 - borrower could rebu the presumption by showing that it was in the borrower's interest

creditors, as a condition of making new funds available, require the existing mortgage to be refinanced at a higher rate, even though the original loan was

C. Unaffordable loans

Creditors may not engage in a -- pattern or practice of making HOEPA loans based on the collateral -- without regard to the consumer's ability to make the scheduled payments (considering consumer's current and expected income, current obligations, and employment status)

1. Proposed rule would expand the current HOEPA rule and deem the practice of making unaffordable loans unfair for non-HOEPA loans as well

--unaffordable loans are used to flip borrowers into another loan that produces more fees for the lenders

--the practice may occur without regard to whether the rates and fees are below or above HOEPA's triggers

--rule would cover all mortgage (open end lines, purchase money) except for:

--loans made under a gov't sponsored program or

--loans where the consumer intends at the outset to sell the home and use the proceeds to repay --as in the case of a bridge loan or reverse mortgage.

EFFECT: This would affect lenders who make no documentation loans based only on a consumer's equity — they might feel the need to document the borrower's qualifications in a way they do not do now.

Under the proposed rule-- If a creditor--as a pattern or practice-- looks only to the consumers' equity in the home—that would be a violation.

And they may look to repayment ability in any way they choose—

The rule would not tell the creditor what they have to look at:
—for example, income verification would not be required

To prove they considered repayment ability they might—

- relying on their knowledge of the customer
- their profession or standing in the community
- the consumers past payment history on other loans
- the balance in their deposit or investment account
- might pull a credit report
- or have the consumer provide some information about employment or other assets.

But if they are challenged and they can show nothing that they looked at --other than the equity in the home—they would certainly be taking a legal risk.

2. However, the proposal would impose a documentation and verification requirement for HOEPA loans -- to make the rule easier to enforce.

For HOEPA loans –rule would be violated if the lender does not as a pattern and practice verify and document consumers’ ability to repay by looking at income and debts to demonstrate creditors’ consideration of repayment ability.

Guidance would be given on how – flexible to ensure that self-employed are not disadvantaged (tax returns) –

D. Prohibiting Specific Acts and Practices That Are Unfair or Deceptive

Authority in HOEPA to prohibit practices

1. For all mortgage loans—if the Board finds the practice to be unfair, deceptive, or designed to evade HOEPA; and
2. for refinancings of mortgage loans—if the Board finds that the practice is associated with abusive lending practices or otherwise not in the interest of the borrower.

1. fraudulent or deceptive practices

--some practices are only unfair in some circumstances but not others—such as balloon notes--

so staff has drafted broad categories of acts that clearly would be illegal b/c they involve fraud, deception, misrepresentations

already illegal under state laws -but states differ in who can sue, who can be sued, and what the remedies are

This would provide HOEPAs remedies to all consumers for all mortgage loans.

List:

deceptive ads

misrepresenting loan terms

getting signatures on blank docs so consumer doesn't see actual terms

affirmative misrepresentations about borrower's qualifications - for a loan (or better loan) --e.g. orally misrepresenting that their credit score didn't make the "cutoff"

--misrepresenting that insurance is required

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--using fraud or deception generally to induce consumer into entering a loan

--including deceptions used to induce consumer into believing they can afford the loan when the creditor knows their income is insufficient to meet the scheduled payments

- all states have UDAP—but not all state UDAPs cover lending, some don't cover mortgages, in some states certain lenders are covered but not all lenders
- some states follow the approach of the FTC Act, and don't allow private law suits only state enforcement
- states where private action can be filed—damages might be limited to proving actual damages
- adding a list of UDAPs to HOEPA would bring uniformity and add federal remedies as stronger deterrent (HOEPA – all finance charges may be recovered)

E. Improved disclosures

1. HOEPA -- 3 days before closing

--currently discloses monthly payment and APR

-- with 3 day rescission period, consumer has 6 days to reconsider, seek other advice, shop.

considered ways to improve the disclosures without complicating the form

a. Loan amount.

Many reports of consumers who ask to borrow a certain amount and they are quoted low monthly payments (based on long amortization periods)

then they get to closing and are surprised by how much more they are borrowing to finance loan charges (and insurance)

We think there is real value in adding the total loan amount to the pre-closing HOEPA disclosure – which may encourage consumers to ask questions in advance

b. Counseling

We also recommend adding a sentence that encourages consumers in high-cost loans to seek independent advice from someone who understands their financial situation or from a credit counselor.

2. Foreclosure Notices

-- there are 5 states where a foreclosure sale can occur without a notice being sent directly to the borrower (publishing a notice sufficient)

--the issue is whether the Board should impose a rule requiring that a notice be sent directly to the borrower before foreclosure.

--the draft rule we circulated recommended that such a rule be proposed

--since then, staff has reconsidered—and we are NOT recommending a rule on foreclosures

foreclosure laws and other laws dealing governing rights in real property have historically been left to the states

thus, the rule we were initially proposing was drafted to require a disclosure—but would not have interfered with parties right to sell the property in foreclosure if state's requirements were satisfied

what we ultimately discovered—is that this would lead to anomalous results when it came to applying HOEPA's remedies if the disclosure wasn't given.

For HOEPA violations—consumer may get penalties that include a refund of all the finance charges paid on the loan

The prospect of a large penalty would be a strong deterrent to skipping the notice--even in states where the foreclosure would be allowed to go forward

BUT--in this would affect even routine foreclosure cases where there had been no abuses and state procedures had been followed—failure to send the notice could result in forfeiture of all finance charges which seemed excessive.

Under HOEPA a court could rule that the violation wasn't material enough to warrant thatn penalty—but it doesn't seem that the Board could do so by rule.

3. Credit Insurance Disclosures

One of the abuses most often reported regarding credit insurance is “packing”--where the premiums are added to loan amount without the consumers request.

Amid the loan closing documents some consumer may not be fully aware of the insurance sale or its terms

Under TILA creditors almost always get consumers to initial a very brief disclosure saying the insurance is voluntary and showing the total cost

The draft we circulated recommended that the Board require a post-closing notice that would be a little more detailed:

- it would notifies the consumer of any rights they have to cancel the policy under state law

- it would explains how much of the premium would be rebated if they cancelled (and how it would be credited to their loan or refunded)

- it would tell then what state insurance regulator to contact if they had a problem or complaint.

The proposed rule raises an issue concerning whether it would preempt state insurance laws/regs in violation of the McCarran Ferguson Act.

Congress can authorize federal laws/rules that preempt state law

If Congress does not do so, then the federal rules must either

- Avoid regulating the business of insurance
- Regulate the business of insurance in a way that does not invalidate, impair or supercede the state scheme

We were initially recommending that the rule be published for comment, so that we could solicit comment on whether a federal rule requiring disclosures might frustrate state insurance disclosure schemes.

Its an area of the law where the dividing line between permissible and impermissible are not entirely clear

What we ultimately concluded however, is that similar to the issue of foreclosure notices

—the substantial HOEPA remedies that could be imposed for failure to send the notice did not seem to fit the violation—

-- considering that the failure could occur either in predatory cases but also in cases where the consumer understood the initial disclosure and was not a victim of “packing”